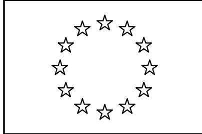

EUROPEAN COMMISSION
DIRECTORATE-GENERAL TAXATION AND CUSTOMS UNION
Analyses and tax policies
Analysis and Coordination of tax policies

Brussels, 27 February 2007
Taxud E1 AAG-GR-FF

CCCTB\WP\052\doc\en
Orig. EN

COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)

An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB

Meeting to be held on Tuesday 13 March 2007

Centre de Conférences Albert Borschette
Rue Froissart 36 - 1040 Brussels

WORKING DOCUMENT

B-1049 Bruxelles / B-1049 Brussel - Belgium. Office: MO59 04/091.
Telephone: (32-2) 299.11.11; direct line (32-2) 298.40.07. Fax: (32-2) 295.63.77.
E-mail: taxud-e1@ec.europa.eu

I. Background information and purpose of the document

1. This note gives an overview of the main issues that emerged during the discussion on the mechanism for sharing the Common Consolidated Corporate Tax Base (CCCTB) at the first meeting of the Subgroup on the Sharing Mechanism (SG6).

2. The topic of the mechanism for sharing the tax base was first discussed at the ninth meeting of CCCTB WG on 13 December 2006 on the basis of the Working Document 'The mechanism for sharing the tax base' (CCCTB/WP/047), and then referred to SG6 for deepening the discussions on the three main approaches to the sharing mechanism, ie on the one hand the macro-based approach and on the other hand the two micro-based approaches 'value added' (VA) and traditional 'formulary apportionment' (FA).

3. The first meeting of SG6 was organised on 1 and 2 February 2007 in Brussels and it was chaired by the Commission Services. Experts from 17 MS attended the meeting[1]. The Commission Services prepared two room documents for the meeting, one summarising the written comments received from MS on the Working Document 'The mechanism for sharing the tax base' (CCCTB/WP/047) and the other discussing the possibility of adjusting the apportioning factor 'payroll', taking into account the differences in wage levels across the EU or differences in labour productivity/profitability across group companies.

II. Key points discussed at the meeting

Preliminary comments

4. Before illustrating the various approaches to the tax base apportionment the Commission Services underlined that: (i) apportionment was a necessary consequence of consolidation; (ii) the tax base should be apportioned to companies and not to MS; and (iii) apportionment criteria should lead to a sharing that is fair, neutral - not prone to manipulations, enforceable, simple and cost-efficient.

5. A comment was made that, if the 'full consolidation' is replaced by a system of profits/losses offsetting between members of a group, the distribution of profits could still be based on an arm's length pricing key. This would avoid the difficulties of a sharing mechanism, while the benefits linked to the cross-border loss compensation could still be achieved. However, the Commission Services maintained that the full benefits of the tax base harmonisation would not be achieved without consolidation, as very soon the level of communality within the CCCTB would be lost, and full consolidation is the only way of overcoming the problems linked to transfer pricing for intra-group transactions.

[1] Austria, Belgium, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Hungary, Italy, Latvia, Luxembourg, , Netherlands, Poland, Slovenia, Spain and Sweden.

6. Some participants requested clarification as to what sort of tax data the Commission Services need from national tax administrations to evaluate the effects of different methods of apportionment. The Chair clarified that this issue would not be discussed in this Subgroup, since the data likely to be required concern more elements of the CCCTB (not only apportionment) and therefore it is an issue that will be discussed at a future plenary on the basis of a Commission paper.

7. At the meeting of the main WG in December 2006 some MS commented that the Commission Services had illustrated the FA approach in a more developed fashion than the macro-based and the VA approaches as if they had shown a preference for the former method. However, those MS remarked that the three options should be further discussed in detail before dismissing one. For that reason, the Commission Services presented again the three initial apportionment methods on equal footing for evaluation, on the basis on a series of slides illustrating the concept of the various approaches, numerical examples and the pros and cons of using each approach.

Macro-based approach

8. The presentation on the macro approach went through several technical design issues that would have to be resolved to define a macro factor for apportionment of groups' tax bases: whether macro-based apportionment would take place between all EU MS or only between countries where each group operates; which macro-factor to use; how and when to measure the macro-factor and how to attribute tax bases to individual group members when there is more than one company of a group in a MS. However, the main basic question open was whether the concept of macro-based apportionment could be accepted in the EU for the division of multinational groups' taxable income.

9. At the end of the presentation experts who intervened acknowledged that the genuine merit of a macro-approach for apportionment is that it is a straightforward method, cost-efficient, simple and easy to manage both for companies and tax administrations.

10. However macro-based apportionment presents the fundamental drawback of disconnecting the real economic activity performed by a company in a country with its tax liability in that country, which conflicts with the very idea of a 'fair' distribution of the tax base. Experts felt that this feature makes of it an unacceptable option on its own. Thus, most participants showed a preference for a fairer rather than a simpler solution.

11. Another issue of some concern was that if macro factors were used to apportion groups' tax bases between *all* MS it could trigger a 'race-to-the-top' of the tax rates among MS, since all MS would get a fixed share of any participating group. Therefore, a sharing mechanism based on macro factors would require a complementary action at EU level on tax rates (harmonising tax rates or fixing a bracket of admissible tax rates). Thus, an expert concluded that macro apportionment does not seem a realistic solution for the CCCTB project; it would

only have sense in a context of more harmonization of corporate taxation at the EU level, for example a scenario with an EU corporate income tax, which is far beyond the current policy.

12. It was also suggested that macro-economic factors could be used in combination with micro-factors in a formula. This possibility was not favoured by some experts, who thought that this type of compromise could end up putting together the disadvantages of both methods. However, the option of adjusting certain micro-factors (for example, labour) with some macro-elements could also be introduced. The Commission Services invited MS experts to reconsider this option when analysing individual factors of the FA.

13. The preliminary conclusion of the discussion on a macro-based sharing mechanism was that, since its drawbacks overwhelm its advantages, it should be temporarily disregarded to focus the analysis on other sharing mechanisms. However, the complete rejection of macro-apportionment depends on what comes next: should the other sharing mechanisms prove to have more flaws than the macro-based approach, it could be considered again. Some participants anyway saw it as a 'last resort'.

<u>*Value Added (VA) approach*</u>

14. Similarly to the macro-based approach, the Commission Services presented again the main features of the VA approach as requested by several MS at the WG meeting in December 2006. A series of slides were presented illustrating the concept of VA, how VA could be computed by each company (either from scratch or starting from VAT returns and making some further adjustments), how it would be used for apportionment and the pros and cons of this approach.

15. At the end of the presentation a fruitful discussion took place. VA was seen as an attractive economic concept, consistent for all sectors and economies. It was mentioned that although it is often claimed that one of the advantages of a VA key for apportionment is that VAT is indeed a familiar notion for EU companies and tax administrations, the economic concept of VA itself and the various definitions that can be followed to measure it (consumption-type *versus* income-type, at origin *versus* destination, etc) are rather unknown to companies. The VA concept, which would be the key for apportionment of corporate income, must not be confused with Value Added Tax. VAT returns would only be the starting point to calculate VA for apportionment (in certain cases, ie sectors within the VAT scope). From the point of view of apportionment, the VA key in any case is an appealing method, since it is a micro-based approach that maintains a certain link between the economic activity of a given company in a given country and the tax liability of that company in that country. Thus it takes the system a bit closer to what is considered a fair outcome of apportionment.

16. However, VA presented also several negative aspects, as follows. <u>First</u>, VA could be a complex method to apply, that involves lots of calculations for companies. In particular, if the VA for apportionment is retrieved from VAT returns, it requires a

series of basic data and a series of subsequent adjustments, which reintroduces complexities and would go against one of the main purposes of the CCCTB (simplification and reduction of compliance costs for companies). Also, the VAT-reporting requirements differ between MS, thus the information that companies could use from their VAT returns to calculate a VA key for apportionment of corporate income would differ across countries.

17. Second, for the purpose of calculating the VA of a company all intra-group transactions have to be valued, and this should be done at arm's length price (ALP). This implies that VA takes us back to the need of using transfer prices (TP) for valuing intra-group transactions and to the incentives of companies to manipulate TP so as to influence the outcome of apportionment in terms of profit allocation. However, since VA is a base much broader than profits the problem of TP manipulation and profit shifting is, in principle, of less importance than in the current ALP system. Since VA is composed of labour (which counts for around 2/3 of the total VA) and interest and profits (which count for around 1/3 of the total VA), the scope for shifting profits through TP manipulation would be narrower than in the current system. In the current system, manipulation of one unit of the TP would give rise to one unit of profit shifted; under a CCCTB system with VA apportionment, the manipulation of one unit of the intra-group TP would result in less than 1/3 of one unit of the taxable base being shifted in the profit allocation process. Thus, the scale of the price manipulation has to be several times larger to achieve the effect of shifting one unit of the taxable base and the risk of discovery is in general larger. However, some experts pointed that if documentation requirements on TP are reduced or eliminated, which would be the natural consequence of the intra-group transactions elimination due to the consolidation at the tax base level, there might be more scope for any manipulation of TP to go undetected.

18. One expert also mentioned that VA and the apportionment outcome can be manipulated not only through TP but also through other components of VA: for example, by transferring staff to the group companies situated in the low-tax countries, VA and therefore the tax base is shifted towards those countries.

19. Another expert mentioned that there could be important distortions depending on whether VA was measured from a production or a consumption point of view. The Commission Services clarified that a VA key for apportionment is supposed to be measured not on production, or consumption, but as an income-type VA. This would be in line with the measurement of the income that the VA factor seeks to apportion (ie, calculated allowing for yearly depreciation instead of immediate allowance for total capital costs).

20. For the above-mentioned reasons (complications to compute the data needed for its application, the need of going back to ALP, implicit risk of profit shifting, etc) the preliminary conclusion of the discussions on VA was that for the majority of experts it is an inappropriate method for sharing the CCCTB and should be put aside for the time being.

Formulary Apportionment (FA) approach

21. The Commission Services presented the FA approach by analysing, for each of the three factors normally used in FA systems (labour, property and sales), the main issues linked to: (i) valuation, (ii) location, (iii) availability of data and (iv) advantages and disadvantages.

    Payroll (labour)

22. It was generally accepted that labour is such an important income-generating factor that it should be included in a formula that aims at sharing the profit of a group to the various members of that group. In principle it should be measured by payroll.

23. As regards the impact on the formula of **outsourced labour**, and the correlated possibility for manipulation, a distinction was made between transactions with third parties as opposed to intra-group dealings. If companies outsource part of their activities to a truly independent labour-service supplier (which for example provides its services to several customers) it would not be necessary to 'reconstruct' such a cost for the service as a 'deemed' labour cost.

24. On the other hand, if the service supplier belongs to the same group as the company receiving the service, and considering that the intra-group transaction would be eliminated at the tax-base level due to the consolidation, in such a case there may be a concern that the apportioning factor 'labour' is allocated to the 'wrong' company, and subsequently the consolidated tax base could be shared 'unfairly'. This may be the case when outsourced employees perform the same activities that would normally be performed by the employees of the receiving company.

25. It was also noted that companies already try to minimise the impact of items such as payroll taxes or social contributions. In addition to the situation described above (outsourced employees), companies could also make use of 'formally' self-employed workers (who in reality operate as dependent employees) to avoid paying social contribution and payroll taxes.

26. The possible formula manipulations due to outsourced labour are even bigger in case of **seconded employees**, who are sent from one group company in a low tax MS to another group company in high tax MS. In this case, employees would be on the payroll of the low tax MS although they perform services for the benefit of the companies in the high tax MS and the intra-group payment would be eliminated due to the consolidation.

27. To prevent this, a method could be used to attribute the cost of the employees to the two companies involved. Among the possible methods, it was considered taking into account the rules that would be applicable to the personal income of the employee (Article 15 of the OECD Model Tax Convention).

28. One important point concerning payroll was the question whether this factor should be adjusted to take into account differences in price/wage levels across EU countries and/or differences in the 'profit-to-labour' ratio or labour productivity across group companies. The Commission Services presented the possible arguments for making adjustments to the *payroll* factor where in certain cases this factor may not give an appropriate distribution of the taxable bases. They also suggested some possible solutions to deal with any adjustments deemed necessary to 'correct' the distribution based on the payroll. For example, the use of 'number of employees' instead of or together with payroll, or the use of an 'adjusted number of employees' factor that would take into account the average wages in national economies. Three diverging views were expressed:

29. Some experts considered that there was no need to adjust the payroll factor, because (i) in the long term differences in wage levels will tend to disappear across the EU, (ii) it is not appropriate to analyse the effects of payroll on the distribution of the taxable bases *in isolation*, because when the formula was based on several factors, there would be an element of self-adjustment through the other factors[2], ie the whole thing will balance out by itself, and (iii) it would be inappropriate to adjust the salaries by comparing the output of a type of business in one MS with the output of another type of business in another MS.

30. Some other experts believed that differences in wage levels do exist and they have to be corrected when using a payroll factor for apportionment, otherwise some MS would be worse off. Finally, a third group of experts mentioned that further research was necessary to assess the impact of introducing or not such a correcting mechanism and that it is necessary to consider in more detail which would be the best solution to any potential need for adjustments to payroll.

Property (assets)

31. Similarly to labour, it was generally accepted that property is such an important income-generating factor that it should be included in a formula that aims at sharing the profit of a group to the various members of that group.

32. The idea of evaluating the property factor by reference to a *flow* concept (ie, the flow of service provided by capital during the course of the year) was briefly mentioned by the Commission Services. Under the approach the flow of capital should be measured by the 'user cost of capital', which equals the economic depreciation plus the financial cost of capital. Although this might appear to be the theoretically correct approach it was not pursued because the calculation would be complex and would involve a large number of subjective estimates. Indeed there is no existing experience of using this as a factor.

33. Alternatively, property as a *stock* concept was discussed. Although it should ideally be valued at its market value it was recognised that this would create too many complications without providing significant benefits. Therefore the preferable

[2] It was suggested that, for example, with a three factor formula with identical weights (1/3 labour, 1/3 property and 1/3 sales) the effects of the different factors counterbalance each other.

option would be to assign to property – for apportionment purposes – the same value that property would have for tax purposes, i.e. the CCCTB tax written down value.

34. Most participants thought that financial assets should not be taken into account for the purposes of apportioning the tax base, mainly due to their mobility (although an exception could be envisaged for financial institutions).

35. As regards the **location** of assets, a similar discussion concerning outsourced labour took place for rented or leased assets. In particular, it was recognised that the main concern relates to intra-group dealings, because by means of *sale-and-lease back* arrangements or similar contracts it would be easy for a multinational group to shift factor (and consequently taxable base) from one jurisdiction to another one.

36. Several experts suggested making use of the conclusions reached when discussing depreciation of assets at the tax base level, also for the localisation of assets for the purpose of the apportionment formula. In concrete terms, the company entitled to depreciate the assets (be it the legal owner or the economic owner) should also take account of the assets for the sharing mechanism.

37. The issue of **intangible** assets was also a source of concern for MS experts. The prevailing opinion was that intangible assets should be taken into account in a formula, although this raises important questions of valuation (especially for self-generated intangibles and intangibles that do not generate a stream of income) and of location (which company should account for the intangible, the company using it or the company receiving the royalty payment for granting the use of it?).

38. The preliminary conclusions of the discussions could be summarised as follows: first, financial assets should not be taken into account for apportioning purposes; second, for valuation and location purposes the same criteria as those used for the calculation of the tax base should be applied to the measure of the property factor; third, more research should be carried out as regards intangible and leased assets, with a focus on intra-group arrangements. This could be done in the framework of the discussion on group taxation, method of consolidation and method for eliminating intra-group transactions.

Sales

39. The apportioning factor 'sales' generated the greatest divisions between experts. Some considered that it is perhaps the most important factor for the purpose of sharing the tax base, since it measures the economic potentiality of a company and is the factor that demonstrates whether a company is doing business or not (the measurement of sales *at origin* is implicit in this view). Other experts disagreed and considered that sales should not be taken into account in an apportionment formula whatsoever. Their main argument was that ‘sales by origin’ is superfluous because it just replicates the distribution already covered by payroll and capital and ‘sales by destination’ has a great potential of manipulation, is an inconsistent concept when companies sell to third countries and compensating consuming states *via* corporate taxation would duplicate the effect of the Value Added Tax in the EU.

40. In the Commission Services' presentation it had been noted that **intra-group sales** should be disregarded when measuring the sales factor. Intra-group sales have not contributed to the consolidated income that the factor seeks to apportion and including intra-group sales would make this factor prone to manipulation of the intra-group transactions' valuation and therefore lead to a reintroduction of transfer pricing problems. However, one expert mentioned that if intra-group transactions were disregarded in the sales factor, the current tax base distribution within a group composed of, for example, a manufacturing company, a distributing company and a marketing company would be completely changed within a formulary system compared to the current situation. The first companies in the chain, ie the manufacturing companies, would get no tax base apportioned on the basis of this factor. Another expert pointed out that in such an example manufacturing companies would receive shares through the other factors (capital and labour). This highlighted the importance of considering the FA mechanism as a whole, ie a combination of factors.

41. As for the choice between **sales by origin** and **sales by destination**, the preliminary Commission Services' presentation suggested: (i) only sales by destination is theoretically meaningful, since the role of a sales factor is to reflect the *demand* side to the generation of profits[3]; (ii) sales by origin would duplicate the role already played by labour and property in the apportioning mechanism; and (iii) sales by origin are prone to manipulation.

42. However, experts who spoke preferred sales (if included in the formula), to be measured *at origin* to take account the efficiency and production capacity of companies. This argument is in line with the view that profits should be counted as realized where the goods are produced (or from where the goods are shipped), regardless of where they are sold. The only reservation made was that perhaps sales could be measured at destination in the case of services.

43. Several experts also identified important flaws in the sales by destination approach. First, the potential of manipulation of sales by destination is great: for example, a company can easily have an independent 'sales agent' wherever it is more favourable and thereby control the outcome of apportionment. Second, due to the requirement that a physical presence or nexus (a subsidiary or a permanent establishment) would be necessary to attribute a share of the tax base to the marketing country, the concept that 'sales by destination' represents the role of demand is conceptually inconsistent particularly when there are sales to countries where the group does not have a PE or a subsidiary. One expert mentioned that the only logical solution is to omit those sales out of the apportioning factor. Third, sales by destination would not reward producing entities and would not allow a distinction between productive entities and unproductive entities. Fourth, marketing countries are already remunerated by VAT and should not benefit twice (that is, also via corporate taxation). In particular it was noted that small countries with a limited demand and exporting countries would be worse off compared to large countries with a significant internal demand and importing countries.

[3] The *supply* side is already represented by the labour and capital factors.

44. As regards **intermediate products**, some experts did not see a potential issue, since they should be treated in the same way as final products. Other experts thought it could be complicated and perhaps the sales factor could be divided into two (both origin and destination) in these cases.

45. It seemed that the ease of manipulation of the sales factor (either when measured at origin or at destination) is an essential issue that will require further work and reflection.

Uniform Formula

46. It was generally accepted that there should be a uniform formula across the EU (same factors and weights for all MS).

Sector specific formulae

47. Few experts commented on this point, mainly considering that there should be as little differences as possible, the financial sector being one potential candidate to a 'special' formula.

III. Further points to be discussed

48. So far, the different apportioning alternatives have been analysed separately: macro-based apportionment, a VA key and FA with three traditional factors, payroll, property and sales. It is clear that each approach has pros and cons and that a ‘perfect’ mechanism is not readily available or obvious. As a next step in the reflections to design the mechanism for sharing the CCCTB, it could be questioned how these approaches may interact to create a sort of ‘mixed’ apportioning method. The idea underlying such a design would be to include the positive elements of each methodology. For example, introducing a macro-factor into a micro-based apportionment could combine the advantage of the fairer sharing attained by micro-factors (that provide a closer link between real economic performance of a taxpayer and the taxing jurisdiction) with some added stability to the mechanism (ie, macro-factors would reduce the manipulation to which micro-factors are very sensitive: FA is prone to factors’ reallocation, a VA key is prone to profit shifting).

49. The initial discussions have shown that the sales factor is the most controversial of all. Sales by origin seems to have conceptual drawbacks (since in principle it replicates the distribution already attained by payroll and property) and it can be manipulated. Sales by origin may have economic sense to apportion taxable income (eg, it adds something to labour and capital) when there are different productivity levels between group companies: that is, some companies produce more/less output for the same labour and capital because they are more/less efficient. But that could imply that for the 'sales by origin' factor to reflect the real performance of each group company, intra-group sales should also be included to take account of all real output of each company which re-introduces transfer pricing problems. Sales by destination may have more theoretical appeal if demand is deemed to play a role in generating profits and therefore consuming states are deemed to have the right to tax a part of corporate income.

50. However, the idea that demand creates profits seems unsustainable when the company lacks other types of taxing nexus in the destination state and also it seems that the place of destination could also be manipulated , which is something to be examined in more detail. In principle, according to economic theory 'sales by destination' is not manipulable, in the sense that the demand curve is something companies do not control, as it is given by the market. But in real life companies are able to arrange sales by destination. In addition to further studying both origin and destination the whole question of whether a sales factor should be included ought to be examined. In that reflection it should be kept in mind that a formula based only on two factors (labour and capital) could give rise to more delocalisation problems.

51. If none of the micro-based approaches to define a sales factor is satisfactory (origin/destination), it could be considered whether sales could be measured at an aggregate macro-level. An initial proposal for another way of defining a sales factor, from a macro- economic point of view, could be to measure it for each group company as the share of ‘total national sales’ in the MS of the company to ‘total sales’ in all MS where the group operates. To be consistent with the idea that a sales factor in the formula is meant to reflect the demand side for the generation of companies’ profits, the macro-sales factor should be measured *at destination*. In that sense some measure of GDP from its *demand* side can be considered as a good proxy for the estimation of national demand.

52. A ‘mixed’ approach like the one described would imply that the supply side of profits’ generation would be represented by micro-factors (labour and capital) whilst the demand side in profits generation would be represented by a macro-factor (aggregated sales at destination). The effect of such arrangement should be subject to further analysis. But in principle it could be tentatively said that the macro-sales factor would add an element that counterbalances the ease of manipulation of the other two micro-factors (and avoid the problems of relying only on micro-factors prone to manipulation, which could give rise to delocalisation problems).

SUMMARY AND PRELIMINARY CONCLUSIONS

The Commission Services intend to put the macro-based approach and the VA in a 'stand-by' position - without definitively excluding these possibilities as a mechanism to share the consolidated tax base.

Concerning the factor 'labour' of the FA approach, it was suggested deepening the discussion on outsourced labour, 'fictitious' self-employees and seconded employees. As regards the opportunity to adjust the factor due to different wage levels across the EU and/or different labour productivity/profitability across group companies, discussions were not conclusive and more work is necessary to decide if it is necessary and if so how to achieve such a result. Research on the availability of data is also

required and the Commission Services will also seek the opinion of the private sector on this.

As regards the factor 'property', more analysis has to be done on the various issues of location and valuation of intangible assets as well as on the question if financial assets should be included in a property factor.

Concerning the factor 'sales' it should be discussed in more detail if the apportionment formula should include a factor that is measured by using (i) sales by origin, (ii) sales by destination, (iii) a macro-factor (aggregated sales at destination), or (iv) if the formula should include a sales factor at all.