Corporate income tax coordination in the European Union

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Summary

The globalisation of economic activity and the growing importance of multinational corporations have far-reaching consequences for national tax policies. Since 1995, the average corporate tax rate in the EU has fallen from 35% to 23%. In addition, differences and incompatibilities between the national systems of corporate income taxation distort investment, complicate the tax system and give rise to conflicts between taxpayers and tax authorities as well as between tax authorities of different countries. Given this, there is a widespread view that greater coordination of corporate taxation is required. Recently, the European Commission proposed introducing a Common Consolidated Corporate Tax Base (CCCTB) in Europe. This article discusses the economic advantages and the drawbacks of the CCCTB concept.

Keywords
Corporate Taxation, Tax Coordination, European Union

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1. Corporate taxation and the globalisation of economic activity

The globalisation of economic activity and the growing importance of multinational corporations have far-reaching consequences for national tax policies. From a global perspective, investment should be located where it is most productive, not where taxes are low. Ideally, the decisions of firms as to where to locate their activity should not be affected by taxes, but for a company taxes are costs, and companies may choose investment locations to avoid high taxes.

For national governments, the increasing mobility of investment and jobs across borders is cause for concern. One way of attempting to attract such investment is to reduce tax rates on corporate income and this has proved enormously popular in the EU over the last two decades. Since 1995, the average corporate tax rate in the EU has fallen from 35% to 23%. Views about the economic consequences of this downward trend in tax rates are divided but, if it continues, revenue collected from corporate income taxes will eventually disappear.

Another very significant problem in the taxation of international profit is deciding where that profit arises. If corporations operate in more than one jurisdiction the right to tax the profits of the corporation has to be divided between the jurisdictions where the firm operates. Some coordination is needed, for instance, to avoid profits being taxed twice or not at all. The usual approach to assigning the right to tax profits of a multinational firm is to treat the entities of the firm operating in different countries as separate firms for purposes of taxation. This approach is usually referred to as the method of separate accounting.

Applying the method of separate accounting for purposes of taxation raises a number of difficulties, though, as there are many ways in which multinational companies can shift profits to countries with lower tax rates. For example, where transactions occur between different entities of a multinational firm, the firm is largely able to choose the transfer prices for goods or services delivered. Tax authorities can challenge transfer prices: the basic approach normally used is that the prices chosen should match prices which would be chosen by unrelated firms. In practice, however, there may be no such transactions. Similar incentives exist with respect to other decisions, such as the use of debt finance or the location of immaterial assets like patents. Several recent studies of firm behaviour conducted at the Centre for Business Taxation suggest that firms respond to these incentives. In a recent study based on balance sheet data from 16 000 multinational firms, Maffini and Mokkas (2009) show that firms systematically report higher productivity in low-tax countries. Another study, which uses similar data, shows that multinational firms tend to locate patent ownership in low-tax countries, rather than in the country where the research, which led to the patent, was carried out (Karkinsky and Riedel, 2009). Many countries have introduced special rules to attempt to prevent profit shifting to other countries, but their effectiveness is limited and many of these rules have created new problems by considerably increasing the complexity of the tax system.

Overall, differences and incompatibilities between the national systems of corporate income taxation distort investment, complicate the tax system and give rise to conflicts between taxpayers and tax authorities as well as between tax authorities of different countries. Given this, there is a widespread view that greater coordination of corporate taxation is required. At the international level, efforts to coordinate corporate taxation on a multilateral basis have been largely unsuccessful. Within the European Union, coordination in setting corporate taxes has also been difficult to achieve, but some important steps have been taken and proposals for more coordination have been intensively debated.

2. Corporate tax coordination in the European Union

According to the EU Treaty, EU Member States have full autonomy in the field of direct taxation, which includes corporate income taxation. This autonomy of Member States to set their corporate taxes is limited only insofar as national taxes must be compatible with EU law. In particular, national tax law should not create obstacles for cross-border economic transactions.

The debate on corporate tax coordination in the EU goes far beyond the legal requirement to remove obstacles to cross-border investment or trade. There are a number of reasons for a closer coordination of corporate tax policies in the European Union, such as:

- Companies operating in the EU currently have to deal with 27 different national tax systems, which gives rise to high compliance and administration costs.
- Differences in effective tax burdens across Member States distort economic activity in the EU.
- The growing importance of multinational companies makes it increasingly difficult to collect corporate tax based on separate accounting systems.
- Conflicts arise between national tax policies and EU law. In a number of cases, the European Court of Justice has declared national tax rules to be incompatible with EU law, in particular with the freedom of establishment granted by the EC Treaty.

Since the foundation of the EU, the European Commission has started several initiatives to coordinate corporate taxation. In 1975, 1984 and 1992 it has also submitted proposals for directives that would provide some harmonisation of corporate tax rates and bases, but most Member States were very reluctant to give up some of their sovereignty in the field of corporate taxation, so the Commission eventually decided to withdraw its proposals. In its report on ‘Company Taxation in the Internal Market’ (2001), the Commission took a new initiative and proposed various options for the coordination of corporate income taxation in the European Union (EU), which included the project of introducing a Common Consolidated Corporate Tax Base (CCCTB). The ensuing debate has largely focused on the CCCTB proposal. The CCCTB would:

i. introduce a common set of rules for the calculation of corporate profits throughout the EU;

ii. introduce full consolidation, so that companies would have to determine only their total EU-wide profit, rather than the profit they generate in each Member State;

iii. allocate a company’s EU-wide taxable profit to individual Member States, based on a geographical distribution of the company’s economic activity;

iv. each Member State would be free to set its own tax rate on its allocated share of profit.

The following explains and discusses some of the key elements of the proposal and discusses its economic implications.

3. Tax coordination in Europe: the project of a Common Consolidated Corporate Tax Base (CCCTB)

In 2004, the European Commission created a working group to study and discuss options for introducing a CCCTB in the EU. Although a final detailed proposal has not yet been submitted, the concepts developed by the working group suggest that such a proposal would have the following main features.

a) Common rules for determining taxable profits

The CCCTB would introduce a common set of rules for the calculation of taxable profits of companies operating in EU Member States participating in the CCCTB. The common tax base would be consolidated, which means that companies or corporate groups would be taxed on the basis of their overall income in all countries. Among other things, this has the important implication that losses made in one country would be offset against profits made in another country. It also implies that all countries participating in the CCCTB would have to agree on common rules for taxing foreign source income and common ways of protecting the common tax base against income shifting to third countries.

b) CCCTB is optional

Companies would have the option to be taxed under the CCCTB rules or to remain in the existing national systems. This implies that two regimes for corporate taxation would coexist, at least for a transition phase.

c) Member States may set corporate income tax rates

The Member States would retain the autonomy to set their tax rates. For some Member States, preserving autonomy in setting tax rates is a key condition for their willingness to support the proposals.

d) Formula apportionment

Multinational firms participating in the CCCTB regime would no longer be taxed on the basis of profits generated in individual Member States, but rather on the basis of EU-wide profits. A key question is how the right to tax this base would be divided between the countries where the firm operates. The solution proposed is a sharing mechanism usually referred to as 'formula apportionment', i.e. the tax base would be apportioned to the Member States according to a formula based on the distribution across Member States of the companies' payroll, employees, assets and sales across countries. The formula would be the same for all Member States participating in the CCCTB.

It is useful to illustrate this with a simple example. Suppose that a firm operates in France and the UK. It has 30 employees in France and 60 in the UK. Wages are the same in the two countries and sales as well as assets in the UK are also twice as high in the UK as in France. Suppose further that, due to differences in other costs like e.g. office rents, communications, etc., the firm makes a <u>loss</u> of 10 in the UK and a <u>profit</u> of 40 in France. Finally suppose, for the purposes of exposition, that the French tax rate is 30% and the UK tax rate is 25%.

How would this firm be taxed under the current tax system and how would it be taxed under the CCCTB?

- Under the current national corporate tax system, the profit of 40 generated in France, would be fully taxed in France and the firm would have to pay taxes of 12 to the French tax authorities. In the UK, the firm would pay no taxes and it could carry forward its loss to set against profits generated in the future.
- Under the CCCTB, the EU-wide tax base of the firm would be consolidated, which means that EU-wide profits are equal to 30. Since two-thirds of the firm's employees, payroll, assets and sales are located in the UK, two-thirds of the EU-wide tax base would be allocated to the UK, so that a profit of 20 would be taxed at the UK tax rate of 25%, whereas the remaining 10 would be taxed by the French government, at the French tax rate of 30%. The firm's overall tax payments would be equal to 8, tax revenue in the UK would be 5 and tax revenue in France would be 3.

This example shows that a switch from the current tax systems to the CCCTB could have drastic implications for the overall tax burden as well as the distribution of tax revenue across countries.

Although the introduction of formula apportionment would bring about a major change to the international tax system, the approach as such is not new. It is currently used in many federal countries, such as Germany, Canada or the US, for purposes of taxing corporate profit at the state or local level.

4. Is the CCCTB a solution to the problem of corporate income tax coordination in the European Union?

The introduction of a CCCTB in the EU would imply a fundamental change in the system of corporate income taxation. The Oxford University Centre for Business Taxation has carried out a number of studies which have contributed to this debate. The role of legal and accounting principles for the design of the new tax base are discussed in Freedman and MacDonald (2008). This study argues that a possible directive introducing a CCCTB would have to build on existing international accounting standards, which would have to be combined with new tax rules. An assessment of the pros and cons of the project from an economic perspective can be found in Fuest (2008). What are these pros and cons? Introducing the CCCTB would bring significant advantages. It would mean that firms would no longer have to deal with 27 different national tax systems. This would probably reduce the compliance costs, although this claim has been disputed. Another significant advantage would be that using transfer prices or financing structures to shift profits within the EU in order to reduce overall tax liabilities would no longer be possible.

However, there are also some drawbacks. First, shifting profits to low-taxed countries outside the EU would still be possible as long as other countries maintained a system of separate accounting. Indeed, the EU as a whole would also maintain separate accounting with respect to profits earned in the rest of the world. Secondly, consolidation of profit may create new distortions, as firms with profits in high-tax countries would have incentives to acquire loss-making firms in low-tax countries. Thirdly, tax rate differences would also continue to distort economic activity in the European internal market. The nature of the distortions would change because incentives would be different (Devereux and Loretz, 2008). For example, if employment is an important factor in the allocation of profit to Member States, then an incentive would be created to locate employment in countries with low tax rates. Fourthly, as shown by Devereux and Loretz (2007), introducing the CCCTB would give rise to a redistribution of corporate tax revenue across the Member States. Member States which lose revenue will be reluctant to accept this or will ask for compensation.

How the introduction of CCCTB would affect tax competition and tax-rate setting by Member States is also an open question. It is clear that the pressure to cut tax rates would continue, but it is difficult to assess whether it would be stronger or weaker than under the current system.

Overall, there is a widespread view amongst individual Member States that the benefits of the CCCTB would not be large enough to be worth the considerable effort involved. At the same time, though, the shortcomings of existing corporate income taxation in the EU persist and the process of tax competition shows no signs of abating. Unless some agreed solution can be found – whether the CCCTB or another option – then the EU may find that the long-term result may ultimately be that tax rates fall so far that this tax ceases to raise any significant revenue.

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