

Comments on Document CCCTB/WP060
Common Consolidated Corporate Tax Base Working Group
Possible Elements of a Sharing Mechanism

Introduction

On 10-11 December 2007, the Working Group held a meeting in Brussels to discuss the outline of a system for a Common Consolidated Corporate Tax Base. I was asked to participate in the meeting as a representative of one of the states of the United States which has had extensive experience with the sharing mechanisms employed by sub-national jurisdictions in the United States to divide a Consolidated (Combined) Tax Base of groups of affiliated entities that operate across jurisdictional borders.

The comments offered herein are my own and may or may not coincide with other representatives at the meeting from the United States. I have also included responses to some of the comments offered by the BusinessEurope Task Force on CCCTB dated December 7, 2007 and distributed at the meeting.

General Remarks

The recommendations by the Commission staff are to be commended. The recommendations are thoughtful and constructive and address most of the problems that can be anticipated. The use of such approach should largely alleviate transfer-pricing concerns within the European Union for those entities that elect to participate. In spite of actions by the States of the United States in allowing for the use of a water's-edge approach, consideration should be given to a broader, worldwide, application of the consolidated filing approach to remove all transfer-pricing concerns.

The proposal is to have the use of a CCCTB to be elective. Political realities may require that the use of a CCCTB be elective but it would be fairer to the business community overall, and would reduce the collective revenue loss to member states, if it was required with respect to all companies and all member states.

A key, and highly recommended, element of the proposal is the requirement that uniform rules with respect to consolidation and the sharing mechanism be adopted by all member states. The lack of the requirement of uniform rules has contributed to tax competition between the States of the United States. Furthermore, under the proposal the use of uniform rules is enforced by the various elements of the dispute resolution process. Having a single authoritative voice to resolve disputes between business entities and member states, and more importantly, between member states is another key element of the proposal which does not exist within the United States except as to limitations on over-reaching.

The recommendation involves the use of a three-factor formula patterned after the formula that has been employed by the States of the United States. In spite of the trend by the States of the United States to move to a single formula, sales, it is believed that a

multiple factor formula is a better approach. There is a benefit from averaging. The use of multiple factors results in no one element being dominate. An over emphasis of one particular activity can be offset or balanced by the consideration of other activities. This will limit the effects of tax competition. If the choice of formula elements balances the economic contributions to the earning of income it will allow the market, not tax strategies, to be reflected in investment decisions.

The elements of the sharing mechanism are relatively simple and rely to a large extent on data which is already maintained. This is a key to an effective system. It is premised on the realization that the factors of the sharing mechanism are a general representation of the activities of a business and that the factors are not what is being taxed and therefore not all activities have to be represented in the factors.

It is believed that the use of a sales factor is a key component of the proposal and furthermore that sales should be assigned by "destination" to reflect the contribution of the market to the earning of income. It should be emphasized, however, that destination does not necessarily mean where the product is ultimately consumed. Destination for the purpose of the sales factor means the customer of the group, not the ultimate consumer. If a group chooses to forgo profits arising from purchasers by the ultimate consumer this decision should be respected. The company that makes the final distribution will realize these profits and will assign them accordingly to its distribution.

Detailed Remarks

Para. 7 Once you go to a consolidated approach and abandon efforts to assign profits to entities, or geographically, a sharing mechanism is required.

Para. 8 These principles are appropriate. It needs to be emphasized that the results of the sharing mechanism are not expected to replicate the results of separate, or arm's-length, accounting. The use of a sharing mechanism is based upon the inherent difficulties and subjectivity of separate accounting and therefore it is not appropriate to judge the results of the sharing mechanism with separate results.

Para. 10 All of the observations in this paragraph are appropriate.

Para. 13 The equally-weighted three-factor formula was used by the States of the United States for decades. An argument can be made to use a double-weighted sales factor on the basis that property and payroll represent the demand-side and that sales, representing the supply-side, should carry equal weight. But on the other hand property and payroll are likely to place a greater demand on government services and therefore correlate to government costs. Any other variance probably has little support in economic theory and would ultimately be characterized as arbitrary.

Para. 14 The weighting of the factors may be "political" and subject to negotiation, it is critical, however, that it be uniform as to the member states, and as to all types of

business to avoid tax competition which is rampant between the States of the United States.

Para. 15 The introduction of different rules to assign different types of income will add complexity and disputes to an approach which is trying to be simple. Classification of income with different principles of assignment occurs within the United States because of jurisprudential concerns arising from the United States Constitution and application of that document by the United States Supreme Court. The European Union does not appear to be burden with those constraints and it would be an error to introduce them if they are unnecessary.

The "business purpose" test commented on by BusinessEurope appears to be a requirement generally accepted by tax agencies. If there is to be a business purpose requirement it should be uniform

Para. 16 The choice of the sharing of the tax base by entity rather than by Member State is much less significant when the rules for the assignment of income by type do not exist. The assignment by entity by the States of the United States is a product of having business and non-business income within the same entity or have two or more business conducted by an entity with a separate sharing mechanism for each business. If those complexities are avoided it would simpler to share the tax base by member state. This also might alleviate concerns with respect to the assignment of sales by "destination" as compared to "origination" and make "destination" assignment more acceptable and remove concerns regarding "nexus." See **Para. 61**

However, it should also be noted that there are strong arguments for sharing by entity when there are changes in the membership of the group either through acquisition or disaffiliation, see the comments on WP 057 Par 103-105. This will also have implications at the time this system is first implemented. It may implications as well to the extent a system of tax credits is used.

It is not clear how local (non-national?) corporate taxes will be integrated with this proposal. It would be viewed as fairer if they were but it may raise political concerns.

Para 18 The basic reason the States of the United States assign losses to an entity and carry them forward on that basis is because of the distinction between types of income (business and nonbusiness) and the possibility that an entity could have two businesses, i.e. two apportionment formulas. The model proposed by the commission does not have those drawbacks. If assignment were to be by Member State, rather than by entity, an argument could be made to do a Member State assignment for carry-forward purposes. This issue also has implications when there are acquisitions and divestures.

Para. 19 This appears to be appropriate. It should be recognized that payroll and sales are essentially self adjusting. Special rules are need for the property factor where you are proposing to average on a beginning-end-of- year basis.

Para 22 Concur, this appears to be the simplest approach. It does assume that the definition of employee does not differ significantly within Member States so that any variances will have a minimal effect.

Para. 23, 24 and 25 Concur generally. Disputes might arise with respect to contracting for temporary workers and whether their activities relate to the production of product or they are providing services such as cleaning and security.

Para 26 Making such an adjustment would add to the complexity and give rise to disputes. The footnote comment about a similar adjustment to the other factors is appropriate. Such an adjustment introduces an false element of precision which is unnecessary.

The use of a headcount component may be politically necessary. It is believed that wage rates will fairly quickly be equalized across boundaries through the market mechanism. This component may not be necessary in the longer term.

Para 27 The that entity employs an individual is not particularly significant when the apportionment formula is applied to a consolidated base and you are not judging its results by separate, or entity, accounting. It is the consolidated business that is the employer and the entity the individual should not be significant unless there are issues arising under Permanent Establishment rules. If you do entity allocation it becomes more significant but still should not be a problem as long as income is computed on a consolidated basis. It also may have some significance for nexus purposes and the allocation of sales.

Para 28 Little discussion about using headcount of employees. Certainly there should be an effort to measure headcount on the basis of some uniform factor such as personnel years or hours.

Para 30 Simplicity, and the fact you are not taxing the assets themselves, supports the limited definition proposed.

Para 31 The States of the United States have included inventory and have not viewed it as a significant problem of manipulation even though there is the possibility of locating warehouses in jurisdictions with low tax rates or no taxes at all. Writing on a clean slate excluding inventory appears to be a better approach.

Para 32 The concerns expressed with including them are appropriate. The issue raised about the treatment of financial companies is a real one. It becomes more significant in the case of a conglomerate which has non-financial activity. If there is a decision made that a single formula (See **Para 70**) should be used it will be necessary to determine an appropriate weighting for financial assets or they will skew the formula because financial assets typically can be leveraged. California addressed this in the circumstance of retailers or manufactures that established financial subsidiaries to facilitate sales by arbitrarily including intangibles at only 20% of their nominal value.

Para 33 - 35 Appropriate discussion of the issue of intangibles. In many cases it is difficult to determine a value. Of particular significance as to the exclusion of most intangibles is the fact that they are used by the group as a whole and therefore they should be assigned or located proportionally everywhere the group is. A tradename is a clear example of this but the same also holds true for an a patent which involves the product made, even though in one location, and marketed by the group everywhere. "Throwing-out" the intangible has the same result as assigning proportionally everywhere. In many respects a destination sales assignment rule would accomplish this result and might be viewed as an acceptable surrogate for assignment to the property factor.

Para 36 It has been the experience of the states that frequently tangible personal property assets continued to be used have they have been fully depreciated. In addition, no adjustment is made for the possible appreciation in the value of assets which may occur frequently with respect to real property. This may be particularly significant when assets are held in different countries and there are significant revaluation of currencies between the countries. The State have used the original tax basis of assets. There are some complaints about the effects of inflation on the value of assets but for sake of simplicity the use of original cost has been accepted.

Market based valuation of economic rent valuation should be avoided because of the complexities it would introduce

Para 38 The principal of beginning\end-of year averaging has been employed by the States of the United States virtually uniformly. This works well for addition of assets throughout the year even to the point of allowing more frequent valuations for averaging purposes if it is required for a fairer reflection.

Para 39 and 40 See comment on **Para 27**

Para 41 Concur that any gain on the disposal of assets should be included in the consolidated base and shared.

Para 42 As long as the proceeds from the disposal of assets is shared the specific entity which holds them at the time of sale should not be material. Also the physical location of the assets typically cannot be easily changed so concerns about manipulation should be minimal.

Para 43, 44 and 46 Concur

Para 45 The States of the United States have not found that destination sales are easily manipulated. As explained in the General Comment section, sales by destination are determined by the destination at the time the goods or services leave the group. While conceptually it might be preferable to reflect the purchase by the ultimate consumer it may not be possible for the manufacturer to know who or where that consumer is. If the

manufacturer is willing to forgo the final profit element, or is willing to lose control over being able to respond to a dissatisfied ultimate consumer, then that should be accepted and the "destination" of that sale is where a third-party receives possession of the item. The seller clearly knows that location.

Para 47 Concur and the VAT tax base provides data for sourcing sales. It should be recognized that including an item in a factor is not taxation of that item but rather using it as a measure of activity which is then applied to income.

Para 48 Concur Intra-group sales should be eliminated. It is only sales outside the group that should be taken into account.

Para 50 Concur. It is not the sale that is being taxed but the income. The sale is only used to measure a specific type of activity.

Para 58 If the concept of economic nexus is not acceptable then a "throwback" or "throwout" rule is absolutely necessary to avoid income escaping from taxation. The "throwback" rule appears to be preferable. The rule advocated by the report is different than the one used generally by the States of the United States but there does not appear to be a strong theoretical preference for one throwback as compared to another, both are inconsistent with a market approach. Throwback to an entity, as compared to a spread throwback at least retains a connection to the entity making the sale.

Par 60 The justification for this treatment turns on whether you do an entity allocation or country allocation.

Para 61 The concept of economic presence is obtaining currency in the United States. It is responsive to the "internet economy" and works well with destination sales. It is, however, non-traditional, and acceptable results can be achieved without resorting to economic presence. Trying to introduce economic presence, though preferable, might be too large a step to take. If sharing is done on a country basis as compared to an entity basis this may not be as big an issue.

Para 62-68 Concur

Para 69 and 70 Concur. Experience suggests that the adoption of special formulas should be done in a manner that allows that to be easily integrated with the standard formula. So, for example, in the case of transportation where many states use mileage as a single apportionment mechanism this result can be achieved by assigning the property used in transporting goods by reference to mileage, by applying mileage to the payroll factor and assigning receipts based on mileage. A three-factor formula is still being used with each of the components assigned accordingly.

The use of the standard formula becomes more difficult when, for example, in the case of a financial concern there is a desire to include intangibles in the property factor. Intangibles are frequently leveraged. Looking at raw macro data in the apportionment

base of one state it was found that the level of property per net income was approximately 10 as great for financials as it was for non-financial corporations.

The suggestion of a *de minimis* rule by BusinessEurope should be considered.

Para 71 Concur. It is particularly important that variations be done on a uniform basis to avoid tax competition. The manner of providing such relief or the standards to be used are much less important as long as the relief is uniformly applied or required. A panel of experts would appear to be an appropriate mechanism.

Comments on Annex to CCCTB/WP/060
Synthesis of possible apportionment rules

Para 3 This is not crucial. Losses can be shared just as easily as profits. This becomes significant if there are different treatments of types of income or multiple apportionment formulas applied to commonly-owned entities. It also has implications in the case of acquisitions or divestitures.

Para 7 It is suggested that a panel of experts make the determination which would then apply uniformly rather than having all competent tax authorities agree.

Para 9 Concur. Has consideration been given to the possibility of the pass-through having a different accounting period?

Para 13 Averaging would not be necessary if the number of employees was measured by "work years" or some similar metric.

Para 14 As long as you are sharing a common tax base it doesn't matter to what entity an employee is assigned assuming you have nexus (a need to deal with Permanent Establishment) to tax in the jurisdiction where the employee is performing their services.

Para 18.2 There can be a concern with respect to appreciated assets and the fact that assets may continue to produce the same income as they are depreciated and even after they are fully depreciated. This is more acceptable when there is a uniform income base with straight line depreciation.

Para 18.4 Eight times capitalization rate is as good as any. Note, however, this may give a current valuation rate while other property is done on depreciated original cost.

Para 20.1 See **Para 14**

Para 23 Concur. The sales factor is only a measurement of activity, not part of the tax base.

December 24, 2007

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