Corporate Tax Harmonization for the Single Market: What the European Union Is Thinking
McLure, Charles E, Jr
Business Economics; Oct 2004; 39, 4; ProQuest Central
pg. 28

Corporate Tax Harmonization for the Single Market: What the European Union Is Thinking

BOTTOM-LINE ISSUES FOR AMERICAN BUSINESS

By Charles E. McLure, Jr.

Charles E. McLure, Jr. is a senior fellow at the Hoover Institution at Stanford University. Previously, he was with the National Bureau of Economic Research, Rice University, and the U.S. Treasury Department where he was responsible for developing the proposals that became the basis of the Tax Reform Act of 1986. He has also worked for the Council of Economic Advisers, as a consultant to various agencies of the U.S. government, and as an adviser to the World Bank, United Nations, International Monetary Fund, and InterAmerican Development Bank. He was recently a member of the OECD's Technical Advisory Group on Taxation of Business Profits. He holds a BA in economics from the University of Kansas and a MA and PhD from Princeton.

When corporations operate in several jurisdictions that impose income taxes, it is necessary to divide taxable income among them. The Commission of the European Communities proposes that the European Union shift from individual national accounting to dividing the income of groups of corporations operating in multiple EU Member States according to an agreed formula. Adoption of the Commission's proposals, politically difficult because EU tax rules require unanimous approval, would have important implications for American corporations operating in the EU. These could include simplification, the ability to offset losses incurred in one Member State against profits earned in another, greater neutrality toward corporate form and cross-border reorganizations, reduced double taxation, perhaps lower tax liabilities, and greater opportunities for expansion into and within the EU. The proposals, however, would also entail transition costs, reduced opportunities for tax planning, and greater uncertainty regarding tax treaty issues.

This paper describes and appraises the Commission's proposals and their implications for U.S. firms.[1]

[1] A companion to this article, which contains more extensive documentation, will appear in *Tax Notes International*, November 29, 2004.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

When a group of affiliated corporations operates in more than one nation or state that imposes an income tax, it is necessary to divide the taxable income of the group among the taxing jurisdictions. The American states employ formulas to "apportion" the income of multi-state corporations among the states where they do business. By comparison, the Member States of the European Union (EU), like other nations, currently employ separate accounting to determine the income of each member of a corporate group and "source rules" to attribute that income to the Member States where the income is deemed to originate. Inherent in that approach is reliance on arm's length prices—prices that would prevail in transactions with unrelated parties—to value transactions between members of the corporate group. But using separate accounting and the arm's length standard (hereinafter SA/ALS) in the context of an integrated market such as the U.S. or the EU is complex and impedes efforts to create a single market. The Commission of the European Communities (hereinafter the Commission), the executive body of the EU, has recently proposed that the Member States of the EU consider shifting to formula apportionment (FA) to divide the consolidated income of groups of EU corporations operating in more than one Member State among those Member States. See Commission of the European Communities (2001, 2002) and Diemer and Neale (2004).

If adopted, the Commission's proposals would have important implications, both positive and negative, for American corporations doing business in the EU. On the positive side, tax compliance would be vastly simpler, losses incurred in one Member State could be offset against profits earned in another, taxation would no longer dictate organizational form or discourage economically rational reorganizations, there would be less double taxation, increased tax competition among Member States might result in lower taxes, and there would be increased opportunities for American firms to expand into or within the EU. On the other hand, there would be transition costs, reduced opportunities for tax-motivated income shifting between Member States, and uncertainty regarding treaty issues.

ACRONYMS USED IN THIS PAPER

CCBT: Common Consolidated Base Taxation
CEN: capital export neutrality
CIN: capital import neutrality
ECJ: European Court of Justice
EUCIT: European Union Company Income Tax
FA: formula apportionment
FTC: foreign tax credit
HETS: Harmonized European Tax System
HST: Home State Taxation
PE: permanent establishment
SA/ALS: standard accounting/arm's length standard
SEs: European Companies (commonly known by their Latin name, Societas Europaea)

Problems of SA/ALS

The economic integration of the EU will make the continued use of SA/ALS to divide the EU-source income of corporate groups increasingly problematical:[2]

- The need to comply with 25 national tax systems creates overwhelming complexity and excessive compliance costs;
- The need to distinguish between types of income and determine the geographic source of each is an important source of compliance costs;
- The growing number of transactions between affiliated corporations increases costs of compliance and administration of transactions-based transfer pricing rules;
- Arm's length prices may not exist for some of the most important transactions between affiliated corporations, including those involving intangible assets such as intellectual property;
- There are both incentives and opportunities to manipulate transfer prices to shift income to low-tax jurisdictions;
- Economic interdependence between operations occurring in various Member States may make it conceptually impossible to arrive at a scientifically defensible division of income resulting from the joint operations;
- When Member States do not agree on the transfer prices a corporation should use, double taxation may result;
- The European Court of Justice (ECJ) may find that thin capitalization rules, intended to prevent excessive use of debt to shift profits to low-tax Member States, contravene the EU Treaty;[3]

[2]See Commission of the European Communities (2002, p. 739), UNICE (2000), and Klemm (2001).

[3]Just as U.S. state tax policy is subject to judicial review to determine whether it violates the Constitution (most notably the Commerce Clause) or federal statutes, the tax policy of Member States is subject to review by the ECJ to determine whether it violates the freedom of movement of goods, services, people, and capital and the freedom of establishment, which are guaranteed in the EU Treaty (currently the de facto constitution of the EU) and are included in the EU draft constitution discussed further in footnote 9.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

- The inability to offset losses incurred in one Member State against profits earned in another discourages cross-border expansion and favors locating economic activities in the larger Member States, since this maximizes the likelihood of being able to offset losses;
- Using SA/ALS can have tax consequences that distort choices of organizational form (e.g., whether to operate via a subsidiary or a branch) or impede cross-border reorganizations;
- The existence of withholding taxes on interest and royalties, as well as other features mentioned above, discriminates against cross-border investment and thus hinders the creation of a single market.

A simple example will illustrate some of the problems with SA/ALS. Suppose that a multinational group headquartered in Luxembourg engages in the following closely integrated activities, using a legally separate entity chartered in the Member State indicated: research in Germany, financing in the UK, production in Ireland, and sales in France and Belgium. Under current practice, each of the six Member States identified would employ SA/ALS, based on relevant domestic law, to determine the income of the entity subject to its jurisdiction. It would thus be necessary to determine the nature of various income flows and the proper transfer prices (including interest rates) for transactions between the members of the group—headquarters activities, financing, research, and final products. Transfer prices, however, may be manipulated to shift income to Ireland, which has the lowest corporate tax rate; arm's length prices may not exist for some transactions (such as royalties paid for the fruits of research activities); and Member States may not agree on particular transfer prices. Also, losses in one Member State generally cannot be used to offset income in other Member States. In short, the current system based on SA/ALS is complex and vulnerable to both over- and under-taxation.

The Commission advanced four alternative taxing schemes for consideration. It first describes salient features of the current system based on SA/ALS, the four alternatives tabled by the Commission, and the political context of the debate. It then discusses the two proposals that are thought to be politically viable, Common Consolidated Base Taxation (CCBT) and Home State Taxation (HST), under the simplifying assumption that all Member States and all eligible corporate groups opt to participate in CCBT or HST. Because the United States and Canada already use FA, some strengths and weaknesses of the U.S. and Canadian FA systems are noted.[4] The paper then considers the implications of making participation optional and of issues concerning taxation of international income flows. It also notes implications for the location of economic activity of harmonizing corporate tax bases but not tax rates. The final two sections describe implications for U.S. firms doing business in the EU and reemphasize the very real political obstacles to harmonization.

[4]For more complete discussions of U.S. experience and its relevance for the EU, see Weiner (1996) and (2001); McLure and Weiner (2000); and Hellerstein and McLure (2004a) and (2004b).

The current system based on SA/ALS is complex and vulnerable to both over- and under-taxation.

Separate Accounting and the Commission's Proposals

The current system

The Member States of the EU generally tax international income flows in a manner consistent with the Model Tax Treaty of the Organisation for Economic Co-operation and Development (OECD), applying the system outlined there to flows of income within the EU, as well as to flows to and from countries outside the EU. Like other nations, the Member States generally tax the net business income of a permanent establishment (PE) deemed to originate within their jurisdiction, that is, income after deduction for expenses of earning income. Moreover, they subject gross payments of interest, dividends, and royalties to withholding taxes, which are often substantially reduced by treaty. Given these differences in the tax treatment of "business" and "passive" income, it is necessary to distinguish between types of income, each of which is subject to "sourcing" rules that specify where such income is deemed to originate. Some Member States exempt foreign-source business income. Others tax the worldwide income of their resident corporations but allow a credit for taxes paid to source countries to prevent double taxation. This difference is generally irrelevant for the issues discussed here, except for those discussed in the section on "international/treaty issues."

Business income is subject to source-based taxation only if the taxpayer has a PE in the taxing state, which the OECD Model Treaty defines as a "fixed place of business through which the business of an enterprise is . . . carried on" (OECD, 2003, article 5), and generally only with respect to income attributable to that PE (OECD, 2003, article 7). The Member States use SA/ALS to determine the amount of business income to tax. Traditional methods of determining transfer prices for transactions between

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

related parties (comparable uncontrolled prices, cost plus a margin, and resale value minus a margin) have recently been supplemented by two "transactional profits methods." In theory, all these methods are based on the analysis of individual transactions, rather than the arbitrary division of aggregate profits (OECD, 2001). In fact, one of the new methodologies, "profit split," involves the use of formulas to divide profits. But its allocation of profits is based on firm-specific analysis of functions performed, assets employed, and risks undertaken, rather than application of a common arbitrary formula that would be applied without regard to these considerations, as in state practice in the U.S.

FA recognizes the problems inherent in using SA/ALS and uses a formula that is admittedly arbitrary to divide income among the jurisdictions where a corporation or a group of affiliated corporations operates. In constructing an FA system, it is necessary to address four issues—the definition of income to be apportioned, the definition of the groups whose activities are to be consolidated, the apportionment formula, and tax administration.

The Commission's four alternatives

The Commission has tabled the following four alternatives for consideration:

1. *Common Consolidated Base Taxation (CCBT).* Participation in CCBT would be voluntary for both Member States and corporations. Participating Member States would agree on the definition of apportionable income, the definition of groups, cross-border offsetting of losses, and the apportionment formula. The Member State where the group parent is headquartered would administer the tax. Domestic tax systems would apply in Member States that do not participate, for groups of corporations that do not opt for CCBT, and for purely domestic corporations (those operating in only one Member State). A Member State could apply the CCBT definition of income to domestic corporations.
2. *Home State Taxation (HST).* As in CCBT, participation in HST would be voluntary for both Member States and groups of corporations. A participating group of corporations would calculate apportionable income under the income tax rules of the Member State where the parent is resident (provided that Member State participates), including those pertaining to consolidation and cross-border offsetting of losses. There would be a uniform apportionment formula. It is assumed that competition for the location of group parents would be kept in check by the principle of "mutual recognition" that is, participating Member States would recognize the legitimacy of the tax rules of other Member States only if they did not deviate too much from accepted norms. Domestic tax systems would continue to apply in Member States that do not participate, for groups of corporations that do not opt for HST, and for purely domestic corporations.
3. *Harmonized European Tax System (HETS).* Under the HETS, contrary to the situation under the previous two alternatives, the corporate income taxes levied by all Member States would be totally harmonized, except with regards to tax rates. HETS can be seen as mandatory application of the CCBT system to all taxpayers in all Member States, including purely domestic companies. There would thus need to be total agreement on all key issues (the definition of apportionable income, the definition of the group whose activities are to be consolidated, and the apportionment formula).
4. European Union Company Income Tax (EUCIT). Revenues from the EUCIT would accrue to the EU, rather than to its constituent Member States. (Revenues might, however, be shared with the Member States.) As this method would not use FA to divide the consolidated income of companies among Member States, it is generally not considered further (Commission of the European Communities, 2002, pp. 461-66).

Table 1 summarizes the salient features of the three FA alternatives. It is important that under all Member States would retain the power to set tax rates. Business groups see this, plus the elective nature of participation in the CCBT or HST, as crucial to the maintenance of healthy tax competition between Member States. (See Commission of the European Communities, 2002, pp. 464, 467; UNICE, 2000, 2002.)

Most observers agree that harmonization along the lines of the HETS would be far preferable to either HST or CCBT, if only it were politically acceptable. But, for reasons specified below, only the latter two alternatives are thought to be politically viable at present. They are the focus of the remainder of this discussion. Adoption of HST or CCBT, if it were to occur, need not be the final step in harmonization—HST might be the first step toward CCBT. If CCBT were to become compulsory for all taxpayers and all Member States, the result would be HETS.

HETS would greatly alleviate these problems, if not eliminate them. Under HETS:

- Transfer pricing problems and costs associated therewith (including the need for thin capitalization rules) would be vastly reduced for transactions within the EU;[5]

[5]As explained below, if value added were used to apportion income, transfer pricing could still be a problem.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

TABLE 1

KEY FEATURES OF THREE EUROPEAN COMMISSION PROPOSALS FOR HARMONIZING COMPANY INCOME TAXES*

	CCBT	HST	HETS
Corporate option	Yes	Yes	No
Member State option	Yes	Yes	No
Definition of income	Participating States	Home State	EU
Definition of group	Participating States	Home State	EU
Choice of formula	Participating States	Participating states	EU
Administration	Home State	Home State	Source State
Choice of tax rates	Member States	Member States	Member States
Revenue recipient	Member States	Member States	Member States
Formula used to divide	Income	Income	Income
Means of coordination	Enhanced cooperation	Enhanced cooperation	EU directive

*Adapted from Hellerstein and McLure (2004b).

- Cross-border loss-offsets would occur automatically, as profits and losses of affiliates operating in various Member States would be added together in calculating the consolidated taxable income of a group;
- Transactions between members of an consolidated group, such as payments of interest, dividends, and royalties, would have no tax consequences;
- Organizational form would have no effect on tax liabilities of a consolidated group; and
- There would be no differences in tax bases to affect cross-border investment. Of course, differences in tax rates might affect cross-border investments.

CCBT would also resolve most of these problems, as would HST to a lesser degree, but only to the extent that Member States and corporations participate. The primary exception is that there could still be as many as 26 tax systems under CCBT (25 under HST).[6] But any one participating corporate group would need to contend with only one of these systems, plus those of nonparticipating Member States. Tax administrations would need to enforce only one tax system under HST or two under CCBT (the common and domestic systems), but under HST they might need to be familiar with others. The existence of parallel systems applied to cross-border and purely domestic firms under CCBT and differences in definitions of income and consolidated groups in HST systems could interfere with cross-border investment. More important, to the extent that either Member States or corporations do not participate in CCBT or HST, the objectives of harmonization would not be realized.

It is instructive to consider the implications of CCBT and HST for the "Luxembourg" multinational group described earlier, on the assumption that the group and all six Member States chose to participate. Under either approach, the group's income would be consolidated and apportioned among the Member States where the group does business through the use of a common formula; SA/ALS would be used only to divide income between EU and non-EU countries and between participating and non-participating Member States.[7] Under CCBT the definition of the tax base, the rules for consolidation, and the apportionment formula would all be uniform. Under HST, the tax base and consolidation rules would be determined by the Home State (Luxembourg in this example); only the apportionment formula would be uniform. Either CCBT or HST would be simpler than the present system and less likely to result in over- or under-taxation. But results are somewhat arbitrary, and neither approach is free from problems.

Political context

While many think that a shift from SA/ALS to FA is desirable, if not inevitable, others believe that political obstacles to such a shift are insurmountable.[8] The treaties

[6]These counts of tax systems are of very different things. Under CCBT there would be a single system that applied to all participating corporate groups operating in participating Member States, as well as a domestic system in each Member State. Under HST participating Member States would apply their domestic tax systems to participating corporate groups subject to their jurisdiction, as well as to domestic corporations.

[7]It was assumed for convenience that all income of the group is from related activities. An interesting issue that cannot be considered here is whether income from unrelated activities should be subject to consolidation and apportionment. The American states distinguish between business income, which is apportionable, and nonbusiness income, which is generally attributed to a particular state or states, based on the deemed location of the property producing the income or to the state of commercial domicile of the income recipient. It seems unlikely that the EU would draw such a distinction, which the Commission does not mention. See also the discussion of "The definition of the consolidated group" below and references provided there.

[8]In any event, the Commission's proposals represent a remarkable turn of events. During the 1980s some members of the EU (most notably the Netherlands and the UK) led opposition to the use of worldwide unitary combination (application of FA to the worldwide activities of corporate groups engaged in "a unitary business," a concept explained below) by some U.S. states. Moreover, less than ten years ago a group of experts appointed by the Commission (the Ruding Committee) rejected a shift to FA (Commission of the European Communities, 1992).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

Some believe that a shift from separate accounting/arm's length standard to formula apportionment is inevitable: others believe it is politically impossible.

establishing the EU include several provisions that condition the current debate on harmonization of corporate taxes.[9] First, under the principle of *subsidiarity*, the Community acts outside its areas of exclusive power only if an objective cannot be sufficiently achieved by actions of the individual Member States and is thus better achieved by the Community. Under this principle, the setting of income tax rates is seen to be the exclusive prerogative of Member States.

Second, adoption of income tax measures requires *unanimity*. It is partly for this reason that the first two alternatives advanced by the Commission (the EUCIT and the HETS) are presently seen to be political "non-starters;" both involve an unacceptable loss of sovereignty over tax policy and would thus be opposed by at least one Member State. The unanimity rule also helps explain why the Commission has not proposed harmonization of tax rates.

The Treaty of Nice, which is still in effect pending adoption of the new EU constitution, provides that as few as eight Member States can engage in "enhanced cooperation." The Commission believes that this vehicle could be used to implement either CCBT or HST, despite the unanimity rule, because both would be optional for both corporate groups and Member States, including those that subsequently join the EU.

The anarchic U.S. approach: a non-starter in the EU

Some American observers may be tempted to suggest that the EU adopt an evolutionary approach in which individual Member States replace SA/ALS with their own version of consolidation and FA. This assumes that a common methodology for answering key questions (the definition of the tax base, the treatment of groups, and the apportionment formula) would develop over time, perhaps via enhanced cooperation, once enough Member States have moved to FA to make the need for agreement possible.

This approach, which virtually no one in Europe is suggesting, seems doomed to failure. Leaving aside the fact that it is a bad idea because of the chaos it would create during the transition—a transition that might never end—the Member States of the EU do not seem prone to follow such an anarchic approach; and it seems unlikely that the ECJ would allow Member States as much latitude as the U.S. Supreme Court has allowed the states. Beyond that, any Member State wishing to shift unilaterally to FA would need to renegotiate its bilateral tax treaties with other Member States, which are based on SA/ALS. The complexity of such a process and the time and effort it would require are mind-boggling.

Key Issues for Common Consolidated Base Taxation (CCBT)

The Commission has recently come down squarely in favor of CCBT over HST as a "systematic long term 'tax solution' for the Internal Market." See Commission of the European Communities (2004b). This section discusses four key issues that arise under CCBT: the definition of taxable and apportionable income, the choice of groups to which FA is to be applied, the choice and definition of apportionment factors, and tax administration. Most of the discussion is equally applicable to HETS. By comparison, the first two of these issues arguably do not arise under the HST, as the tax base and rules for consolidation would be governed by the domestic law of Member States where parents are resident. Subsequent sections consider the effects of non-participation by Member States and corporations—assumed away for present purposes—and the taxation of international flows of income and related treaty issues.

The definition of income

Under CCBT, participating Member States would all utilize a single definition of apportionable income. Because of current differences in the definition of taxable income (involving, *inter alia*, depreciation allowances, capital gains and losses, intangibles, overhead costs, and entertainment) this degree of uniformity will be difficult to achieve.

Contrary to the situation with free trade or the value added tax, there is no objectively supportable definition of income for tax purposes; rather this is largely a matter of political philosophy and consensus, conditioned by policy objectives. Unlike the situation in the United States and Canada, there is no higher-level government in the EU that provides a

[9]The constitutional situation in the EU is in flux as this article is being written (August 2004). On June 18, 2004 agreement was reached on a new constitution that would replace the existing EU Treaty, and heads of state of the Member States are expected to sign the constitutional treaty in Rome in late October, 2004. The principles of subsidiarity, unanimity in tax matters, and enhanced cooperation would be maintained (though modified slightly) under the new constitution. Since ratification requires the approval of all Member States, it is by no means certain that the new constitution will ever take effect.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com
المنارة للاستشارات

definition of income from which to start in defining apportionable income; each Member State goes its own way. Further complicating matters, each Member State currently sets its own accounting standards, and the degree of conformity of taxable income to income reported on financial statements differs between Member States. These conditions favor HST, which would merely require enough similarity to generate mutual recognition, rather than complete agreement.

Two recent developments may spur harmonization. First, the creation of European Companies (commonly known by their Latin name, *Societas Europaea,* hereinafter SEs) may provide impetus for tax harmonization for these large companies, for without harmonization becoming an SE may hold relatively little attraction.[10] (In the absence of harmonized taxation, an SE will be governed by the tax law and treaties of the Member State where it is chartered.)

Second, beginning in 2005, companies listed on EU stock exchanges must utilize International Accounting Standards for financial accounting. This requirement should facilitate agreement on a common definition of income for tax purposes. Yet financial accounting and tax accounting serve different purposes; and once accounting based on International Accounting Standards is in effect, various participating Member States would need to agree on a common pattern of conformity of the latter to the former. See Commission of the European Communities (2002, pp. 494-95), (2003a), (2003b), and (2003c); European Federation of Accountants (2002); Diemer and Neale (2004), and Selbach (2003).

The definition of the consolidated group

It is assumed that FA would be applied to the *consolidated* income of participating corporate groups, based on the income and apportionment factors of the entire group. Without consolidation, taxation would not be neutral with regard to organizational structure, cross-border loss offset may not occur, transfer pricing problems would persist, and opportunities and incentives to shift income between Members States to minimize taxes would remain.[11]

In the United States consolidation of the federal tax returns of domestic corporate affiliates depends solely on the degree of common ownership. Thus, the activities of commonly owned corporations can be "combined" for state tax purposes only if the affiliates are engaged in a "unitary business," as defined by various court cases.

There are advantages and disadvantages to both legal (ownership) and economic (unitary) definitions of the consolidated group. The economic approach is conceptually appealing but difficult to implement, as it relies on subjective judgements based on complex factual analysis. The ownership approach is vastly simpler, but can give anomalous results. Anomalies notwithstanding Hellerstein and McLure (2004a, pp. 203-206) lean toward an ownership-based test.

The choice, definition, and weighting of apportionment factors could have important implications for taxation of American multinationals operating in the EU.

The apportionment formula

The choice of apportionment formula—the choice, definition, and weighting of apportionment factors—poses conceptual and theoretical problems and could have important implications for the aggregate tax liabilities of American multinationals operating in the EU.[12] (See the section on "Effects that cannot be generalized" at the end of this article.) Apportionment formulas currently employed in the United States are based on a weighted average of the ratios of in-state to total payroll, property value, and sales.[13] The Canadian provinces base apportionment on payroll and sales, which are weighted equally in all provinces. Following Lodin and Gammie (2001, pp. 47-50), the Commission has raised the possibility of basing apportionment on value added at origin.[14] (See Commission of the

[10]See Lannoo and Levin (2002). EU law regulating the formation of an SE will become effective on October 8, 2004. An SE can be created in one of four ways: as a holding company, as a joint subsidiary, through a merger, or by the transformation of an existing company.

[11]Some activities might, however, be excepted from this treatment, either because the standard apportionment formula does not produce satisfactory results (e.g., transportation, professional athletics, and finance and insurance) or because the activities are accorded special treatment under the national laws of Member States (e.g., insurance, shipping, airlines, and oil and gas).

[12]On conceptual and theoretical problems, see Klemm (2001) and McLure (2002). On practical problems with the way the factors are defined in the United States, see Hellerstein and McLure (2004a) and (2004b).

[13]These "factors" were traditionally weighted equally, but over the last 25 years there has been a decided shift toward assigning at least half the weight to sales; and some states now use only sales to apportion income, to improve their investment climate. (See Mazerov, 20019.)

[14]The standard approach to formula apportionment utilizes "micro" apportionment factors that reflect the circumstances of the taxpayer. An alternative floated by the Commission, the use of "macro" factors, could have anomalous effects and should not be considered seriously. If, for

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

European Communities, 2002b, p. 414).

Conceptual/theoretical issues. Since the objective of formula apportionment is presumably to attribute corporate income to the jurisdictions where it arises, capital is the most logical apportionment factor. In this view, there is little economic rationale for including either sales or payroll in an apportionment formula, and including sales is perhaps best seen as a political compromise that allocates more income to "market" jurisdictions and less to production jurisdictions. This reasoning suggests that basing apportionment on value added would not be a particularly good idea, since payments to labor account for the vast majority of value added. On the other hand, apportionment based on value added at origin, minus labor costs, has theoretical appeal, as this adjustment would isolate the contribution of capital to the creation of value added. However, subtracting the cost of labor would magnify vulnerability to manipulation of transfer prices.

Apportionment based on value added. It would be possible to base CCBT or HST apportionment on the EU's universally applied value-added tax (VAT).[15] However, the VAT is destination- rather than origin-based. To make the apportionment origin-based, it would be necessary to add exports to the VAT base and exclude exports—another avenue for manipulation of transfer prices, though less so than measuring income under SA/ALS.

Administration of CCBT

There is currently no central EU tax administration, and none is envisaged under the Commission's CCBT proposal. Rather, as under the HST proposal, tax authorities of the Member State where a group is headquartered (hereafter the "Home State") would administer the tax on behalf of all participating Member States, calculating the apportionment factors for each participating Member State, as well as apportionable income.[16]

Corporations whose parents are not headquartered in the EU pose an intriguing problem. Activities of first-tier sister subsidiaries of a foreign parent (and, of course, their lower-level subsidiaries) should be consolidated, otherwise the benefits of the harmonized system would not be achieved. There are several ways to deal with such a situation. Most obviously, the multinational could interpose an additional EU corporate layer between the non-EU parent and the EU subsidiaries. But the foreign multinational might simply be allowed to elect the Member State where the group is deemed to be headquartered. The availability of such an election could offer tax planning opportunities for American multinationals. This would be especially true under the HST.

Having the Home State administer the taxes of all Member States runs the risk that some Member States would use lax tax administration to benefit groups headquartered locally. Moreover, some Member States may simply not want to devote administrative resources to audits that would benefit primarily other Member States. Lax administration would be most likely in small Member States with relatively small fractions of the economic activities used to apportion income, as the payoff from good administration would be relatively small for them.

It thus seems likely that other participating Member States would reserve the right to challenge the determination and division of the tax base made by the Home State.[17] However, Mutual Agreement Procedures contained in bilateral tax treaties and the EU Arbitration Convention should significantly restrain these tendencies, since, unlike the current situation under SA/ALS, the CCBT system would at least provide a single legal benchmark. Even so, effective administration of the CCBT would require an unparalleled degree of trust and exchange of information among tax administrations. One also wonders whether Member States would be willing to trust their fiscal destiny to the courts of the Home State. A super-national system of tax courts would help assure uniform application of CCBT by all participating Member States.

Concluding remarks on CCBT

Despite the clear advantages of a uniform system of consolidation and formula apportionment, there are substantial obstacles to making the shift from SA/ALS to CCBT, even on an optional basis. The need for Member States to reach agreement on the definition of apportionable income, the rules for consolidation of groups, and the apportionment formula raises knotty problems, as does the question of tax administration. First, existing defini-

example, apportionment were based on industry averages, there could be both a "toll charge" for expansion into high-tax Member States and opportunities for abuse by taxpayers.

[15]See Lodin and Gammie (2001, pp. 47-50). It would be necessary for entities that are exempt under the VAT to calculate value added for purposes of apportioning corporate income; in some cases (e.g., financial institutions and insurance) this would be difficult. See also Hellerstein and McLure (2004a).

[16]Existing rules for determining corporate residence would be used to determine where the parent is headquartered. These rules, unlike American practice, are generally based on the place of effective management.

[17]U.S. experience offers few lessons for the EU. First, the Member States cannot rely on the tax administration of a higher government (the IRS, in the case of the U.S.). Second, the U.S. states sometimes engage in joint audits of particular taxpayers, but there is no requirement that they do so or that they accept the results when they do. See Hellerstein and McLure (2004b).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

tions of income are diverse, and there is no objective standard against which to choose among them. Second, there is no clearly best way to define groups for purposes of consolidation. Third, no apportionment formula is clearly superior to all others. Finally, tax administration would require unprecedented cooperation among participating Member States. Unfortunately, U.S. experience does not provide guidance in most of these areas. Rather, "don't do what we do" is the pervasive message from U.S. experience. See Hellerstein and McLure (2004a).

Inherent in home state taxation is the risk that Member States will compete to be chosen as the Home States of corporate groups by enacting generous tax laws.

Home State Taxation (HST)

The HST system would have a uniform apportionment formula, but would rely on the Home State definitions of income and consolidated groups. Its main attraction is the ease and speed with which it could be implemented. Also, it is sometimes advocated as a means of easing the compliance burden on small and medium-sized enterprises, without jeopardizing large amounts of revenues.[18] However, HST would be problematical for several reasons. The root of some of these problem, lies in the fact that HST is offered as a means of implementing taxation at source, but is based on the residence of the corporate parent. The following discussion of these problems, like that of the CCBT, assumes away issues created by the optional nature of the HST system.

A hybrid of capital importing and exporting neutrality

The peculiar feature that gives HST its name would create troubling economic effects. Tax economists commonly distinguish between tax systems characterized by capital export neutrality (CEN) and by capital import neutrality (CIN). Under CEN, taxation is the same for all taxpayers *resident* in a given jurisdiction. By comparison, under CIN it is the same for all income derived from a particular *source* jurisdiction. HST is a hybrid of CEN and CIN. Apportioned income is taxed at the tax rate prevailing in the source jurisdiction, as under CIN. But the income to be apportioned (like the definition of the group) is defined by the law of the Member State of residence of the parent company, as under CEN. It is thus inevitable that neither CEN nor CIN can be fully achieved under HST. It is particularly worrisome that taxpayers operating in a given Member State, but headquartered in different Home States, will pay tax based on different definitions of apportionable income and of corporate groups. Mutual recognition is the sole guarantor that there will be a relatively level playing field in any source jurisdiction.

[18]The Commission advocates undertaking a pilot study of the use of Home State Taxation for small and medium enterprises; see Commission of the European Communities (2003c) and references provided there and (2004a) and (2004b).

Inherent in HST is the risk that Member States will compete to be chosen as the Home States of corporate groups by enacting generous tax laws. (Moreover, the possibility that lax tax administration may be used to lure headquarters activities is even more worrisome under HST than under CCBT, for reasons to be explained below.) Schön (2002, p. 285) raises the possibility that tax subsidies found in the domestic laws of the Home States of corporate parents would be "exported" to other participating Member States where subsidiaries operate, creating revenue losses there. Moreover, groups headquartered in other Home States not offering similar tax subsidies would be placed at a competitive disadvantage, as would purely domestic corporations, unless matching subsidies were granted them. Again, mutual recognition is the sole guarantor that there will be a relatively level playing field for headquarters activities.

The authors of the HST proposal have argued, "The HST technique . . . is not aimed at obtaining more tax neutrality in the sense of export or import neutrality. Instead its aim is to achieve more tax neutrality for enterprises with cross-border activities . . . and to remove the extra costs caused by the company tax obstacles to cross-border activities. . ." (Lodin and Gammie, 2001, p. 20). But perhaps the goal of capital import neutrality cannot be dismissed so easily. Whether the ECJ would condone the differential taxation of participating groups headquartered in different participating Home States that is inherent in HST remains in doubt, especially in the light of recent rulings against Member State attempts to discriminate in their treatment of resident and non-resident companies. Also, Schön (2002, p. 286) raises the possibility that discrimination may be challenged under the domestic constitutions of Member States.

Cross-border loss offsets and consolidation

The treatment of cross-border losses under the HST is potentially troublesome. Existing provisions for cross-border loss-offset are far from uniform and, on the whole, not very generous. Unless deductions are allowed for virtual-

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

ly all losses incurred in other participating Member States, a primary objective of base harmonization would not have been met.[19]

Administration of HST

As noted above, there is a great deal of common ground in the administration of CCBT and HST. However, HST has some issues that are not found in CCBT. One important difference is that a group of corporations that opts for the HST system would need to know only the tax rules of the Home State, and not those of other participating Member States. This could be the source of substantial simplification. It would, however be necessary to know enough about the tax rules of all Member States participating in HST to make the related decisions of whether to opt for HST and where to establish headquarters operations (or whether to change Home States.)

Again, it is much more difficult to assure that tax administration does not depart too far from the norm required for mutual recognition than it is to assure that statutes and regulations meet a similar standard. This problem seems substantially greater for HST than for CCBT. Mutual Agreement Procedures and the EU Arbitration Convention would provide less comfort than under CCBT, since there would be no external legal benchmark against which to measure the performance of the Home State tax authorities.

The courts of the Home State would presumably pass judgement on decisions made by the tax authorities of their jurisdiction, even when the bulk of economic activity occurred elsewhere. This is not likely to go down easily with the tax authorities of other participating Member States. Yet the institution of a supra-national tax court seems unlikely, as such a court would need to rule on application of 25 Home State tax systems.

[19]The Commission offers the example of a parent located in a participating Member State that does not allow consolidation and two subsidiaries located in another participating Member State that does allow consolidation. If the group were to participate in HST it would lose the ability to offset the losses of one subsidiary against the profits of the other. The resulting incentive to shift profits to the loss-making subsidiary implies that transfer pricing problems would persist (Commission of the European Communities, 2002, p. 477).

The voluntary nature of HST complicates matters further. Consider a situation in which a parent headquartered in participating Member State A sells a subsidiary located in participating Member State B to another corporation. If the purchaser is also headquartered in Member State A, the tax rules applicable to the subsidiary would not change. If the purchaser were part of a group headquartered in Member State B or in another participating Member State, the tax rules of the Member State of residence of the new parent would apply. But if the purchaser were part of a group headquartered in a non-participating Member State or outside the EU, the tax rules of Member State B would be relevant.

The mechanics of mutual recognition

The mechanics of mutual recognition, a cornerstone of HST, would need to be spelled out more clearly than they have been. As noted above, mutual recognition is the only protection participating Member States would have against the export of tax subsidies and the use of generous definitions of the tax base and tax administration to compete for the headquarters of groups of corporations. But is mutual recognition a one-time thing? Or could it be withdrawn, once granted, if a participating Member State were subsequently found to be engaging in unacceptable competition for headquarters activities? Could lax administration of seemingly satisfactory statutes precipitate withdrawal of mutual recognition? Would groups headquartered in a Member State that lost mutual recognition no longer be eligible for consolidation, at least until they were reorganized with a parent headquartered in another participating Member State? Would the "nuclear option," to kick a Member State out of the HST club, ever be exercised, given the economic disruption it would cause? If not, what protection against tax base competition would remain? How these and other questions regarding mutual recognitions are answered could have important implications for American multinational companies operating in Europe.

Summary assessment of HST

HST would be an innovative solution to a vexing problem, but it has no counterpart in any country, including the United States and Canada, whose experience with FA is often cited in the EU debate. The principal advantage of HST is the speed with which it could be introduced. There seems to be a presumption that, over time, there would be a tendency for the tax bases of Member States to converge, tempered by recognition that adoption of HST might impede further evolution toward a more harmonized system.[20] It is thus seen as a "pragmatic response," a "workable solution," and a "'halfway' house, balancing the needs and concerns of business and governments and permitting those Member States which already have reasonably similar tax systems to provide a joint solution for business." (Commission of the European Communities, 2002, p. 467.) While substantial cooperation would be required, most obviously in the choice of an apportionment formula—but perhaps also in the rules for consolidation and cross-border loss offsets—it would not be necessary to choose a common definition of apportionable income, a problem that has stymied previous efforts at

[20]See Commission of the European Communities (2002, p. 471), (2003c). Schön (2002, p. 284) notes, "In Europe, however, we are used to the fact that transitional regimes have an inclination to linger around for decades."

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

harmonization. Schön (2002, p. 285) warns, however, "Although the simplicity and elegance of HST cannot be denied, the influence it will have on the competitive situation of domestic and international business and the Member States should make us think twice about its advisability."

Economic and Revenue Effects of Optional Features

Economic effects

Table 2 shows the effects of Member State and corporate decisions on participation in CCBT or HST. The table examines a corporate group that consists of three corporations, each of which operates in one of three Member States, and only there. The situation is identical under CCBT and HST, except for obvious differences. Thus, the table and the discussion that follows show differences only by indicating where "HST" would be substituted for "CCBT." The top line shows the current state of affairs for all corporations operating in the EU, as well the situation of corporations that choose not to participate in CCBT (or HST); SA/ALS is used to determine the income of the various legal entities operating in the three Member States.

The bottom line shows the situation for a group of corporations that chooses to participate in CCBT (or HST), when two Member States (A and B) choose to participate but one (C) does not. First, participating Member States A and B use SA/ALS and the CCBT definition of income (or the definition of the income in the Home State in the case of HST) to isolate the income earned within their joint boundaries (hereafter AB income); and non-participating Member State C employs the same methodology, but its own definition of income, to determine the income of the corporation located there. Second, A and B use a common apportionment formula to divide the consolidated AB income between them. The definition of income under domestic law is used for purely domestic firms in each of the three Member States.

Three decisions determine how a particular corporation is taxed—that is, how income is defined and how it is divided among Member States: (1) whether the corporation is part of a group that opts to participate in CCBT (or HST), (2) whether the Member State where the corporation operates participates in the scheme, (3) whether the domestic definition of income confirms to the CCBT definition if either the Member State or the corporate group does not participate in CCBT. (In the case of HST the last decision is replaced by another: the choice of Home State.) The results can be summarized as follows:

- If both the Member State and the group participate in CCBT (HST), FA is used to apportion consolidated AB income, as defined under CCBT (Home State) rules;
- If either a Member State or the group does not participate in CCBT (HST), SA/ALS and the domestic definition of income are used to determine taxable income;
- For a purely domestic corporation, the domestic definition of income is used to determine taxable income;
- In the prior two situations the domestic definition of income may or may not be modified to conform to the CCBT definition;
- Under HST, the choice of Home State determines the tax regime to which a participating group is subject in the participating Member States.

Because of optional features deemed to be necessary for political reasons, a variety of differences in tax treatment will occur, depending on how these decisions are made. If CCBT were mandatory, all groups operating in more than one Member State would be subject to the same rules (i.e., the same definition of income and the same

TABLE 2

EFFECTS OF MEMBER STATE AND GROUP PARTICIPATION IN CCBT (HST) ON METHODS OF DETERMINING SOURCE OF INCOME (THREE AFFILIATES OPERATING IN THREE MEMBER STATES)

	PARTICIPATION IN CCBT (HST) BY MEMBER STATES		
Group participation	**Member State A: Yes**	**Member State B: Yes**	**Member State C: No**
No	Income of entity in A is determined by SA/ALS, based on definition of income in A	Income of entity in B is determined by SA/ALS, based on definition of income in B	Income of entity in C is determined by SA/ALS, based on definition of income in C
Yes	Total income of group earned in Member States A and B, determined under CCBT (Home State) definition of income (and isolated from income of entity in C by SA/ALS), is apportioned by common formula		Income of entity in C is determined by SA/ALS, based on definition of income in C

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

consolidation rules, as well as the same apportionment formula), as in the bottom left-hand corner of Table 2. If, in addition, domestic law corresponded to CCBT, purely domestic corporations would be subject to the same regime. Comprehensive application of HST would not, of course, produce the same degree of uniformity, as definitions of income and groups would continue to be governed by 25 Home State tax regimes, whether participation were mandatory or not.

Westberg (2002, p. 328) has argued that the ECJ may take a dim view of the discrimination that HST could create, for example, when parents located in non-participating Member States have subsidiaries operating in a participating Member State. This criticism would apply equally to CCBT, if domestic law differed from the CCBT. Of course, domestic law could be aligned with CCBT, whereas no alignment is possible under HST. On this important topic, see also Schön (2002, pp. 280-81).

Revenue effects

The parallel operation of two tax systems in a given country (or of 25, in the case of HST) is also problematic because, on average and all things equal, it would reduce revenues. First, revenue would be lower, because a taxpayer can generally be expected participate or not, depending on which system produces the lower liability. Second, there may be opportunities for tax arbitrage.

International/Treaty Considerations

Member States have many tax treaties with nations outside the EU, as well as with each other. Virtually all of these are bilateral treaties that rely on SA/ALS for the division of business profits between treaty partners. In addition, relations among Member States are governed by the EU treaty. Harmonization of corporate taxes in the EU also raises knotty issues in this area.[21]

An EU directive establishing HETS or a convention establishing CCBT or HST via the enhanced cooperation procedure would presumably replace bilateral treaties between participating Member States. (Lodin and Gammie, 2001, pp. 84-85). But a CCBT or HST convention would not apply to non-participating Member States. (By definition, there would be no non-participating Member States under the HETS.) In particular, Member States participating in either CCBT or HST would employ formula apportionment to divide consolidated income earned in those Member States by corporate groups that had opted for such treatment. By comparison, they would be bound by existing bilateral treaties to use SA/ALS to divide income with non-participating Member States. This differentiation could well run afoul of non-discrimination clauses of both the EU Treaty and bilateral treaties between participating and non-participating Member States.

There could also be problems of relations with third (non-EU) countries. Some would occur because some Member States currently exempt foreign source income, while others tax worldwide income, but allow foreign tax credits (FTCs) for taxes paid to source countries. A simple example, taken from Lodin and Gammie (2001, p. 55) and based on the HST, illustrates the nature of the problem, even if the legal disposition of all issues in the example are not clear.

Suppose that a second-tier subsidiary T in a non-EU country pays a dividend that is subject to a ten percent withholding tax to a parent S that is the Swedish subsidiary of a British parent B. Under current Swedish law and a bilateral treaty between Sweden and the non-EU country, the dividend might be exempt in Sweden, in which case there would be no credit for the withholding tax; no British tax consequences, and no international double taxation.

Under HST, British law would prevail; thus the dividend, grossed up for both the withholding tax and the underlying income tax paid by T, would be included in the consolidated income of the S/B group and a FTC would be allowed for both taxes collected by the non-EU country. But no British FTC would be allowed for tax on the portion of the grossed-up dividend attributed to Sweden; and Sweden also would not allow a credit, since it employs an exemption system. Thus international double taxation would occur.

If the dividend were paid instead to a British subsidiary of a Swedish parent, international double taxation would be avoided under current law via the British system of worldwide taxation and FTCs. Under the HST, Swedish law would prevail and the dividend would be exempt from both Swedish and British tax, but the British treaty with the non-EU country might arguably obligate the UK to allow the FTC; in that case international under-taxation would occur.

While issues would not be identical under HETS or CCBT, it seems that treaty provisions for exemption and for worldwide taxation with FTCs cannot comfortably coexist under those systems either. (Taxation of foreign-source dividends under CCBT would create the type of problem described in the example with the British parent; exemption would create those described in the example with the Swedish parent.) Hellerstein and McLure (2004a) argue that the conceptually correct solution is to omit foreign-

[21]This discussion of treaty issues relies heavily on Lodin and Gammie (2001, pp. 53-58 and especially pp. 77-104). See also Westberg (2002) and Weiner (2003).

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

source dividends and income of foreign PEs from the apportionable tax base, at least until existing bilateral treaties can be renegotiated or replaced by a consistent EU treaty with non-EU countries.

Effects on the Location of Economic Activity

Source-based taxation generally distorts the location of economic activity toward low-tax jurisdictions, whether based on SA/ALS or on FA.[22] Distortions may result from differences in tax bases, apportionment formulas (in the case of FA), or tax rates. Differences in tax bases may occur under SA/ALS, but not under an FA system based on a harmonized definition of income, such as the CCBT. Such differences may exist under HST but are expected to be minimized by the discipline of mutual recognition. Distortions caused by the differences in apportionment factors are not relevant for SA/ALS. Distortions caused by rate differentials occur under both SA/ALS and FA but are likely to be different. We focus on the last two types of distortions.

Formula apportionment could cause problems with non-EU countries, resulting in either under taxation or double taxation.

Formula apportionment and the location of economic activity

One way to think about distortions caused by FA is to see an apportioned income tax as separate taxes levied on the individual apportionment factors. (See McLure, 1980. Mintz and Weiner, 2003, and Sørensen, 2004, apply this reasoning.) Thus, a tax apportioned under the standard three-factor formula employed in the United States would resemble taxes levied directly on payroll, property, and sales; and it can be expected to have economic effects similar to the effects of such taxes. It would discourage the conduct of the economic activities that enter the apportionment formula. That is, the part of the tax that resembles a payroll tax would discourage employment in the taxing jurisdiction, and the part that resembles a tax on property would discourage investment. Where all jurisdictions use the same apportionment formula, the tax will discourage those activities most in jurisdictions whose tax rates are highest. If all jurisdictions use the same apportionment formula and tax rates are harmonized, these effects do not occur.

Harmonization of tax rates: the road not taken

Effective (marginal and average) corporate tax rates in the Member States vary considerably. It is impossible to describe this variation adequately in the space available, but a few observations are worthwhile. (For more details, see Commission of the European Communities, 2002, pp. 517-762.) Effective average corporate tax rates for 1999 ranged from roughly ten percent in Ireland to about 40 percent in Germany. Statutory rates are by far the most important determinant of effective average tax rates. Harmonization of statutory rates would therefore go a long way in reducing the dispersion of effective rates.[23] By comparison, harmonization of tax bases would actually increase dispersion, if statutory rates remained unchanged, because high statutory rates and base erosion tend to be found together (Commission of the European Communities, 2002, p. 14-15). It is, of course, unlikely that tax rates would be left unchanged, if tax bases were harmonized. More likely tax rates would be adjusted to approximately offset the revenue effects of base harmonization.

In deciding whether to propose rate harmonization, the Commission faced competing objectives, as well as political constraints. Regarding the economic benefits of tax harmonization the Commission wrote:

> "For assessing the overall importance of these problems and possible solutions, it is necessary to consider *economic efficiency*. From an economic point of view company taxation in the Internal Market must
>
> - ensure that tax considerations distort as little as possible economic decisions by operators,
> - not hinder the possibility of general tax competition while tackling all harmful or economically undesirable forms of tax competition." (Commission of the European Communities, 2001, p. 5, emphasis in original.)

These two objectives are generally inconsistent; the first requires harmonization of tax rates, as well as tax bases, but the second requires that Member States retain the power to set tax rates. Faced with this apparent quandary, the Commission came down squarely on the side of tax competition, stating, ". . .at this point in time,

[22]This assumes that taxes do not exactly reflect benefits provided by the taxing jurisdiction and that location-specific economic rents are not involved. Also, foreign-tax credits allowed by residence countries may offset locational non-neutralities that source-based taxation would otherwise create. This last consideration would be relevant only for potential investment from outside participating Member States and are ignored for present purposes.

[23]Martinez-Serrano and Patterson (2003, pp. 20-21) note that between 1999 and 2002 significant rate reductions, accompanied by base broadening, have reduced the dispersion of tax rates significantly. They do not indicate what has happened to effective tax rates.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

there is no convincing evidence for the Commission to recommend specific actions on the approximation of national corporate tax rates or the fixing of a minimum corporate tax rate." (Commission of the European Communities, 2001, p. 9.)

That the Commission would devote so many resources to examining effective tax rates and the reasons for their differences seems rather odd, given that the substantial differences in statutory rates appears to be the main determinant of differences in effective rates, that political agreement on harmonization of statutory rates was virtually impossible, and that elimination of tax-induced economic distortions was not the objective of the exercise.[24] Regarding the last point, Mintz (2004, p. 221) has observed. ". . .the real aim of consolidation is to make the corporate tax system in a highly integrated market work 'better' so that governments can administer and businesses can comply more easily with the corporate tax. Otherwise, the unconsolidated corporate tax systems impede rationalization of the corporate sector."

Why Harmonization Matters for American Corporations

If the EU were to succeed in harmonizing the corporate income tax bases of the Member States along the lines of the CCBT or the HST, American corporations that participate would experience both benefits and costs. These would differ somewhat, depending on which system were adopted—and, of course, on the degree of participation by Member States and the characteristics of particular corporations. It is thus difficult to generalize about the potentially most important costs and benefits, the effects on aggregate tax liabilities, or the effects on incentives to invest in various Member States. Nonetheless, the following observations may illustrate some general tendencies.

Benefits

Many of the benefits of harmonization are implicit in the list of problems of SA/ALS at the beginning of this article:[25]

- *Simplification.* There would be substantial simplification and a concomitant reduction in compliance costs—a benefit that cannot easily be overstated. Simplification would, of course, be greater, the larger the number of EU Member States where an American multinational operates and the larger the number of those Member States that participate.
- *Loss offset.* Under CCBT, and perhaps under HST, losses incurred in one participating Member State could be offset against profits in another.
- *Neutrality toward organizational form.* Taxation would no longer dictate organizational form or discourage economically rational reorganization. (This would depend, however, on how consolidation and loss offsets are handled.)
- *Reduction of double taxation.* Harmonization should reduce the incidence of double taxation.
- *Tax competition.* If tax bases were harmonized, as under CCBT, taxation would become more transparent and rate reductions would be the only remaining instrument of tax-based competition for production activities. (That is, provisions such as accelerated depreciation could not be used for this purpose.) There is thus some chance that tax-based competition for production facilities would become more intense. HST, which does not involve harmonization of tax bases, could create competition for headquarters activities; this form of competition might be manifested in lax administration under both HST and CCBT.
- *Increased business opportunities.* All the benefits just listed would contribute synergistically to create increased opportunities for American firms to expand into or within the EU. This benefit is likely to be especially important for relatively small American businesses.

Costs

Harmonization would also entail costs:

- *Transition costs.* The timing of the choice to participate on the part of American corporations that are already operating in the EU would allow transition costs to be moderated somewhat. Moreover, it seems likely that the long-term benefits of simplification would swamp transition costs.
- *Reduced opportunities for income shifting.* It would be more difficult to shift income to low-tax Member states, via transfer pricing and choices of capital structure and organizational form. However, it might still be possible to shift income to affiliates in low-tax non-participating Member States or to low-tax countries outside the EU. The ability to shift income would depend on how many and which Member States participate, as well as on the diligence and ability of tax administrators in monitoring income-shifting. If low-tax Member States participate, American multinationals that currently benefit from income shifting within

[24]Note, however, that the Commission's mandate from the EU Council of Ministers included analysis of "differences in effective levels of corporate tax in Member States." See Commission of the European Communities (2001), (2002, pp. 3-4).

[25]Some of these benefits would be even greater under EUCIT or HETS, but, for reasons noted, neither of those proposals is likely to be adopted, at least not quickly.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com
المنارة للاستشارات

the EU may simply prefer not to participate in the harmonized scheme. However, to do so would forego the advantage of simplification.

- *Uncertainty regarding treaty issues.* Issues in the taxation of international flows of income that are currently relatively clear would probably become less clear, at least for a while.

Effects that cannot be generalized

While most corporations operating—or thinking about operating—in several Member States are likely to experience the costs and benefits mentioned above, it is difficult to generalize about some effects. Potentially of special importance are changes in the distribution of the tax base among Member States, and thus changes in aggregate EU tax liabilities, that would occur with the shift from SA/ALS to FA. Changes in the distribution of tax base would depend crucially on the way the business is organized and operated and the apportionment formula chosen. (They would probably depend much less on changes in the definition of taxable income.) Changes in tax liabilities would depend as well on existing tax rates and tax rate changes that accompanied the shift to FA Suppose, for example, that a corporation with taxable income of €100 produces entirely in Member State P, which levies a 20 percent corporate tax, but sells only half its output there, selling the rest in another Member State M, where the tax rate is 40 percent, without the benefit of a PE. Under current law and the posited facts, the corporation would owe tax only to the Member State P, where its production is located; thus its tax liability would be €20. If the apportionment formula accorded equal weight to property and sales only 3/4 of taxable income would be apportioned to Member State P (the average of the property factor of 100 percent and the sales factor of 50 percent), the remainder being apportioned to Member State M. Thus, assuming no change in tax rates, total tax liability would increase to €25 (20 percent of 75 in Member State P, plus 40 percent of 25 in Member State M). It is, of course, also possible that tax reductions would occur. (For example, if the tax rate were 40 percent in Member State P and 20 percent in Member State M, total tax would fall from €40 to €35.) Further complicating matters is uncertainly about whether and how tax rates would be adjusted if EU tax systems were to be harmonized.

Concluding Remarks

The case for harmonization is overwhelming. Yet the obstacles are daunting. The unanimity provision militates against a solution. It seems possible, however, that the confluence of three developments will eventually lead to breaking of the political logjam. First, in part because of developments in other areas (e.g., accounting reform) Member States' tax bases and treatment of groups may converge over time, thereby making adoption of common policies easier. Second, the problems inherent in SA/ALS will burgeon as the economic integration of the EU proceeds, providing strong impetus for harmonization. European business has been especially vocal about the need for a more uniform system. Third, and perhaps most important, decisions of the ECJ may make the present system increasingly untenable. One cannot, however, predict with certainty whether and when the logjam will break, let alone what the result will be. ■

ACKNOWLEDGEMENTS

I wish to acknowledge the helpful comments Robert Crow, Walter Hellerstein, and Joann Weiner made on earlier drafts.

REFERENCES

Commission of the European Communities. 1992. *Report of the Committee of Independent Experts on Company Taxation.* Luxembourg.

Commission of the European Communities. 2001. "Towards an Internal Market without Tax Obstacles: A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-wide Activities." A Communication from the Commission to the Council, the European Parliament, and the Economic and Social Committee, COM (2001) 582 final, available at *http://europa.eu.int/comm/taxation_customs/publications/official_doc/IP/ip1468/communication_en.pdf,* visited August 13, 2004.

Commission of the European Communities. 2002. "Company Taxation in the Internal Market." Commission Staff Working Paper. Luxembourg: Office for Official Publications of the European Communities. SEC (2001) 1681.

Commission of the European Communities, Directorate General Taxation and Customs Union. 2003a. "The Application of International Accounting Standards (IAS) in 2005 and the Implications for the Introduction of a Consolidated Tax Base for Companies' EU-wide Activities." Available at *http://europa.eu.int/comm/taxation_customs/taxation/consultations/iaspaper06feb2.pdf,* visited August 13, 2004.

Commission of the European Communities, Directorate General Taxation and Customs Union. 2003b. "Summary Report on the results of the DG Taxation and Customs Union open consultation on *The application of International Accounting Standards (IAS) in 2005 and the implications for the introduction of a consolidated tax base for companies' EU-wide activities.*" Available at: *http://europa.eu.int/comm/ taxation_customs/taxation/consultations/ias_summary_en.pdf,* visited August 13, 2004.

Commission of the European Communities. 2003c. "An Internal Market Without Company Tax Obstacles: Achievements, Ongoing Initiatives and Remaining Challenges." Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, COM (2003) 726 final, available at *http://europa.eu.int/eur-lex/en/com/cnc/2003/com2003_0726en01.pdf,* visited August 13, 2004.

Commission of the European Communities. 2004a. "Home State

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com

Taxation for Small and Medium-sized Enterprises." Commission Non-Paper to informal Ecofin Council, 10 and 11 September 2004 (7 July), available at: *http://europa.eu.int/comm/taxation_customs/taxation/company_tax/docs/Non-Paper_HST_EN.pdf, visited August 13, 2004.*

Commission of the European Communities. 2004b. "A Common Consolidated EU Corporate Tax Base." Commission Non-Paper to informal Ecofin Council, 10 and 11 September 2004 (7 July), available at: *http://europa.eu.int/comm/taxation_customs/taxation/company_tax/docs/Non-Paper_CCBT_EN.pdf,* visited August 13, 2004.

Diemer, Rolf, and Thomas Neale. 2004. "The European Union's Longer-term Plans for Introducing a Common Consolidated Tax Base for the EU-wide Activities of Companies." *Cahiers de Droit Fiscal International.* 89b, 69-96.

European Federation of Accountants. 2002. "Company Taxation and Europe Today and Tomorrow: Round Table on Direct Tax." Brussels, October 16. Available at *http://www.fee.be/issues/PDF/Report%20FEE%20Direct%20Tax%20Round%20Table%202002.pdf,* visited August 13, 2004.

Hellerstein, Walter, and Charles E. McLure, Jr. 2004a. "The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States." *International Tax and Public Finance.*11:2 (March), 199-220.

Hellerstein, Walter, and Charles E. McLure, Jr. 2004b. "The European Commission's Report on Company Income Taxation: Contextual Considerations in Transferring US Experience to the EU." *Bulletin for International Fiscal Documentation.* 58:3 (March), 86-98.

Klemm, Alexander. 2001. "Economic Review of Formulary Methods in EU Corporate Tax Reform." In Malcolm Gammie, Claudio M. Radaelli, and Alexander Klemm. *EU Corporate Tax Reform: Report of a CEPS Task Force.* Centre for European Policy Studies.

Lannoo, Karel, and Mattias Levin. 2002. "An EU Company without an EU Tax? A Corporate Tax Action Plan for advancing the Lisbon Process." A Research Report by the Centre for European Policy Studies.

Lodin, S.O., and M. Gammie and IBFD Research Department. 2001. *Home State Taxation and Tax Treaty Aspects.* Amsterdam: International Bureau for Fiscal Documentation.

Martinez-Serrano, Alicia, and Ben Patterson. 2003. "Taxation in Europe: Recent Developments." European Parliament, Economic Affairs Series, ECON 131 EN, 01-2003, available at *http://www4.europarl.eu.int/estudies/internet/workingpapers/econ/pdf/131_en.pdf,* visited August 13, 2004.

Mazerov, Michael. 2001. "The Single-Sales-Factor Formula: A Boon to Economic Development or a Costly Giveaway?" *State Tax Notes.* 20: 21 (May 21), 1775-1817.

McLure, Charles E., Jr. 1980. "The State Corporate Income Tax: Lambs in Wolves' Clothing." In Henry J. Aaron and Michael J. Boskin, editors, *The Economics of Taxation.* Washington: Brookings Institution, 327-46.

McLure, Charles E., Jr. 2002. "Replacing Separate Entity Accounting and the Arm's Length Standard with Formulary Apportionment." *Bulletin for International Fiscal Documentation.* December, 56:12, 586-99.

McLure, Charles E., Jr., and Joann M. Weiner. 2000. "Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income." In Sijbren Cnossen (ed.). *Taxing Capital Income in the European Union: Issues and Options for Reform.* Oxford: Oxford Univ. Press. 243-92.

Mintz, Jack. 2004. "Corporate Tax Harmonization in Europe: It's All About Compliance." *International Tax and Public Finance.*11:2 (March), 221-34.

Mintz, Jack, and Joann Martens Weiner. 2003. "Exploring Formula Apportionment for the European Union." *International Tax and Public Finance.* November,10:6, 695-711.

Organisation for Economic Co-operation and Development. 2001. OECD *Transfer Pricing Guidelines for Multinational Enterprises and for Tax Administrations.* Paris: OECD. Travel version.

Organisation for Economic Co-operation and Development, Committee on Fiscal Affairs. 2003. *Model Tax Convention on Income and on Capital.* Paris: OECD. Condensed version.

Selbach, Sabine D., (2003) "The Harmonization of Corporate Taxation & Accounting Standards in the European Community and Their Interrelationship." *Connecticut Journal of International Law.* 18 (Spring), 523-83.

Shön, Wolfgang. 2002. "The European Commission's Report on Company Taxation: A Magic Formula for European Taxation?" *European Taxation.* August, 42:8, 276-86.

Sørensen, Peter Birch. 2004. "Company Tax Reform in the European Union." *International Tax and Public Finance.*11:1 (January), 91-115.

Union of Industrial and Employers' Confederations of Europe (UNICE). 2000. "UNICE Memorandum on Cross-border Company Taxation Obstacles in the Single Market."

Union of Industrial and Employers' Confederations of Europe (UNICE). 2002. "UNICE's Reaction to the European Commission Communication and Report on Company Taxation in the Internal Market: 'Towards an Internal Market without Tax Obstacles,'" COM (2001) 582 final, available at *http://europa.eu.int/comm/taxation_customs/taxation/company_tax/docs/conference/unice_en.pdf,* visited August 13, 2004

Weiner, Joann M. 1996. "Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level." *Tax Notes International* 23, 2113-41, also available at *www.ustreas.gov/ota/ota83.pdf,* visited August 13, 2004.

Weiner, Joann M. 2001. "The European Union and Formula Apportionment: Caveat Emptor." European Taxation. 41, 380-88.

Weiner, Joann M. 2003. "EU Prepares for Corporate Tax Reform at Rome Conference." *Tax Notes International.* December 8, 32, 913-24.

Westberg, Bjorn. 2002. "Consolidated Corporate Tax Bases for EU-Wide Activities: Evaluation of Four Proposals Presented by the European Commission." *European Taxation.* August, 42:8, 322-30.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission. www.manaraa.com