

Comments on document CCCTB\WP\026

Common Consolidated Corporate Tax Base Working Group

– The territorial scope of the CCCTB–

Introduction

In November 2005, the Commission presented its working paper on “international aspects of the CCCTB”.¹ This has been followed up by a paper on the “territorial scope of the CCCTB”.² Considering the great importance of this topic, we would like to make some comments thereon. We are very grateful for the opportunity to share our views on these complex issues.

The positions taken below may be subject to revision as other areas of the CCCTB are explored. When the expression “foreign” or “third country” is used below, it refers to non-CCCTB countries. The term “domestic” refers to sources or entities situated within the CCCTB-area.

General principles

For reasons of economic efficiency and simplicity, we believe that the CCCTB should be based on the principle of *Capital Import Neutrality*. This would provide for a level playing field in relation to third countries, something that is particularly important if European businesses are to be competitive in the global economy. We therefore support the Commission in that double taxation should be resolved by means of exemption. A CCCTB based on the credit method would be extremely difficult to apply as it reflects the actual tax rates of the various Member States.

In order to ensure simplicity and certainty, exemption should be provided for through clear rules within the CCCTB-regime itself. Such an approach would resolve many of the double tax problems arising in cross-border businesses. It would also minimize the difficulties of having to apply bilateral double tax treaties in the context of the CCCTB. As double tax treaties can only reduce the tax liability, their applicability is limited to situations where the underlying tax legislation (i.e. the CCCTB) provides for a less favourable relief than the treaty. Thus, where the CCCTB provides for a comprehensive relief by means of exemption, the problems of having to apply and/or renegotiate existing treaties are kept to a minimum.

Some issues (e.g. limitations of withholding taxes and mutual agreement procedures) would nevertheless still need to be resolved through double taxation treaties. In order to ensure a common and stable tax base, we therefore endorse, parallel to the CCCTB, the development of a common EU double taxation treaty.

When discussing the territorial scope of the CCCTB, it is useful to make a distinction between the tax object (i.e. the income) and the tax subject (i.e. the person liable to tax on that income). As for the *tax subject*, we believe that the CCCTB should only cover resident entities (i.e. entities situated within a CCCTB-country). The inclusion of foreign tax residents

¹ CCCTB WP 019 – International aspects in the CCCTB.

² CCCTB WP 026 – The territorial scope of the CCCTB.

would generally extend too far as the taxing rights of such entities lies outside of the EU. An exception refers to domestic sources held indirectly through foreign entities. This issue will be dealt with further below.

Under this approach, it may be necessary to uphold an appropriate distribution of the taxing rights *vis-à-vis* third country entities through transfer pricing rules. Any such rules should be developed around the arm's length principle. To ensure a common tax base, it is important that these rules are adopted as part of the CCCTB-regulation. For reasons of efficiency, they should also be accompanied with an appropriate dispute resolution mechanism.

As foreign residents are excluded, the CCCTB needs to provide for a clear distinction between CCCTB and non-CCCTB entities. The country of incorporation seems appropriate as a main criterion. However, the CCCTB should potentially also include non-incorporated entity types. Additional criteria, as well as a tie breaker rule, might therefore be necessary. In line with article 4 of the OECD Model Tax Convention (OECD MTC), the "place of effective management" as defined in the commentaries to the model should be considered.³

The CCCTB must furthermore establish the types of entities to be included. The Task Force agrees that the scope of entity types covered by the CCCTB should be as wide as possible. Company groups are currently structured using a wide range of various entity forms. For reasons of neutrality and efficiency, the taxation should not influence the choice of the business form.

With the exception of dividends, all types of *tax objects* should be included in the CCCTB (e.g. business income, royalties, interest etc.). No distinction should be made between domestic and foreign income in this respect. The exclusion of certain income leads to difficult delimitation problems and should therefore be limited to dividends. This exception is motivated by the importance of avoiding the economic double taxation of the underlying income.

In its paper, the Commission suggests that certain income, such as foreign passive income, potentially could be left outside the CCCTB and taxed according to domestic rules. The Task Force would like to emphasize that such a "split approach" is unacceptable. The aim of the CCCTB is to replace 25 parallel tax systems with one common scheme. A split approach would counteract the very purpose of a common and simple tax base as it would lead to a situation where company groups no longer have to comply with up to 25 but rather 26 tax systems. It would also lead to great demarcation problems, complexity and counteract the important goal of predictability. In relation to passive income it would also introduce into the tax system of many Member States a new concept of passive income.

For these reasons, the CCCTB must be a comprehensive system which is "exclusive" and not "supplementary" to the domestic tax regimes. That is, where a company has opted for the CCCTB treatment, its income should be taxed solely under this system and Member States must not impose any taxation by reference to their domestic rules (e.g. on income exempt under the CCCTB).⁴

³ According to the commentary to article 4 the place of effective management "*is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made*".

⁴ This does not exclude the application of double tax treaties.

Territorial scope of the CCCTB

There seems to be a considerable confusion in how to understand the concepts of “territoriality” and “world-wide taxation”. To avoid misunderstandings it is crucial that concepts are clearly defined. For the purpose of this paper, they should be understood as follows:

Territoriality - taxation due to the source of the income (within the territory)

World-wide taxation - taxation due to the source of the income and/or residence of the tax subject (within the territory).

In general, the Task Force sees great benefits in designing the CCCTB around the principle of territoriality (i.e. source taxation) *provided* there will be no underlying domestic taxation of any exempt income.⁵ For reasons of competitiveness, the CCCTB should also allow for the deduction of foreign losses, possibly accompanied with a recapture mechanism. Such an approach would be simple, competitive and resolve many of the double tax problems currently arising due to overlapping tax jurisdictions.

Even though some countries are taxing on a source basis only, most Member States are taxing on a world-wide basis. Perhaps these States hesitate to make such a shift for the CCCTB relative to their existing national systems. Should this be the case, there are a number of aspects that have to be considered in order to ensure a CCCTB which is sufficiently simple and competitive and which resolves the many double tax problems that arise under a world-wide approach. Some principal aspects of such an approach are dealt with below.

As a general remark, the inclusion of world-wide income does also mean the inclusion of world-wide losses. There must be no limitation in this respect. Furthermore, the territorial scope of the CCCTB must be uniform for all CCCTB countries. That is, the CCCTB should *either* follow the principle of territoriality *or* world-wide taxation. A divided system where some countries uses one system and some the other (as sketched in para. 28 of the Commission working paper – WP026) is not acceptable as it would lead to insurmountable complexity and counteract the very purpose of creating a simple and *common* system.

A CCCTB based on world-wide taxation

Scenario 1 - Income earned by residents from sources within the CCCTB jurisdiction.

Income (and losses) earned by residents from sources within the CCCTB jurisdiction are to be included in the CCCTB.

When determining the source of an income, it is crucial to recognise that it refers to the place where the income creating activity is carried out. Royalties are consequently sourced in the country where the research etc. is conducted and/or where the licensor is situated (and not where the licensee is situated). Likewise the source of an interest income is where the lender is situated (and not the borrower). Dividends (as after-tax business income of the shareholder) are sourced where the subsidiary is residing and business income where the activity is carried out. This approach follows the commonly accepted principles established in the OECD MTC.

To optimize the benefits of the CCCTB and provide for a competitive system, CCCTB source income should be included and consolidated also where the source is held indirectly by a

⁵ Most notably of income from third country sources.

resident via a third country intermediate. A disqualification of such “indirect sources” from the CCCTB would contradict the objectives of neutrality and efficiency.

Scenario 2 - Income earned by residents from sources without the CCCTB jurisdiction. As a consequence of the world-wide approach, income and losses attributable to foreign sources should be included in the CCCTB. This also regards third country sources held through tax transparent foreign entities.

The taxation of non-CCCTB sources will inevitably lead to double taxation. As established above, this should be resolved by means of exemption. For reasons of competitiveness and to uphold the important principle of net taxation, this approach must not interfere with the possibility of deducting foreign losses. However, to prevent double non-taxation, it seems necessary, despite added complexity, to accompany this possibility with a recapture mechanism for later profits.

The CCCTB regime needs to provide for a clear and common PE definition. Considering the widespread use of the OECD MTC, the definition developed therein should be considered. What is more important, foreign income that is not attributable to a foreign source as defined under the CCCTB-legislation must not be taxed by means of the domestic rules in the relevant Member States. For the reasons mentioned above, the CCCTB tax jurisdiction must be defined exclusively by the common foreign source definition.

An important issue is how to calculate the income from third country sources. Self evidently, income from sources within the CCCTB-jurisdiction should be calculated according to the CCCTB regime. With respect to foreign sources, however, a calculation following the rules in the foreign state could also be acceptable. This would ease the administrative burden considerably since there would be no need to recalculate the income according to the CCCTB regime. Furthermore, it would not contradict the objective of having a *common* tax base as all companies would apply the same foreign rules.

At the same time, however, the very core of the CCCTB is to enable a calculation of all income and losses according to the same rules regardless of where they are generated. To comprise these contradictory objectives, we therefore suggest that it should be possible for the companies to elect whether the calculation of foreign source income should be done according to the CCCTB-rules or if the rules of the third state should be used for CCCTB purposes. Such an election could be combined with a minimum time limit for a re-election. Regardless of the calculation method used, the income should then be consolidated under the CCCTB-regime.

Finally, we agree with the Commission that income covered by the CCCTB should not be subject to withholding tax within the CCCTB jurisdiction. This would contradict the very idea of eliminating double tax problems currently arising between the Member States. This should be established directly in the CCCTB-regulation.

Scenario 3 - Income earned by non-residents from sources within the CCCTB jurisdiction. According to previous suggestions, entities situated outside the CCCTB-area (i.e. non-residents) should not be included in the CCCTB as such. For the reasons established above, income attributable to a domestic source held by a non-resident entity should nevertheless be

included if that entity is ultimately owned by a CCCTB-parent. In such cases the income of the source and the parent should be calculated and consolidated under the CCCTB rules.

The importance of resolving double taxation and to tax only net profits does, however, extend beyond this situation. It is equally immediate where there is no direct ownership relation between the CCCTB-entity and the CCCTB-source, but where they are both held by a common foreign parent. We therefore strongly suggest that such source income also is included in the CCCTB.

Additional issues and remarks

A crucial issue in each scenario above is the allocation of profits and losses to the PE (foreign or domestic). We believe that the most appropriate approach is to follow the arm's length principle established in the OECD MTC.

The Commission suggests that the use of the exemption method would have to be accompanied with prudent anti-avoidance rules. It is crucial that any such rules are only adopted where absolutely necessary and to ensure that they do not infringe on the principle of net taxation. Anti-avoidance rules also tend to be complex and infringe on the objective of predictability.

An important issue is how to define the concept "group of companies", that is, to what extent do two or more companies have to be related in order to benefit from the CCCTB. The answer very much depends on how the consolidation is to be calculated. For reasons of simplicity, we believe that the consolidation should be based on the companies' entire income or losses (rather than a fraction thereof based on the level of ownership). As a consequence, the group concept will most likely require a minimum level of ownership. Any such threshold should, for reasons of competitiveness, be kept as low as possible. Such a threshold should also recognise indirect holdings through third country entities.

Finally, in order to ensure a uniform application of the CCCTB rules throughout the Member States, the CCCTB needs to provide for common definitions in a number of aspects. This especially regards terms such as 'tax residence', 'income', 'loss', 'permanent establishment', 'branch' and 'company/entity' (covered by the CCCTB).

Conclusions

In conclusion, we would like to see a system which is based on *Capital Import Neutrality* and which features the following principal characteristics:

1. The CCCTB must be comprehensive and exclusive in relation to domestic systems. No taxation must be levied under domestic rules.
2. Double taxation should be relieved by means of exemption.
3. The CCCTB should only cover entities situated within a CCCTB-country.
4. The scope of entity types covered by the CCCTB should be as wide as possible.
5. A system based on source taxation (territoriality) is preferred if it is accompanied with the competitive feature of foreign loss deduction, with a possible recapture mechanism.
6. If taxation is to be levied on world-wide basis (as defined above), both income and losses attributable to foreign sources shall be included.

7. Under a world-wide regime, foreign source income shall be exempt to avoid double taxation.
8. The exemption of foreign source income must not infringe on the possibility to deduct foreign losses. It could, however, also under a world-wide regime, be accompanied with a recapture mechanism to ensure taxation of net profits.
9. Dividends must under any regime be exempt to prevent economic double taxation.
10. All other income/losses (most notably business profits, royalties and interest income) shall be included in the CCCTB.
11. The source of an income refers to the place where the income creating activity is carried out (royalties where e.g. the licensor is situated, interest income where the lender is situated, dividends where the subsidiary is residing and business profits where the business is performed).
12. The CCCTB must provide for common definitions of central concepts such as “permanent establishments”, “tax residence”, “income”, “loss” etc.

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