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COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)

The mechanism for sharing the CCCTB

Meeting to be held on 13 December 2006

Centre de Conférences Albert Borschette
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WORKING DOCUMENT

I Introduction and purpose of the paper

1. Over the last two years the Common Consolidated Corporate Tax Base Working Group (hereinafter the CCCTB WG) has been discussing structural elements of the tax base (assets, provisions, taxable income, etc.), its scope (the personal scope and the territorial scope, i.e. the international aspects) and the issue of consolidation of the tax base. Indeed, it is Commission Services' firm view that only the consolidation of profits and losses earned by various entities of the same group located in different Member States would bring the expected benefits in terms of reduction of compliance costs and elimination of tax obstacles to the proper functioning of the internal market (elimination of intra-group transactions and consequent transfer pricing problems, cross border loss relief, etc.), thus best contributing to the Lisbon strategy¹.
2. The consolidation of the tax base requires a mechanism to share it in a fair, efficient and commonly agreed manner among the Member States/entities concerned. Therefore, the purpose of this paper is to discuss with the experts from Member States² the various possibilities for the apportionment mechanism. To prepare such a discussion, Member States received a pre-publication copy of the Taxation Paper *'The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options'* by Ana Agúndez-García. Additionally, the Member States were informed about another paper on this subject (*'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada'* by Joann M. Weiner) which was published by DG Taxation and Customs Union as a Taxation Paper on 4 November 2005.
3. The first paper referred to above presents different approaches of the apportionment mechanism (such as the macro-based apportionment, and micro-based mechanisms, including a Value Added key (VA) and a traditional Formulary Apportionment (FA) option) as discussed in the scientific literature. It focuses mainly on the complexities and challenges linked to the various apportionment mechanism systems and may give the impression to the readers that the sharing out mechanism is very complicated and burdensome. However, it does not include a comparison between the apportionment mechanism and the current system of separate accounting (SA) with arm's length pricing (ALP) for intra-group transactions and therefore does not examine the disadvantages of the SA with ALP method.
4. However, it should be noted that the ALP method is very complex, costly, resource intensive and leaves room for profit shifting strategies. It could also be questioned whether it is meaningful in highly integrated business groups of companies and whether it produces the correct allocation of profits to individual members of the

¹ COM(2005) 532 final of 25.10.2005

² As a group of experts the role of the Working Group is to provide technical assistance and advice to the Commission and contributions by members will therefore be made in a technical capacity. No Member State will be called upon to make political commitments and participation by a MS in the WG does not commit it to implement a CCCTB. As an expert advisory group the Working Group will take no decisions.

consolidated group and by implication to individual Member States. The Commission Services have been recommending since 2001 that any comprehensive solution to the tax obstacles in the internal market should include consolidation of the tax base and its subsequent apportionment avoiding as far as possible the complexities of the arm's length method.

5. One of the issues linked with the apportionment of the CCCTB which has been raised in discussions on Group Taxation is whether the consolidated tax base should be attributed to only one group company in each Member State (even when there are two or more group members in that jurisdiction) or to each individual group company. It is the Commission Services' current view that the shares of the tax bases should be attributed to individual companies for practical reasons (ie, companies can take into account pre-existing losses, foreign income and related tax credit, non apportioned income, etc; this issue is mainly linked to the related administrative and legal consequences³) but this can be discussed more carefully when the administrative details are further examined.
6. It should be noted that together with a proposal for the CCCTB, the Commission Services will prepare an impact assessment of the possible consequences of the introduction of the CCCTB. The detailed arrangements for such an impact assessment are not finalised yet, but one element could be an analysis of how a move to a new method of sharing out the 'EU tax base' would impact on Member States' corporation tax bases. To date, it is not possible to carry out a comprehensive analysis comparing the current distribution by Member State of groups' tax bases under the current system with the distribution by Member State of groups' tax bases in accordance with a sharing mechanism due to the lack of publicly available tax base data. To this end, the Commission Services would like to know whether Member States would be prepared to provide the necessary tax data to carry out such an assessment. Without this data the impact assessment would be carried out on the basis of publicly available accounting data, using the current distribution of accounting profits as representative of the current distribution of corporation tax bases.
7. As a final introductory point the Commission Services would like to emphasise that there are two main aspects to the issue of the sharing mechanism. First, the actual definition of the factors – for example how in the macro approach GDP should be defined or in the micro approach how sales should be defined, and how easy it would be for companies to calculate reliable figures which could be audited, etc. Second, the actual choice of factors for the formula, as well as how any such factors should be weighted (from 0% to 100%). The CCCTB WG, a technical group formed to advise the Commission Services, clearly has a role to play in the work on the first aspect. However, the second aspect concerns the distribution of the

³ The Commission Services have prepared two papers on the administrative and legal framework, the Working Document CCCTB\WP\030 'Administrative and legal Framework/Questionnaire', in http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/article_2453_en.htm, and the Working Document CCCTB\WP\036 'Points for discussion on 'Administrative and legal Framework'', in http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/article_2648_en.htm

consolidated base between Member States and, regardless of existing international tax practices and definitions, there are analytical issues where MS expert input in the WG would be useful although this issue also has a political dimension that goes beyond the remit of the WG.

II Basic principles

8. The Taxation Paper by Ana Agúndez-García analyses in particular the two main types of apportionment mechanisms, as first mentioned in the Company Tax Study (2001)⁴: a macro-based apportionment and the micro-based apportionment mechanisms with both the traditional formulary apportionment and the Value Added approach. The Taxation Paper is structured in a way that the discussed apportionment mechanisms are evaluated on the basis of criteria such as equity and efficiency (ie neutrality, enforceability, simplicity and cost-effectiveness). For the sake of completeness, it should be noted that the paper deals also with issues concerning the delineation of the tax base, for instance, whether all income earned by an entity should be *apportioned* (consolidated and shared out) or whether some income could be *allocated* directly and exclusively to a group company due to the special nexus with the source⁵. However, the present Working Document concentrates on the possible methods of apportionment and does not discuss at this stage what if any income should be allocated.
9. **Macro-based apportionment:** Apportionment of the groups' consolidated tax base could be done by reference to factors aggregated at national level (macro factors) such as GDP, national VAT bases, etc. A method based on macro factors would be simple and cost efficient both for firms and tax administrations. It would also avoid the incentives to change the location of the groups' economic activities (ie, factor shifting to minimize the groups' tax burden), which may create some economic distortions. However, macro factors cannot guarantee the basic requirement of fair treatment of individual corporate income taxpayers, as they can produce a large mismatch between the creation of value in a particular country by a given multinational group and its tax bill in that country.
10. **Value Added (VA) approach:** Apportionment could also be based on a VA key that assigns the groups' tax base on the basis of the ratio 'VA by a group member-to-total VA of the group'. The VA concept is familiar to taxpayers and tax administrations in the EU and the adjustments needed to move from the current VAT base (*consumption-type VA measured at destination*) to a VA-apportioning factor (that should account for depreciation allowances *-income type VA-* and should be measured *at origin*) are not insurmountable. A VA key for apportionment relies (partially) on *profits*, thus it would ensure the attribution of the taxable bases (at least partially) to where the groups' profits have been realized, thereby avoiding 'misattribution' concerns (by reference to current principles of assignment of taxing rights for corporate income taxation). VA is also a consistent concept that could be

⁴ 'Company Taxation in the Internal Market', SEC (2001) 1681.

⁵ As an example, the capital gain from the sale of an immovable property may be considered as having a strong nexus with the country where the property is located.

used for all economic sectors (though sectors outside the scope of the EU VAT would have to calculate their VA 'from scratch'). However, a VA key to apportion consolidated income has also some flaws that should be noted. First it requires the retention of arms length pricing for intra-group transactions in order to calculate the value added, thereby it reintroduces transfer pricing obligations and profit shifting incentives through the sharing mechanism (though much less pronounced than in the current system). Second, as labour represents on average 2/3 of VA in EU economies it places a heavy tax burden on labour. Finally, if value added is calculated by the 'addition' method it could be criticised for its circular nature as national profits have to be calculated in order to provide a key to distribute the consolidated profits on a national basis. However, if the 'subtraction' method is used national profits are not required for the calculation, although they could be relatively easily retrieved.

11. **Formulary Apportionment (FA) approach:** Finally, apportionment could also be based on the contribution of each jurisdiction to any given group's total taxable profits by using a predetermined formula whose elements represent the factors that are deemed to generate the group income. Thus, those jurisdictions in which (relative to others) there is a larger presence of that group's income-creating factors will get larger shares of that group's consolidated profits. FA could be defined as a method for determining the corporate tax base of a single company or group of associated companies attributable to a MS by reference to a formula that assigns a proportionate share of the company's or associated companies' corporate tax base to the state by reference to a factor or factors that reflect (or are deemed to reflect) the underlying income-producing activities within the state⁶.
12. The three above mentioned mechanisms to share the consolidated tax bases have advantages and drawbacks and therefore it is not really appropriate to state that one method is in all respects better than the others. As regards FA, however, it should be noted that it has been applied for many years in the USA and Canada and both countries appear satisfied by the outcome of the mechanism and are not planning to move to another system. In the following section the FA approach will be analysed in more detail.

III Formulary apportionment approach

a. Basic design of the FA

13. The principle of FA is that it should be based on factors that reflect the source of income generation as closely as possible. The factors traditionally taken into account are payroll, assets/property and sales/gross receipts. There are two types of definition issues that should be systematically analysed for the use of these factors in an apportionment formula: the *valuation* and the *location* of each factor. In the

⁶ Following the definition by Hellerstein, W. (2005): "The Case for Formulary Apportionment", *International Transfer Pricing Journal*, Vol. 3, p. 105.

following paragraphs a brief analysis with advantages and drawbacks/disadvantages of each factor is presented. Only the main problems of the factors' determination are discussed, some other questions are left out and will be discussed in the future.

14. As a general remark concerning FA, it should be noted that the scientific literature strongly recommends the use of a uniform formula (identical factors and weights in all MS taking part in the CCCTB). If one looks at the situation in USA, where each state is free to choose its own formula, one can observe distorting tax competition on the factors (for example a unilateral move to a lower weight on the labour factor by a given State may increase employment in that State to the detriment of employment levels in other States). Also, non uniform formulae can lead to double taxation (or double non taxation), although this may be less of a concern in the USA as state tax rates are comparatively low and are deductible for federal tax purposes.
15. (i) Payroll: "The payroll factor is meant to reflect the contribution of labour as a production factor in the generation of corporate income"⁷. This factor would allocate a portion of the consolidated base to each jurisdiction in which the labour force contributes to the production of profits (where the employee operates). It could be measured by all kinds of compensation paid to employees (ie, including salaries, commissions, bonuses, etc). Thus in general, payroll would appear relatively easy to measure and to locate in most cases, therefore bringing administrative advantages⁸.

Notwithstanding, one possible essential matter of concern with using a payroll factor for apportioning consolidated income is the difference in labour costs across MS, since wage levels differ significantly across the EU. "If payroll is used as a factor, with no adjustment for differences in labour costs between jurisdictions, the result may be an unacceptable allocation of the tax base... A corporation may have located operations in low-cost jurisdictions to take (*legitimate*) advantage of saving in labour costs, and yet under FA with a payroll factor, the saving (as reflected in higher profits) would be attributed disproportionately to high-wage jurisdictions"⁹.

How this could be tackled, for example, by considering only (or also) the number of employees, needs to be discussed by experts.

Using the number of employees, however, could also bring potential distortions of the division of taxable income, "because group units with identical numbers of employees might indeed have rather different levels of labour productivity, but still the territories where they are respectively located would receive equal shares of the group tax base"¹⁰.

⁷ Taxation Paper by Ana Agúndez-García, p. 47.

⁸ Although there can be further complications like the location of employees, contributions in kind, part-time workers or workers seconded abroad, 'outsourcing'/'contracting out' of labour to other states, etc, which require detailed examination.

⁹ Ch. E. McLure, Jr. (2002): "Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment", *Bulletin for International Fiscal Documentation*, Vol. 56, p.594.

¹⁰ Taxation Paper by Ana Agúndez-García, p. 48.

16. (ii) Assets: Capital/assets is/are a key income-producing factor, and it may be generally accepted that it should be included in a FA mechanism. However, there are several issues to be discussed. In this paper, the three main concerns are presented.

First, there exist difficulties because of the measurement/valuation of the assets. If market value is used this could lead to valuation problems because very often market values are not known (no market trading) and would be complex to determine due to price fluctuations (important source of uncertainty). Alternatively, the historical costs could be used. Here comparability issues may arise due to depreciation at different rates or acquisition at different times. Another possibility would be to use the accounting book value or the tax book value. As all the group members would be applying common (the CCCTB) rules the best comparability would be achieved if the tax book value of the assets were used for valuation purposes.

Second, the inclusion of intangibles should be discussed. Intangibles present evaluation issues, location issues and even definition issues; in addition, being very mobile, they could be used for profit-shifting purposes. In the USA intangibles are often excluded from the asset factor (and some commentators such as Joann Weiner support this practice) for apportionment purposes for practical reasons. Income arising from intangibles (along with all other sources) is therefore apportioned on the basis of the other factors. It should however be stressed that this exclusion could lead to a misattribution of the common tax base because intangibles are nowadays one of the potentially most important profit-generating factors. The issue of how to deal with and define intangibles is therefore open to discussion for MS experts.

Third, the inclusion of rented/leased assets in the factor should be discussed, due to the potential distortions on the economic decision of whether to rent/lease or purchase assets¹¹.

17. (iii) Sales: Profits of companies come from selling goods/services. Thus, *sales* is "an income-creating factor eligible to appear in a formula that seeks to estimate the contribution of each jurisdiction to group's profit"¹². There are several issues to be discussed in connection with sales; in this paper, the main concerns are presented: (i) some definition issues and (ii) the differences between 'sales by destination' and 'sales by origin'.

The definitions of 'sales by origin', 'sales by destination', 'throw-back rule' etc. should be discussed and analysed by the Group. In general, using the 'sales by origin' factor means locating the sales (and apportioning tax base accordingly) in the country from where the goods are shipped. Using the 'sales by destination' factor means locating the sales (and apportioning the tax base accordingly) in the country where the goods are eventually placed on the market for the customers (individuals

¹¹ This issue is also linked to the discussion about legal/economic ownership that was held in conjunction with the topic of assets and tax depreciations.

¹² Taxation Paper by Ana Agúndez-García, p. 52.

or companies not being members of the group) or put into service (eg equipment installed in a building). Intra-group sales should be eliminated from the calculation of any 'sales' apportioning factor (either by origin or by destination) as "only third-party unrelated sales have contributed to the net group profits that the factor seeks to apportion"¹³ (intra-group sales have been eliminated during the calculation of the consolidated base). Otherwise, the intra-group transfer pricing problems, which the CCCTB aims to solve, would reappear through the sharing mechanism.

'Sales by origin' can be relatively easily used for profit-shifting (the place of shipment is under the company's control). In contrast, 'sales by destination' are not generally under the control of the company. However, 'sales by destination' raises several other theoretical and practical issues. One issue is what to do with the share of the tax base to be attributed according to this criterion in the cases of 'no where sales', ie sales to third countries or to countries where the group does not have a subsidiary or a PE. The 'throw-back rule' would mean that 'no where sales' are attributed to the country of shipment¹⁴, therefore causing a switch from the 'sales by destination' to the 'sales by origin' factor, and thereby undermining the logic of allocating income to states where the sales are made (the destination states). Finally, by introducing a 'sales by destination' factor manufacturing and distributing countries would receive a reduced share of the base compared to marketing countries' increased share. This would represent a big change from current practice. For example, this could change the distribution of the tax base for a group containing manufacturing companies, distributing companies and marketing companies.

The provision of services raises similar issues concerning the definition and location of the activity, for example the provider of the service (origin basis) versus the place where the service is provided (destination basis).

A further issue to be discussed is whether the definition of sales should include gross receipts, ie any other income, be it dividends, royalties, rental income, interest, capital gains, etc or should it be refined to exclude some or all of these.

18. Among the various issues which will have to be eventually addressed in the legislative proposal is the question of how the factors should be weighted. For example, all factors could be weighted equally (one third if there are three factors – the Massachusetts formula – one half if there are two factors, such as only labour and capital, or only labour and gross receipts), or some factors could be weighted more than others. In the middle of the last century the vast majority of the US States applied the Massachusetts formula. Since the early 1980s the States have moved towards a greater weight given to the sales (gross receipts) factor, measured at destination, while decreasing the weight on property and payroll. In 2004, 23 States used a formula which gives a weight of 25 percent each to payroll and property and

¹³ Taxation Paper by Ana Agúndez-García, p. 53.

¹⁴ Other solutions are possible, such as a 'spread throwback rule', by which the corresponding part of the 'no where sales' would be attributed back to *all* EU countries where the group operates, possibly proportionally to other factors.

50 percent to the sales factor¹⁵. The Canadian provinces have used (for half a century) an equally weighted formula with the two factors sales (gross receipts) by destination and payroll¹⁶. Therefore, the US and Canada show experiences based on formulae that weight equally origin-based supply and destination-based demand factors, a weighting solution that seems to be tailored at balancing the interests of the manufacturing and the marketing states

19. 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 question, which this technical group could provide input on, 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. For example in the USA there are special formulae for construction contractors, airlines, railroads, trucking companies, television and broadcasting, financial institutions and publishing, etc. Some commentators (Weiner) suggest that financial industries should use a two-factor formula that allocates income according to the location of payroll and of certain financial items, such as deposits. Transportation companies could use a mileage factor; all other companies should use the standard formula.
20. The brief description of the three factors has shown that – in reality – there are not 'ideal' solutions and the choice concerning the definition, valuation and location of the factors and their inclusion (and their weighting) in the formula requires a great deal of work. It is Commission Services' view that the choices to be made must take into account that the factors should be easy to measure and difficult to manipulate by companies.

b. General assessment of the FA

21. Since it does not rely on *profits* by territory to apportion taxable bases, FA with traditional factors (payroll, capital and 'sales by destination') largely removes (or at least significantly reduces) the current incentives to shift paper profits across countries to minimize the groups' overall tax burden. As profits are not to be determined by group member individually, FA helps in reducing most costs related to transfer pricing for businesses and tax administrations, thus entailing significant savings in compliance and administrative costs for intra-EU intra-group transactions. (There will still be scope for profit shifting and transfer pricing issues with non-EU affiliates or EU-affiliates non consolidated in the group, as these transactions will remain on the arm's length basis).
22. On the other hand, as long as the apportionment mechanism relies on mobile factors under the control of the company, FA creates incentives for firms to shift factors across countries to minimize the groups' overall tax burden and thereby it may give

¹⁵ Taxation Paper by Joann Weiner, p. 12.

¹⁶ Taxation Paper by Joann Weiner, p. 15.

rise to certain tax competition by governments to attract real economic activity into their territories, which may create some economic distortions.

23. The potential distortions and economic effects of FA depend on the degree of mobility of the factors chosen. In general, the more weight on mobile factors, the more likely are the distortions regarding the allocation of factors in the Internal Market. The property/assets factor (real investment) and 'sales by origin' are supposed to be the most mobile factors of all, whilst labour force and 'sales by destination' are less mobile or their location less controllable by firms.
24. FA converts the corporate income tax into an implicit tax on the factors used in the formula¹⁷, all the more if the factors are immobile, as they will most likely end up bearing the tax. FA may therefore have some incidence effects on workers and consumers if greater weight is assigned to labour or 'sales by destination' respectively (ie, the corporate income tax may convert into a payroll tax or a tax on sales by introducing such factors in the apportionment formula).
25. FA can be assessed as a simple and cost effective methodology as regards data collection issues. Perhaps its most important complexities in practical application may be the use of different formulae for different sectors and the valuation of intangibles.

IV Questions to Member States

26. Member States are invited to respond to the following questions:
 - Do MS agree to concentrate on the formula apportionment method to share the tax base, therefore dropping out the options of a macro-based apportionment and of a VA approach?
 - Do MS agree to make use of a uniform formula, without letting MS freely decide the factors and the weights?
 - Do MS have any comments on the factors to be included into an apportionment formula?
 - Do MS agree to analyse more in detail how such factors as payroll, assets and sales could be defined?
 - Do MS agree to establish a subgroup to continue discussions on this topic?

¹⁷ This idea stems originally from McLure, Ch.E., Jr. (1980): "*The State Corporate Income Tax: Lambs in Wolves' Clothing*", in H. J. Aaron and M. J. Boskin (eds.) *The Economics of Taxation*. Washington: Brookings Institution, and it has been extensively developed ever since.

- Do MS agree to disclose tax data in order for the Commission Services to assess the impact on the tax bases distribution of the switch from the current system of SA to FA, or do they accept that accounting data would be an adequate 'proxy' for simulation and impact assessment purposes?