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COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)

CCCTB: possible elements of the sharing mechanism

Meeting to be held on 10, 11 and 12 December 2007

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WORKING DOCUMENT

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Executive Summary: Based notably on the work undertaken in the context of the CCCTB WG and its sub-group on the sharing mechanism, the Commission Services in this paper present some initial ideas on a possible apportionment mechanism for a CCCTB. A three-factor formula, based on company-specific data, with labour (consisting of equal weighted payroll and number of employees), assets (without intangibles and financial assets and inventory) and sales (measured 'at destination') is suggested as a promising approach for sharing the consolidated tax base of a group of companies. The Commission Services consider that the weighting of the factors is not a technical issue and recommend that any discussion on the weighting be carried out at political level. Therefore, a discussion of the weighting of the factors is not included in this paper. To apportion the tax base to a given jurisdiction a physical presence of the company (such as a permanent establishment or a subsidiary) should be necessary. In the case of sales to third countries or Member States without physical presence (so-called no-where sales) a spread throw-back rule should be applied, i.e. these no-where sales should be included in the sales factors of companies on the basis of their proportionate share of the other two factors – labour and assets. The Commission Services also consider useful the introduction of a so-called safeguard clause in case where the outcome of the apportionment for a specific company would obviously lead to an unfair result. The ideas set out in this paper are meant to invite experts' comment and do in no way prejudge the contents of a possible future Commission proposal

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I. Purpose of the paper

1. This paper sets out the possible elements of a mechanism to share the Common Consolidated Corporate Tax Base (CCCTB) among the various entities of the consolidated group. It is notably based on work done to date in the CCCTB Working Group (WG) and its sub-group 6 on the sharing mechanism[1], but also seeks to take account of the discussions with business and academics.

2. This paper should be read in conjunction with the Commission Services Working Document on '*CCCTB: possible elements of a technical outline*' (hereinafter: the 'outline of the CCCTB')[2]. In particular, definitions of eligible entities, taxpayers, consolidated group and consolidated tax base are contained therein and are assumed to be known here.

3. The purpose of the paper is to prompt comment and discussion on key issues in order to assist the Commission Services in taking the work forward and to highlight a number of areas on which further guidance from the WG would be helpful.

4. The paper merely represents work-in-progress and does not purport to be comprehensive. Guidance on outstanding matters would be welcome. The ideas presented in this paper are meant for discussion and do in no way pre-judge the contents of a possible future Commission proposal.

II. Scope of the paper

5. The paper covers the basic rules for sharing the tax base among the various entities of consolidated groups. The same rules would apply to a single resident entity with one or more Permanent Establishments (PEs) in the EU and also non-EU-resident entities/groups with two or more subsidiaries/PEs in the EU. For the sake of simplicity, the paper refers to a 'group' but this would also mean all possible combinations of resident and non-resident companies and PEs. Certainly, the sharing mechanism would only apply to EU subsidiaries/PEs; the relationship to the non-EU entity would remain on arm's length pricing. For the sake of completeness it should be noted that it is irrelevant whether the subsidiaries/PEs are located in the same MS: in other words, the sharing mechanism would apply also in a purely domestic situation. Applying the sharing mechanism to purely domestic consolidated groups seems necessary because every member of the group has to know exactly the amount of its apportioned tax base, in order e.g. to be able to off-set pre-existing losses or tax credits.

6. The particular situation of some economic sectors like financial institutions, transportation services like airlines and railways, television and broadcasting etc. and

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[1] As foreseen in the terms of reference for the CCCTB Working Group, a sub-group was set up in December 2006 to analyse more closely the issue of sharing the tax base. That subgroup was chaired by the Commission Services and met twice in Brussels in February and June 2007. The results of those meetings are summarised in two Commission Working Documents that were presented at the meetings of the main Working Group held after the meetings of the subgroup and can be found at the following web-page: http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/article_3831_en.htm and http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/article_4381_en.htm

[2] It is the Commission Services Working Document CCCTB\WP\057, which can be found at the following address: http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm. That document began to bring the various structural elements of the base together into a coherent set of rules and was presented at the CCCTB WG meeting on 27-28 September 2007.

how the CCCTB might need to be adapted to take their needs into account is currently being reviewed and this paper does not cover any possible special sharing mechanism which might be recommended for them (see also section VII).

III. Basic principles of a possible sharing mechanism

7. The Commission Services believe that one of the major benefits of a comprehensive reform of corporate taxation in the EU come from the EU-wide consolidation of profits and losses earned by various entities of the same group located in different MS[3]. However, the consolidation requires a mechanism to share the consolidated tax base among the various entities of the group. The sharing mechanism itself is not the purpose of the comprehensive tax reform, but a necessary and unavoidable consequence of the consolidation.

8. The sharing mechanism is aimed

   - To be as simple as possible to apply for taxpayers and tax administrations and easy to audit for tax administrations;
   - To be difficult to manipulate by taxpayers, i.e. the mechanism should not rely on factors the location of which are easy to move so as to artificially shift (part of) the consolidated taxable base to benefit from any differential in corporate income tax rates across the EU; and
   - To distribute the tax base among the various entities concerned in a way that can be considered to be fair and equitable; and
   - Not to lead to undesirable effects in terms of tax competition.

   It is not the purpose of the sharing mechanism itself to replicate the current distribution of the national shares of multi-national groups' taxable profits (which would also have to take into account the effects of the new base size and of consolidation) and therefore the sharing mechanism should not in principle be designed with that goal in mind. However, the Commission Services are well aware of the political importance and sensitivity of potential budgetary implications for the MSs. MSs are informed about and involved in the extended impact assessment which is currently being carried out to assess, among other things, the impact of the comprehensive tax reform proposal on geographical distribution of EU multinational groups' tax bases[4].

9. In theory, various methods to share the tax base are available and have been discussed within the CCCTB WG, in particular a macro-based approach, and two micro-based or firm-specific approaches: a Value Added key and a formulary apportionment. Detailed information on the discussions is available in the relevant Commission Services Working Documents, together with the reasons why the formulary apportionment was

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[3] For example the Communication [COM(2007) 223 final] from the Commission to the Council, the European Parliament and the European Economic and Social Committee on: '*Implementing the Community Programme for improved growth and employment and the enhanced competitiveness of EU business: Further Progress during 2006 and next steps towards a proposal on the Common Consolidated Corporate Tax Base (CCCTB)*' in http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm, or the Commission Services Working Document CCCTB\WP\047 on '*The mechanism for sharing the CCCTB*' in http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/article_3147_en.htm

[4] See the Commission Services Working Document CCCTB\WP\058 '*Input from national tax administrations for the Impact Assessment of the reforms at the EU level of corporate tax systems*' and its Annex, in http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/article_4381_en.htm

seen as the preferred approach, rather than the macro-based or the Value Added approach[5].

10. The 'formulary apportionment' approach (i.e. an apportionment based on a formula containing company-specific factors) seeks to share the tax base by using weighted factors. The Commission Services suggest a multiple-factor formula in order to create a robust, i.e. not volatile apportionment mechanism. If a formula consists of three or more factors the relocation of one unit of one of these factors would shift less than one unit of the tax base. A mix of factors is also more likely to capture all the key profit-generating factors. In addition, negotiations on the definition (the scope) and the weighting of the factors among Member States with the aim of finding a generally acceptable formula seem to be easier if three or more factors are used.

11. The Commission Services' view is that the sharing mechanism should attribute the shares of the consolidated tax base to the various entities of the consolidated group on the basis of micro-based apportioning factors that contributed to the generation of the taxable base (profits) of each individual taxpayer. The Commission Services also believe that the sharing mechanism should preferably take account of both the supply and the demand side on the generation of companies' income. The production/supply side of profits' generation should be represented by the production factors (i) labour (measured by means of payroll and possibly number of employees) and (ii) capital (measured by means of assets) whilst the demand side in profits' generation should be represented by a 'sales by destination' micro-factor.

12. The formula to apportion the tax base to a company A of a given group would be as follows:

$$\text{Tax Base A} = \left(\frac{1}{\mathrm{m}} \frac{\text{Sales}^{\mathrm{A}}}{\text{Sales}^{\mathrm{Group}}} + \frac{1}{\mathrm{n}} \left(\frac{1}{2} \frac{\text{Payroll}^{\mathrm{A}}}{\text{Payroll}^{\mathrm{Group}}} + \frac{1}{2} \frac{\text{Number of employees}^{\mathrm{A}}}{\text{Number of employees}^{\mathrm{Group}}} \right) + \frac{1}{\mathrm{o}} \frac{\text{Assets}^{\mathrm{A}}}{\text{Assets}^{\mathrm{Group}}} \right) * \text{CCCTB}$$

with $\frac{1}{\mathrm{m}} + \frac{1}{\mathrm{n}} + \frac{1}{\mathrm{o}} = 1$

13. The Commission Services consider that the weighting of the factors is not a technical issue and recommend that any discussion on the weighting be carried out at political level and once the impact assessment of the different possible options has been carried out.[6] Therefore, a discussion of the possibilities how to weight factors is not included in this paper. However, as a working assumption an equal weighting of the three factors labour, assets and sales could be assumed.

14. It is extremely important that the formula is uniform across all MS, i.e. MS should not be allowed to apply domestic variations to the formula by attributing different weights to the factors, adding or eliminating factors or using different rules for defining the factors. However, as it will be discussed in section VII, it should be possible to apply a limited set of variations to the standard formula for certain specific sectors – provided that also the sector specific formulae are uniform across the EU.

[5] See in particular CCCTB\WP\052 in http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/article_3831_en.htm
[6] See paragraph 25 of the Working Document CCCTB\WP\058 mentioned in the previous footnote 4.

15. The Commission Services suggest that all taxable income, i.e. business and non-business income, earned by the group should be consolidated and apportioned on the basis of the given formula (in other words, the income to be shared is the consolidated tax base calculated in accordance with the CCCTB rules, without further adjustments). Alternatively, a distinction between 'business' income (income earned in the ordinary course of trade and business) to be shared and 'non-business' income (mainly passive income such as interest, royalties and dividends) to be allocated directly to the MS of source may be drawn. However, such a distinction would increase the complexity of the system and would open up possibilities for profit shifting within a group.

16. The share of the tax base should be apportioned to each individual entity in accordance with the given formula. This seems preferable to the alternative solution of apportioning the share directly to the taxing jurisdictions (the MSs). The distinction is relevant when in the same MS there is more than one entity entitled to receive a share of the tax base. Although attributing the share of the consolidated tax base to the MS would possibly simplify the calculations (in particular as regards sales, as shown below), it is necessary that each entity knows its tax base to calculate its tax liability on the basis of its specific situation (for instance pre-existing losses, possible tax credits, etc.).

IV. Basic principles of a possible formulary apportionment

17. This section deals with the basic rules for (i) defining the scope, (ii) valuing and (iii) locating each of the factors used in the formula. It should be borne in mind that in a multiple-factor formula with e.g. an equal weighting of the factors there is an element of self-adjustment and choices concerning each factor have a limited impact on the final outcome. Therefore, when an approach has been suggested for the sake of simplicity, it should be noted that a more complicated approach would in all likelihood not significantly change the result[7], particularly at an aggregate level.

18. The calculations for sharing the tax base would be done annually. The current Commission Services view is that a positive consolidated tax base (net profit) would be shared immediately, but a negative consolidated tax base (a net loss) would be carried forward at the level of the group and would be off-set against future consolidated profits.

19. Rules for entering entities in relation to the consolidation would apply to the sharing as well. For instance, it is currently considered that an entity entering the group in the middle of the tax period would have to split the tax period in two parts and apply consolidation and sharing for a fraction of the tax period. In this case, time apportioned factors should be applied. These would also be applied if a company leaves the group in the middle of the tax year.

V. Factors to be included in the formula

1. Labour

20. The Commission Services tentatively suggest a labour factor that consists of two equal weighted elements: payroll of the work force and number of employees.

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[7] For example the valuation of assets at fair value instead of at tax written down value.

21. To calculate the share of the tax base for a given entity on the basis of the labour factor, it is necessary to know the costs and the number of the qualifying work force attributable to that entity and compare that value with the cost and the number of the qualifying work force attributable to the entire group. Therefore, three elements need to be known to define the factor: (i) scope of the work force (ii) value (cost) and (iii) location of the work force.

22. As regards the qualifying work force (**scope**), it is suggested that all personnel employed by a given entity should be covered, including managers and directors. The definition of an employee should be based on domestic legislation of the MS where the employee works and should mutually be recognised among MSs, similarly to the mutual recognition of, for instance, environmental legislation as far as provisioning for clean-up costs is concerned.

23. It is suggested that also personnel employed under interim/temporary contracts should be accounted for by the 'effective' employer if this interim personnel provides the same services that would have normally been performed by the firm's 'ordinary' employees.

24. On the contrary, outsourced services to third parties (cleaning, security, and in general any provision of services which goes beyond simply putting workers at the disposal of the company) should not be taken into account. However, if the service supplier of the outsourced services belong to the same consolidated group as the company receiving the service, from the point of view of location of the factor, the labour costs of the employees providing the 'outsourced services' should be attributed to that entity where the employees are effectively working. In this case, one should look at the place where the services are performed (see below).

25. As regards their **cost**, it is suggested that the figure to take into account is the remuneration that is taken into account as a deductible expense for the purpose of calculating the tax base, including fringe benefits, social contributions, stock options etc. This direct link between deductible costs under the CCCTB and sharing of the tax base would render the calculations fairly straightforward.

26. It should be mentioned that during the discussion in the WG and sub-group 6 the issue arose whether there should be adjustments to correct differentials in wage levels across EU countries. Some experts called for some adjustment to take into account the lower average level of wages in some MS to avoid an unfair apportionment. In contrast, other experts favoured a simple approach only based on the amount of wages paid without any inclusion of a correction based on headcounts. The Commission Services would not suggest including such an adjustment[8]. However, the inclusion of the number of employees as an apportionment factor has to some extent a similar effect.

27. As regards their **location**, it is suggested to look at the place where the employees provide their services. In the vast majority of cases this will coincide with the place where the entity that registered those employees on its 'payroll' is located. However, there may be cases where a person is registered as an employee in a given entity but effectively performs her/his services for another entity, possibly in another MS. In this case the (seconded) employee would be counted for the 'payroll' allocation factor of the latter entity. This rule is coherent with a similar rule for assets (see section below) and aims to avoid factor shifting, especially in an intra-group context. Where employees provide their services for different entities during a tax year, their cost should be shared

[8] Among the various arguments already expressed, it should be stressed that such an adjustment should – to be coherent – also apply to the other factors.

based on number of months. A kind of 'de minimis' rule could be considered in case of very low costs of seconded employees in proportion to the total payroll in order not to increase compliance costs for companies in situations with only a minor impact on the apportionment of the tax base.

28. The number of employees (full-time equivalent) of each entity of the group should be determined taking into account the scope and the location of the workforce as described above.

2. Assets

29. To calculate the share of the tax base for a given entity on the basis of this factor, it is necessary to know the value of the qualifying assets attributable to that entity and compare that value with the value of the qualifying assets attributable to the entire group. Therefore, three elements need to be known to define the factor: (i) scope of the assets (ii) value and (iii) location of the assets.

30. As regards the qualifying assets (**scope**), theoretically a broad definition of assets involved in the generation of profits would be appropriate. However, for reasons of practicality and simplicity it is suggested that only fixed tangible assets (land and buildings, plant and machinery, other fixture and fittings, tools and equipment) should be taken into account. This means that intangibles, financial and current assets (including inventory) would be excluded from the denominator and numerator of the formula. All the other fixed tangible assets should be taken into account for the asset factor including idle (i.e. not used) assets.

31. Although inventory (stocks) could represent a very important component of assets for certain sectors (e.g., trading companies), the Commission Services would tend to propose the exclusion of inventory from the asset factor because inventory could be rather mobile and therefore their inclusion could be prone to manipulation (e.g., establishment of a warehouse in a low-tax country in order to shift part of the tax base in this country via an increased asset factor).

32. The reason for suggesting not including financial assets in the asset factor is that due to the mobility and high value of financial assets they could easily be used for factor and thereby tax-base shifting purposes. An exception for financial institutions could be envisaged as financial assets represent the main income generating part of the asset factor for those institutions.

33. The reason for suggesting excluding intangible assets is mainly of a practical nature. First, it is sometimes very difficult to value intangible assets, especially self-generated intangible assets. Although one could find methods for doing that (such as valuing intangible assets by subtracting from the value of the company as a whole the value of all identifiable assets and liabilities - residual of a full company valuation), this would lead to complex calculations and high compliance costs for companies. Although intangible assets purchased from third parties could be easily measured by their purchase price, this would lead to an unfair solution (for apportionment purposes) for companies that predominantly use self-generated intangible assets. Indeed, self-generated intangible assets would not be included in the asset factor; however the ability of intangible assets to generate income does not depend on their internal or external origin. Second, even if a solution for their valuation was found, some uncertainties on their location would still remain, especially when intangibles are created and/or used by the entire group and not by a single member of the group (such as a brand). Third, intangible assets are very mobile and could be used as a tax-planning tool to shift part of

the factor from one tax jurisdiction to another (the transfer of (intangible) assets within a consolidated group would be done in a tax neutral manner, e.g. at tax written down value).

34. It should be mentioned that some experts in the WG have voiced their concern that in case intangibles were not taken into account, an important income-generating factor would be disregarded, thus leading to a misattribution of tax base. However one could argue that intangible assets – and their contribution to generating income – are already (partly) included indirectly in the apportionment formula via the other factors: salaries of researchers and other employees dealing with intangibles; assets used for creating intangibles (unless written off immediately or deducted in full as explained in the 'outline' paper); and proceeds from the sales of goods or services which include in their value the value of intangibles (the location of these sales depends on the applied concept of sales, i.e. sales by origin or sales by destination).

35. The Commission Services consider that, for the reasons mentioned above, intangible assets should not be counted for in the assets factor. However, the Commission Services are interested in the views of those experts who recommend including intangibles in the asset factor, and in particular in their suggestions on how the valuation and location problems referred to above could be overcome.

36. As regards the **valuation** of assets, the Commission Services suggest taking into account the tax written down value (historical costs minus tax depreciation) of the assets (or of the pool, in case of non-individually-depreciated assets[9]). This would allow for a straightforward identification of the value to compute in the formula. Other options (fair value, historical cost or even a flow approach) have been considered but the tax written down value approach seemed to be the most suitable approach. Among the various arguments in favour of making use of the tax written down value, one should mention that the tax written down value reflects most closely the market value of the asset (the market value was seen as the theoretically correct value of an asset but was disregarded due to the difficulties and compliance costs related to measuring it, i.e. the costs and difficulties of revaluing all assets each year would be disproportionate to the benefits of using market value as opposed to tax written down value).

37. The method to determine the tax written down value of the qualifying assets could be as follows: first, the tax written down value of the qualified individually depreciated assets could be taken from the calculations prepared for the tax base of the entity; second, in case of pooled assets, the tax written down value of the entity's assets pool at the end of the tax year could be used. In accordance with the proposed rules on depreciation in the outline paper, inventory, financial assets and intangible assets would not be included in the pool. The former two are not depreciable assets and the latter ones are, where appropriate, depreciated individually.

38. To calculate the asset factor the year end's tax written down values of the assets could be used. Alternatively, an average value of the tax written down value of the assets could be taken into account. This seems necessary to fairly reflect the fluctuation of assets (due to e.g., purchase, construction, sale of assets etc.) during the tax year. The average value should be determined by averaging the values of the tax written down value at the beginning and ending of the tax year. For example if tax rate increases/decreases were announced in a given MS the group could consider to purchase a high value asset in December (instead of January when it is necessary) via an entity located in a given MS

[9] However the location of rented/leased assets depreciated 'in pooled' could give rise to compliance costs.

in order to increase the asset factor in this MS. The same could be done with a transfer of such an asset from one group company to another. Without the averaging method the full tax written down value of this asset would be taken into account by the asset factor in the relevant company, although this asset was only used for one month and therefore could also generate income only for one month in that company. On the other hand this kind of tax planning has only a 'one-year-impact' and therefore, it could be considered that by not averaging the objective of simplicity is emphasized in this case. Experts are invited to comment if in their view an averaging method seems to be necessary to prevent companies from this kind of tax planning.

39. As regards the **location** of assets, it is suggested to attribute the asset to the entity which is effectively using the assets. In the vast majority of cases that location would coincide with the location of the economic owner of the assets, i.e. who has the right to depreciate the assets; however there could be situations where the assets are depreciated by an entity but effectively used by another entity: this rule would assign it to the latter.[10] This rule is also coherent with a similar rule for seconded employees (see section above) and aims at avoiding factor shifting, especially in an intra-group context.

40. Such a rule would have implications in the cases of rented/leased assets. It would mean that intra-group leased/rented assets would be located for factor purposes where they are used, rather than with reference to the legal owner, or the company depreciating them for tax purposes. As regards leased/rented assets to/from third parties or related parties[11], leased/rented assets should be taken into account by both the lessor and lessee, the first[12] valuing them as any other assets (tax written down value) and the second valuing them at a fixed rate, at 8 times[13] the net annual rental rate. It should be noted that it is not a problem per se if an asset appears in two different formulae where the two parties of the leasing contract do not belong to the same CCCTB group (no risk of double (non) taxation), because the two assets indeed generate two different types of income.

41. When a group company sells assets to third parties the corresponding proceeds[14] would be shared and taxed. Intra-group asset transfers do not affect the consolidated base because they are recognised at tax written down value. However, they affect the apportionment mechanism because the location of assets determines the entities which are entitled to a share of the consolidated tax base. The following tax planning technique could be used: first, an asset is transferred at its tax written down value to an entity of the group located in a low tax MS without triggering taxation; second, the asset is sold to a third party, and a bigger share of the tax base would be attributed to the company located in the low tax MS because of the location of assets (factor shifting). However, the exclusion of easily movable assets such as inventory, financial assets and intangible assets and the location rule stating the effective place of use of the assets should already reduce strongly the room for such artificial planning techniques.

[10] The situation described above may occur depending on the tax base rules applicable to leasing (still to be drafted).

[11] Transactions between related parties that do not consolidate (between 20% and less than 75%) would be treated as third party's transaction for this purpose.

[12] For financial assets where the economic owner depreciated the asset, it would be the lessee who valued them at tax written down value; the lessor at 8 times the net annual rental rate.

[13] This figure has been suggested in line with current practice in the USA. That would lead to a constant valuation in line with the historical cost approach, rather than tax written down value.

[14] In case of 'pooled' assets the taxation is spread over several years because the proceeds decrease the depreciable base of the pool thus reducing the depreciation allowances which are available for deduction in future years.

42. As a possible anti-avoidance rule to counter intra-group transfers of assets towards low-tax MS, and subsequent sales of those assets to third parties within e.g. one year, the formula could consider the asset in the numerator of the fraction for the entity that originally owned the asset and not for the entity that owned the asset when the asset was sold or otherwise left the group[15] (if the sale to third parties occurs within e.g. one year from the intra-group transfer).

3. Sales

43. It should be mentioned that during the discussion in the WG and sub-group 6 the most controversial issue was whether a 'sales' factor should be included at all in the formula due to its conceptual and practical difficulties. However, sales could be seen as a reasonable apportioning factor since companies make profits only insofar as their output is sold. In addition, sales are currently used in formulary apportionment systems of the US and Canada and no plans seem to exist for changing this fact.

44. It should also be mentioned that most MS experts that would support the inclusion of sales as a factor would prefer sales measured 'at origin' (taking into account the place from which the goods are shipped) rather than 'at destination' (taking into account the place in which the goods are ultimately delivered). However, the Commission Services believe that **sales by origin** has a weak conceptual basis as an income generating and apportioning factor. First of all, it replicates to a significant extent the role played by assets and payroll as income-generating factors. Secondly, if intra-group transactions were eliminated from the factor – as it seems plausible both for conceptual and practical reasons – sales by origin would not attribute the tax base to the 'right' locations, in the sense that the effects of the contribution of intermediate inputs to the generation of income or the differences in productivity of the other factors across a chain of companies of a given group would not be 'picked up'.

45. The location of the factor 'sales by origin' could be easily manipulated (thus allowing tax planning via factor shifting) because the place of shipment to third parties is easy to control (although possible transportation costs have to be taken into account). A similar risk would exist for the 'sales by destination'-factor; however, due to transport costs (the goods are meant to be physically delivered to the place of destination) and the reduction of the profit margin (in case of the use of an independent agent, for instance) the factor shifting would be of less concern. In addition, sales by destination are less mobile, because companies can not control the location of consumers as they can with the location of assets and employees. Therefore there appear to be fewer possibilities for tax planning with a 'sales by destination'-factor. These are the main reasons why the Commission Services would be inclined to suggest the inclusion of a 'sales by destination'-factor in the formula.

46. Although the concept of **sales by destination** is currently not used for allocating taxing rights on corporate income among various jurisdictions (or at least not explicitly), it can be argued that 'demand' is an income generating factor since companies make profit only insofar as their output is sold. The role of a sales factor in the formula is to represent the demand side in the generation of income and for that it has to be measured at destination. 'Sales by destination' is used in existing formulary apportionment systems on this conceptual basis.

[15] Assets could leave the group other than because they were sold if, for example, the company owning the assets leaves the consolidated group, due to a sale of shares (all the shares or just enough to fall below the minimum voting right threshold, either permanently or temporarily), a business re-organisation, a change of legal form, etc.

47. It is also often affirmed that 'demand' in the MS of consumption is already taxed in the EU via VAT. However, also other factors (such as assets and payroll) are subject to other taxes than corporate income tax in the MS of production. Moreover, the inclusion of a factor in the formula does not imply a new taxation of this factor but the allocation of taxing rights among taxing jurisdictions on the basis of this factor. There was also a concern that compensating consuming states via corporate taxation would duplicate the effect of the VAT in the EU. However, only a part of the tax base – which would depend on the weight of the sales factor in the formula – would be attributed to consuming states; manufacturing states would be remunerated via the labour and the asset factor as supply-based factors.

48. If sales were to be included intra-group sales should be excluded, since they have not contributed to the consolidated income that the factor seeks to apportion. Also, if intra-group sales were in the factor they should be taken into account at arm's length price, thus re-introducing transfer pricing complexities that the system would like to eliminate. In turn, and taking the sales factor in isolation, excluding intra-group sales from the factor could lead to a rather different apportionment of the tax base compared to the current situation, because for instance manufacturing entities in a MS selling to marketing entities of the same group in another MS would have no (extra-group) 'sales' for the purpose of the apportionment. This reflects that the Member State where the manufacturing companies are located has played no role in the generation of the group's income from the demand side point of view. However, it has played a role from the production side and this should be reflected in the income allocated to that Member State through the supply-based factors (labour and assets). Thus, as mentioned before, in a multiple-factor formula each factor influences the final outcome only partially.

49. Similar to the two previous factors, it is necessary to compare the value of the qualifying sales attributable to a given entity with the value of the qualifying sales attributable to the entire group. Therefore, three elements need to be known to define the sales factor: (i) scope of the sales (ii) value and (iii) location of the sales.

50. As regards the qualifying sales (**scope**), it is suggested that only (but all) proceeds of sales of goods and provision of services should be covered (the core business) (like the item 'net turnover' of the profit and loss account). Revenues from exempt income (such as financial capital gains covered by the participation exemption scheme) and extraordinary income should not be counted for in the factor. Revenues from passive income such as interest, dividends, deemed dividends and royalty should not be included, either - unless it represents the revenues accrued in the ordinary course of trade or business (the core business). It should be stressed that the exclusion from the sales factor of revenues from passive income affects only the formula. As mentioned before the entire tax base would be shared among the various entities of the group (i.e., including passive income).

51. The suggested solution should avoid artificial attribution of mobile income to a favourable location (factor shifting). It would also avoid complex discussions concerning the location (where should a royalty be located? Where the payer is located or where the receiver of the royalty is located, or where the intangible that give raise to the royalty is located? Etc.)

52. As regards the **value** of sales, it is suggested that the figure to take into account is the one taken into account for the purpose of calculating the tax base, also in terms of non-monetary payment, exchange rate etc (see Para. 43 of the outline paper). As before, this direct link would render the calculations fairly straightforward.

53. As regards their **location**, it is suggested to attribute sales of goods for factor purposes to the (group) entity which is located in the MS where the sales to third parties occur, i.e. the final place of physical delivery (if identifiable, otherwise the last-identifiable third-party receiver of the physical delivery in the sales chain) (sales by destination). Intra-group sales would not be taken into account, and therefore transfer pricing issues will not arise.

54. To determine the place of destination the (existing, but also some of the currently proposed) VAT rules to determine the place where goods and services are deemed to have been supplied could be used as a starting point. Also, from a compliance cost view point, it would be relatively straightforward for companies to determine the location of the destination of sales in the various jurisdictions, as they already apply VAT rules.

55. Sales of immovable property could be located in the Member State where the immovable property is located. Sales of movable property could be located in the Member State where the goods are physically delivered, that is – if known – the place of ultimate destination. In the Commission Services' view the physical delivery of goods is an important requirement to prevent manipulations that could occur if for example only the billing address or other easy to manipulate requirements were to be used. However, in the vast majority of cases the rule of taking into account only the physical delivery coincides with the Member States where the purchaser is established. For particular cases particular rules should be determined. For example the sales of goods on transport services, e.g. ferries, could be located where the transport begins or ends.

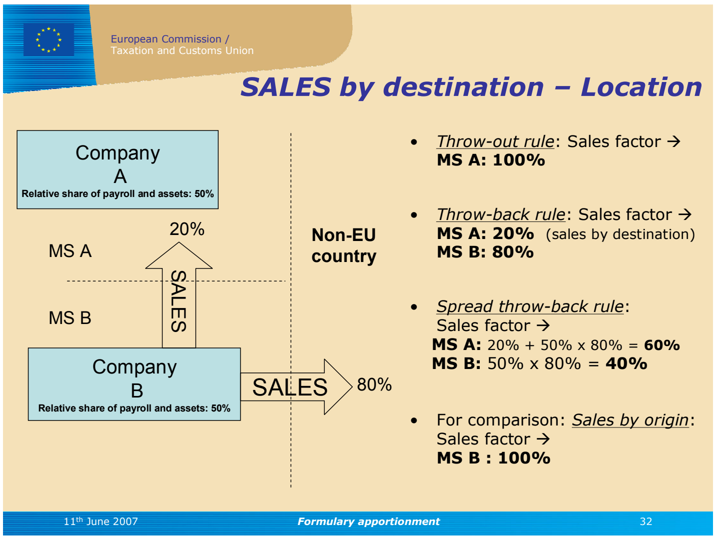
56. Services supplied that are related to immovable property could be located in the Member State where the immovable property is located. This would be a parallel rule to the sale of immovable property. The supply of other services could be located in the Member State where the services are actually used or enjoyed – this means at the destination of the service supply. For example, restaurant and catering services, cultural, artistic, sporting, scientific, educational, entertainment and similar, ancillary services to transport and work on movable property could be located in the Member State where the activities are physically carried out. Electronically supplied services, telecommunication services, radio and television broadcasting and distance teaching could be located in the Member State where the consumer is established.

57. The necessary data to locate sales should in principle largely be available via the recapitulative statements (VAT statement to record sales of goods made to other EU Member States) of the entities. However, in certain situations goods, such as triangular trades where the purchaser sells goods on to a second purchaser but the goods are delivered direct to the second purchaser by the original seller, the necessary information of the final place of delivery could not be taken from the recapitulative statement of the original seller but would have to be recorded and provided separately by the taxpayers. The same requirement for separate records would exist for services.

58. In cases where the sales occur in a MS where the group does not have a taxable presence (a subsidiary or a PE – see Nexus section below) or in a third country the sales would be taken into account by the other entities of the group proportionally to the other factors (spread throw-back rule). The spread throw-back rule gives implicitly a higher weighting to the other two factors – labour and assets.

59. It is suggested to apply neither the throw-out nor the pure throw-back rule due to the potentially incoherent results to which those solutions could lead. As it can be seen in the following example a throw-out rule would lead to the result that for Member State B no sales would be taken into account. A pure throw-back rule would result in the

introduction of sales by origin which could be seen as an inconsistency in a 'sales by destination'-concept.



60. When sales occur in a MS where the group has two or more entities, it is suggested that the sales should be taken into account by all the entities located there proportionally to the other factors (similarly to the spread throw back rule).

VI. Nexus

61. If a 'sales by destination'-factor is applied it is questionable how to treat sales that occur in a Member State where the group does not have a physical taxable presence like a PE or a subsidiary of the group (the same question arise with assets and labour, although it is less probable that assets and employees are located in a Member State without a physical presence). The question arises whether an economic nexus, i.e. the significant presence of at least one of the apportionment factors (asset, labour or sales) in that jurisdiction, should be sufficient to apportion some of the tax base to that Member State or if a physical presence, i.e. the presence of a PE or a subsidiary in that jurisdiction, is necessary. Theoretically, an approach based on a (significant) economic presence would be coherent with the idea that both 'supply' and 'demand' are the income generating factors. Furthermore, it would seem to more adequately deal with the challenges of the "internet economy". However, the Commission Services suggest that, at least for the time being, for the apportionment of the tax base a physical presence in this Member State should be necessary because the concept of economic presence would represent a completely new method for taxing companies' profits, which would also be not in line with OECD principles. Furthermore, the definition of nexus based on economic presence would imply that small companies currently only subject to corporation taxes in one MS, but also having significant sales in other MS would suddenly be liable to corporation tax in other MS thus increasing their compliance burden.

VII. Formula tentatively preferred by the Commission Services

62. As already mentioned before, the choice of the apportionment factors of a formula should follow the objectives that the formula should (i) be as simple as possible to apply for taxpayers and tax administrations and easy to audit for tax administrations; (ii) difficult to manipulate by the taxpayers; (iii) be considered to lead to a fair and equitable

distribution of the tax bases among the various entities concerned; and (iv) not lead to undesirable effects in terms of tax competition.

63. Therefore, the Commission Services suggest a three-factor formula with the factors labour, assets and sales. Contrary to a one- or two-factor formula, in applying a three-factor formula it is less attractive 'manipulating' one of the factors because such manipulation would change the apportionment only to the extent the factor is weighted.

64. The labour factor would consist of two elements: payroll and number of employees that could be weighted equally. The scope of the labour factor, in which employees would be taken into account, could depend on the definition of an employee in accordance with the domestic legislation and on a mutual recognition approach. The valuation of the payroll could be taken from the CCCTB rules to determine the taxable base. Both measurements fulfil the objective of a factor that is simple to calculate and easy to administer. The same is true in most of the cases for the location rule for the labour factor. However, in the case when employees would be located where they effectively work and not where they are on the payroll, higher compliance costs could occur, although such information should be available for the companies concerned.

65. The asset factor includes all fixed tangible assets. They would be valued for depreciable assets with their tax written down value (could be easily taken from the CCCTB rules to determine the taxable base) while certain non depreciable assets such as land would be valued at cost. Intangible and financial assets and inventory would not be included due to their potential for manipulation and difficulties in valuation and location (esp. intangible assets). The qualified assets would be located where they are effectively used, with special rules to be applied for rented/leased assets. The application of these special rules could introduce some kind of complexities but are borne in the necessity of preventing manipulations, although a de minimis rule could be applied to ensure any additional complexity were proportionate.

66. The Commission Services suggest a 'sales by destination'-factor especially because such a factor is less easy to manipulate by companies and thus due to its 'immobility' would limit the overall impact of the formula on tax competition in the EU. Only the proceeds of sales of goods and provision of services should be taken into account (the core business) with the necessary data available, in most cases, through the recapitulative VAT statements. In particular cases, companies will have to provide information on the effective place of delivery (on which they should have records). As a physical presence is necessary in order to allocate tax base to a jurisdiction, no-where sales could occur if the group does not have a PE or a subsidiary in the destination state of the sales. In such cases a spread throw back rule should be applied.

67. When deciding on the composition of the apportionment formula, the likely impact on tax competition among Member States also has to be taken into account. The purpose of the CCCTB is to remove the existing company tax obstacles to the smooth functioning of the Single Market. The purpose is not to intensify tax competition. However, the existing scientific literature seems to suggest that tax competition will be the stiffer, the more elastic the apportionment factors are to tax changes. A formula including mobile assets could therefore intensify tax competition while one including sales by destination could limit it. A mix of defined factors as suggested by the Commission Services could therefore lead to a balanced outcome.

68. The Commission Services suggest reviewing the whole formula, i.e. the factors and the weighting, after a period of e.g. 5 years in order to examine if the apportionment mechanism has lead to an apportionment that can be considered as a fair and equitable

distribution of the tax base among the Member States or if, on the other hand, some adjustments on the formula are considered to be necessary for the future.

VIII. Sector-specific formulae

69. In view of the specific characteristics of some economic sectors, a single apportionment formula covering all economic sectors may not adequately reflect the importance of the various factors generating profits in each sector. Thus, another issue, on which expert input is sought, is for which sectors (if any) a specific formula should be foreseen and how any specific formulae and factors could be defined for such sectors (keeping in mind that there was general agreement that sector-specific formulae should be as limited as possible). In the current view of the Commission Services the following sectors seem to need special formulae: financial services, transportation services such as airlines and railways, and television and broadcasting services.

70. To determine the sector-specific formulae it would be preferable to adapt as far as possible the measurement of the factors in the general formula to the specificities of a particular sector rather than opting for a completely different formula for the relevant specific sectors. Such an approach would have significant advantages in the case of groups active in different economic sectors (conglomerates), if it were decided to apply different sector-specific formulae to parts of such businesses.

IX. Safeguard clause

71. The Commission Services believe that it seems reasonable to introduce a safeguard or 'escape' clause in case the outcome of the apportionment for a specific company would obviously lead to an unfair result (e.g., the apportionment would not fairly represent the extent of business activities carried out in the various countries concerned). This would allow for – on request of the company and with authorisation from the tax administrations or on agreed request of all concerned tax administrations – the use of an alternative method to share the base. Such a safeguard clause should be applied only in very exceptional cases and should not mean re-introducing separate accounting and arm's length pricing to apportion the tax base. Since the apportionment concerns common interest, any such adjustment (deviation from the application of the apportionment formula) should be commonly agreed by the tax administrations concerned and not be granted or requested unilaterally. Another reason to introduce such an 'escape' clause is the need to react on changes in the business environment with an adjusted or specialised formula. Experts are invited to comment on how such a safeguard clause could be formed.