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COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)

*An overview of the main issues that emerged at the second meeting
of the subgroup on International aspects (SG 4)*

Meeting to be held on 1 June 2006

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WORKING DOCUMENT

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I Introduction

1. The purpose of this note is to give an overview of issues that emerged at the second meeting of the Subgroup on International Aspects (hereafter the 'SG4') and identify the issues that need to be further developed at the CCCTB WG's plenary on 1st June 2006. This document builds up on and refers to working documents 'International aspects in the CCCTB' CCCTB\WP\019\doc\en, 'The territorial scope of the CCCTB' CCCTB\WP\026\doc\en and 'An overview of the main issues that emerged at the first meeting of the subgroup' CCCTB\WP\029\doc\en and has to be read in close conjunction with them.
2. While the first meeting of the SG4 focused on more general structural and legal issues the second one concentrated on possible solutions for the CCCTB taking into consideration the scope of tax resident and non resident companies and what income earned by them should be covered by the CCCTB.
3. This document covers three main areas discussed by the SG4:
 - Possible solutions for foreign income of tax residents (worldwide/territoriality),
 - Income earned by non-residents from sources in the CCCTB jurisdictions, and
 - Definitions (tax residence, permanent establishment, foreign income).

The Commission Services presented a series of examples during the second meeting of the SG4 to illustrate the main issues and possible solutions. Similarly as in previous work on international issues experts concentrated only on situations where 'third countries' are involved, i.e. those outside the EU.

4. The question of allocation of profits to a permanent establishment emerged at the second meeting and experts discussed whether MS participating in the CCCTB will need to agree on a common approach. This topic represents a large area to be covered and will need further analysis. Members of the group are invited to give their preliminary views on what directions this work should take. Some of the key points to emerge, as explained below, were as follows:
 - For practical reasons it may seem preferable to exclude foreign income from the consolidation, but the method of allocation of profits to foreign PEs would have to be common, and would probably have to be done on the arms length basis.
 - As excluding foreign income does not avoid several complications (e.g. retention of arms length basis) the apparently more complex approach of including foreign income in the CCCTB should not be completely dismissed because of the benefits that it would be bring if a satisfactory method could be defined.
 - As regards income earned by non-residents from CCCTB sources, whether included or excluded from the CCCTB, it is likely that the arms length basis for calculating the profits of such PEs will be required under existing tax treaties with third countries, and again a common method would be desirable.
 - Significant work has already been carried out within the OECD on the question of allocating profits to PEs and this needs to be taken into account. As mentioned on various occasions rules and principles developed within the OECD, in general create a starting point for relevant parts of the CCCTB. The CCCTB aims for a much higher level of harmonization than the OECD work in relation to corporate

taxation, since the single market is a more integrated area than the OECD area, so the OECD rules do not necessarily give a suitable answer to all the issues that arise in connection with the CCCTB.

II Solutions for taxation of foreign income of tax residents (worldwide/territoriality)

5. The Commission Services outlined the four possible solutions of how to deal with the foreign income of tax residents. Two of them (A1 and A2) require participating MS to agree on either worldwide or territorial and the other two (B1 and B2) allow a combination of a worldwide and a territorial approach as they exclude the foreign income of tax residents from the consolidated tax base and leave it for participating MS to decide whether it should be taxable or not (worldwide or territorial). The description of the four possibilities is annexed to this document.

6. There was a general consensus that inclusion of foreign income in the consolidated tax base to be shared by participating MS might be too difficult. We have 23 world wide and 2 territorial systems among MS and they point out that the choice of the policy of (i) worldwide taxation and credit / exemption or (ii) territoriality system represents a fundamental element of MS fiscal policy. Therefore, a system that presupposes an obligatory switch to a different principle would require a major (political) change in tax policy by a number of Member States. Although worldwide plus exemption results in a similar situation as the territorial approach there are still some difficulties with these (sometimes exemption is denied and reverts to credit for example). For MS who use the credit method there is the problem of allocating the credit. Interaction with bilateral tax treaties provides an additional problem. This leads to a preference for Option B. This leads to a general preference for the solution whereby the taxation of foreign income is left outside of the CCCTB. If the foreign income of tax residents is made taxable by a participating MS the experts thought such income should be taxed according to common rules even though it is not part of the consolidated base. On the other hand most of them found it important that the selection of the method for elimination of double taxation remains in hands of each participating MS in order to enable them to preserve existing tax treaties.

III Income earned by non-residents from sources in the CCCTB jurisdictions

7. Most MS think that the CCCTB should also be available to non resident members of the group, i.e. if they have a permanent establishment on the territory of the CCCTB jurisdictions their results should be consolidated with the rest of their CCCTB group. Some of them point out that otherwise a discriminatory situation may arise. They also agree that the change of the allocation of profits method would probably cause a problem in respect of existing tax treaties, so that only a profit or loss calculated at arms' length could be included in the CCCTB.

8. Some MS do not agree that in a situation when a non-resident parent has a subsidiary and a permanent establishment both in the CCCTB jurisdictions the subsidiary and the permanent establishment should be consolidated. This problem should be discussed in connection with the definition of the consolidated group.

9. Most MS agree that the application of the arm's length principle when allocating profits to a PE is the only solution compatible with the existing tax treaties and practices. Non residents'

permanent establishments should be integrated into the CCCTB groups and their profits or losses should be determined at arm's length when included in the CCCTB. Such allocation would also be relevant for the third state, where the company is tax resident. When the CCCTB (including the non residents' profits calculated on the arm's length basis) is consequently apportioned according to the CCCTB allocation mechanism the result may be different from the arm's length allocation. However, the MS where the permanent establishment is would probably, under its tax treaty with the third country, not be able to tax more than the amount calculated on an arms' length basis. If the CCCTB allocation were higher the difference should be compensated by the other participating MS (in the same proportions as the apportionment of the CCCTB).

10. In the long term perspective it should be considered whether a change to article 7 of the tax treaties with third countries would not lead to more efficient results. A common policy for such renegotiation would be necessary.

IV Definitions (tax residents, permanent establishment, foreign income)

11. The SG4 went on to discuss how a common definition of a tax resident and a permanent establishment should be developed.

Tax residency

12. If worldwide taxation of tax residents is applied in the CCCTB or in some participating MS a common approach of how a tax resident (or a taxpayer whose worldwide income is subject to taxation) is defined has to be established. A company could be deemed to be a tax resident in one of the participating MS either if it is a tax resident according to a national rule or based on a 'common rule for a tax residency', e.g. a company is considered to be a tax resident of a MS if for example it has its seat and/or place of effective management and/ or is incorporated there.

Permanent establishment

13. The actual definition of a permanent establishment will affect two different areas (i) permanent establishments of tax residents situated outside of the CCCTB jurisdictions and (ii) permanent establishments of tax non residents situated on the territory of the CCCTB jurisdictions. Although these are different, the understanding of the term permanent establishment should be consistent in both situations. The OECD Model was used as a starting point; however the role of the OECD Commentary in the CCCTB remains unclear. The CCCTB legislation could either give a very detailed definition describing when a permanent establishment is established or it could be based on the common principle and use the similar definition as for example the Interest & Royalties Directive ('a fixed place of business situated in a MS through which a business of a company of another Member State is wholly or partly carried on'). The latter approach would require MS to agree on a common interpretation in all participating MS in particular situations described in the OECD Model. Whether a legislative measure or 'soft law' should be used to reach the goal of a common understanding of the term "permanent establishment" needs to be discussed. In addition to that it has to be taken into account that the CCCTB definition may be modified by the definition in tax treaties with the third states (i.e. not all tax treaties follow strictly the OECD Model). A common approach to future negotiations would be therefore highly advisable.

Foreign income/Income from CCCTB jurisdictions' sources

14. For any of the above mentioned solutions it is very important to find a common way of how the foreign / domestic income is determined. Based on previous discussion the common definition of foreign income should be derived from the OECD practices. However the detailed discussion revealed that although the OECD Model sets up common principles the practical application and details of how the actual income and expenses are to be allocated to a permanent establishment are not necessarily the same in all MS.

15. If foreign income is not included in the consolidated tax base, common rules for defining this excluded income, i.e. allocating of income to permanent establishments, are required. Otherwise some MS may allocate more income than others to such PEs leaving less to be put in the consolidated base. An extensive discussion on this particular issue has been underway at the OECD for many years. However the CCCTB will need this to be agreed much more quickly and to a greater extent for CCCTB. It followed from the meeting that some MS would appreciate a common EU policy.

16. Similarly if income earned by non residents from the CCCTB jurisdictions sources is to be included in the CCCTB common rules for determination of this income, i.e. attribution of profits and losses to a PE will have to be agreed for the same reason as mentioned in the previous paragraph.

17. Common rules for the allocation of profits to a permanent establishment would mean agreeing on a common approach to the analysis of risks, functions and activities performed by the permanent establishment if the separate entity approach developed at OECD level is to be applied. The functional analysis would give a guidance of how to allocate assets and liabilities to a permanent establishment and income and expenses incurred by a permanent establishment and the head office. The level of detail would have to be higher than at the OECD. Members of the Group are invited to comment on how the Group and the SG4 should progress in this particular issue in the most efficient way.

18. More discussion of how income other than business profits is to be dealt with in the CCCTB is necessary. Some specific rules on where the source of income is deemed will be needed for dividends, interest and royalties. The most viable solution seems to be to follow the OECD Model, with the same caveat as regards the additional degree of commonality required as outlined above.

SUMMARY

POSSIBLE SOLUTIONS	Residents' income from sources outside of CCCTB jurisdictions				Non-residents' income from CCCTB sources	
	Excluded from consolidation (i.e. MS can decide whether taxable or not)		Common approach to whether taxable or not		Included in the consolidated tax base	Not included in the consolidated tax base
	Common rules (B1)	National rules (B2)	Territoriality in all MS (A1)	Worldwide approach in all MS (A2)		
CCCTB implications	<ul style="list-style-type: none"> • Common approach to allocation of profits to a PE (at arms' length) and in general common definition of foreign income outside of the CCCTB necessary • Common rules for calculation of foreign income tax base would prevent tax planning • If taxed can be consolidated with the share on the CCCTB after apportionment (common/national) • If taxed and consolidated double tax relief can be done after apportionment 	<ul style="list-style-type: none"> • None of MS able to tax foreign income of tax residents. • A set of specific anti-avoidance rules to prevent planning through low tax countries necessary. 	<ul style="list-style-type: none"> • Common definition of tax residents (taxpayers with a general tax liability) necessary • Double tax relief problems <ul style="list-style-type: none"> (i) existing bilateral treaties stipulate different methods for different situations and third countries (ii) sharing of ordinary credit 	<ul style="list-style-type: none"> • Apportionment among participating MS done according to different mechanism then arms' length, if the results are not the same, the difference has to be dealt with 	<ul style="list-style-type: none"> • Non-discrimination clause in bilateral tax treaties may create problems • The consolidated base does not cover all activities of the group in the EU (space for cherry-picking) 	
Third states' perspective	<ul style="list-style-type: none"> • The third state allocates profits and losses to a PE at arms' length as required by bilateral treaties 				<ul style="list-style-type: none"> • The third state provides double tax relief up to the amount of taxable profit allocated to a PE at arms' length at maximum 	

A. Solutions with common application of either worldwide taxation of tax residents or territoriality principle

1) *Territoriality principle applied in all participating MS*

Income from the sources in the CCCTB jurisdictions (domestic income) is taxable. Taxable income is covered by the CCCTB and common rules apply to it. Income earned from sources outside of the CCCTB jurisdictions is neither taxable nor covered by the CCCTB. A set of anti-avoidance rules to combat shifting income outside of the CCCTB jurisdictions source (mainly in low tax jurisdictions) is a very important element for this solution. The common rules for determination of foreign income and consequently permanent establishment and its profits would be necessary. On the other hand the definition of tax residents and rules for giving double tax relief are not necessary in this option.

2) *Worldwide taxation of residents applied in all participating MS*

Any income earned by tax residents of the CCCTB jurisdictions is taxable. Taxable income is covered by the CCCTB and common rules apply to it. Common rules for elimination of double taxation are necessary. Participating MS will need to decide whether exemption or credit method, eventually which of them for which income will be used in the CCCTB and they would also need to agree on technical details of how they would be applied in the CCCTB. If a credit method is used for elimination of double taxation, it would have to be apportioned among participating MS (for example according to the same formula used for apportionment of a consolidated tax base). For ordinary credit method it needs to be decided how to treat the excessive amount of tax paid abroad. Possible implications of tax treaties provisions have to be considered prudently. Details of implications of the two methods for elimination of double taxation in the CCCTB are discussed in paragraphs 20 and 21 of the International aspects WD and paragraphs 15 – 28 of the territoriality scope WD.

B. Solutions combining worldwide taxation of tax residents and territoriality principle

1) *Income from the sources outside of the CCCTB jurisdictions (foreign income) is not included in the CCCTB and can be taxed at national level according to common rules*

Income from the sources in the CCCTB jurisdictions is taxable and included in the CCCTB. Income earned by tax residents from the sources outside of the CCCTB jurisdictions is not included in the CCCTB. Participating MS can decide whether it should be taxable (worldwide taxation of tax residents) or not (territoriality principle). If the foreign income is taxable at MS level, common rules apply. Afterwards the MS decide whether they would like to consolidate their portion of the common consolidated corporate tax base with the foreign income of company within the CCCTB group. This will be relevant mainly in the situation when a worldwide income of tax residents would be subject to tax and a credit method is applied. The consolidation at national level would be done after apportionment and according to common rules. In comparison to current situation the profit or loss of a permanent establishment will be first have to be kept apart of the tax base of the company and calculated separately. It could be consolidated with the tax base of the respective company after apportionment of the CCCTB. MS which decided to tax worldwide income of tax residents would provide a double taxation relief at national level. Common rules would apply to double taxation relief. Although the technique of calculation of final tax due is different, same results as now could be reached.

2) *Foreign income not included in CCCTB, national rules apply*

This solution is very similar to the previous one (B1.). The difference is that calculations done at MS level would not be done according to common rules, but according to national rules. If MS decide to tax worldwide income of tax residents the relief for double taxation would be given at national level as well. Whether a credit or exemption method would be applied would also be up to respective MS and existing tax treaties could be applied in such a case. The level of uniformity of the 'corporate income tax system' would be much lower. Such solution might open the door for tax planning techniques making a use of varying national rules. The two solutions B1 and B2 can be combined and the decision of which steps done at national level need common rules and which can be done according to national rules without major difficulties can be done separately for each of them

- *rules for calculation of a tax base of a PE,*
- *rules for consolidation of apportioned CCCTB with the tax base of a PE,*
- *rules for double taxation relief.*