HOME STATE TAXATION VS. COMMON BASE TAXATION

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The Commission's Study on "Company Taxation in the Internal Market" and the related Communication entitled "Towards an Internal Market without Tax Obstacles" together represent a significant development in EU policy on corporate taxation. In the "Monti Package", attention was focused on "harmful" tax competition produced by preferential tax regimes, and on removing specific obstacles to cross-border flows (interests and royalties). The new EU Commission's Study and Communication, on the other hand, focus on the general corporate tax regimes of member states and their effects on the Internal Market.

The commission's study and communication

A comprehensive solution has many advantages over the existing system

The first two parts of the Study, by comparing existing tax legislation and the effective tax rates on domestic and cross-border investment, clearly demonstrate the existence of important tax distortions that are very likely to bring about a misallocation of capital and welfare losses within the EU. The second two parts of the Study review the most important obstacles to the Internal Market, and suggest a wide range of remedial measures. The new policy consists of a two-track strategy based on:

a. specific measures designed to address the most urgent problems in the short and medium term;
b. a longer-term "comprehensive" solution according to which companies operating at the EU level will have one single consolidated corporate tax base. This consolidated tax base should be subsequently allocated across different EU jurisdictions by an automatic formula, and taxed at the national tax rates, which member states will continue to establish themselves.

There is no doubt that this "comprehensive" solution is the most important advance made by the new Commission's strategy regarding corporate taxation. Its implementation would entail a major change in the present situation and would produce a series of transitional costs, too, as the Commission's study makes quite clear. However, a consolidated tax base with formula apportionment in many respects appears the most suitable one for a truly internal market, where it is becoming increasingly difficult to correctly ascertain where profit is earned and consequently apportioned according to separate accounting and arm's length principles.

The Study reviews different targeted and comprehensive solutions: its comparative analysis of the various options frequently underlines the need for further analysis before any decision on the best direction to follow can be taken. The proposals reviewed constitute the starting point for a broad debate involving not only the member states, but also the business community, tax experts and academics. This debate should involve a discussion of both targeted and comprehensive solutions: specific short-term measures must not only be consistent with the comprehensive longer term solution, but also constitute the building blocks of its achievement. In doing so, the prospect of a consolidated corporate tax base at the EU level might even help overcome some of the difficulties experienced by those targeted solutions (e.g. the directive on cross-border losses) proposed in the past, in so far as it will provide a coherent framework within which to tailor short- and medium-term measures.

A consolidated corporate tax base with formula apportionment

It is well known that a system like the one envisaged by the Commission has many advantages over the existing one and over specifically targeted

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measures. A system of consolidated profits with formula apportionment could, in fact:

- in one move both tackle and solve some of the most important obstacles within the Internal Market, such as transfer pricing problems, the impossibility of loss compensation, and the possibility of double taxation on dividends, interest and royalties;
- reduce compliance costs for companies and tax administrations resulting from having to deal with 15 different tax rules and laws, which is seen as being one of the most important and urgent problems to be resolved;
- be consistent with the aim of preserving a significant degree of tax autonomy of member states when it comes to setting their tax rates, which is in keeping with the subsidiarity principle;
- reduce the incentive to shift profits within the group to those countries with the lowest tax rates, since the implementation of formula apportionment is suggested together with unitary accounting within the group.

However, economic studies also suggest that a consolidated tax system with formula apportionment does not guarantee global economic neutrality. With regard to the allocation of the factors of production within the EU (where the system of automatic allocation would be restricted), the exact types of distortions will depend on the factors included in the formula, and their magnitude will be a function of the divergence in tax rates between countries. In fact, a tax levied on a base that is apportioned according to a given formula corresponds to a set of taxes levied on the various different factors included within the formula, and the effective tax rate on each factor changes with the use of this factor. The different tax rates levied nationwide will distort the allocation of capital according to the extent that capital is included in this formula. As the experience of other countries clearly shows, this system, albeit far from perfect, can nevertheless constitute a viable solution which manages to satisfactorily trade off differing needs, and in particular efficiency against fiscal autonomy and a relatively greater degree of simplicity.

The proposed system is in fact similar to those already adopted by federal states like the United States or Canada, the subject of numerous studies and writings. An analysis of these countries' experiences underlines not only the advantages, but also the flaws, of such systems, together with the problems of implementing and maintaining the formula method.

However, the EU countries would have to face more problems than a federal state in adopting a system of consolidated taxation with formula apportionment of the tax base. As underlined in the Study, "the two examples mentioned, USA and Canada, have one fundamental distinctive feature in comparison to a possible EU system. In each case they have both a national (federal) tax and a local tax or taxes (USA-State and Canada-Provinces)" (p. 419–420). In the EU there is a lack of any "federal corporate tax base" which at the same time provides a clear benchmark for the establishment of the tax base to be apportioned: on the contrary, there are 15 different sets of accounting and taxation rules and laws defining what constitute taxable profits in each of the member states. Similarly, there is no "federal tax rate" constituting a minimum tax rate, on top of which the states or provinces of the federation can apply their own rates, but once again 15 different tax rates.

Unlike in the US and Canada, there is no "federal corporate tax base" or a "federal tax rate" in the EU

I am now going to concentrate on these "additional problems", problems that are peculiar to the EU situation and ones that are destined to further complicate any transition process towards the new consolidated tax base for EU businesses proposed by the Commission. Thus I will not be going into other very important issues such as the choice of the "right" formula and the effects this might have on the tax revenue of the member countries.

Establishing the tax base

With regard to the problem of how to define the consolidated tax base, the Commission's Study analyses four different options: Home State Taxation (HST), Common Consolidated Base Taxation (CCBT), European Corporate Income Tax (EUCIT), and the "Harmonised" Corporate Tax Base.

Harmonised compulsory approaches, like EUCIT and the "Harmonised" Corporate Tax Base, are generally recognised as being better suited to meeting the objectives of efficiency and simplicity of the tax system. However, the Study focuses its attention on two proposals, HST and CBT, which require a much smaller degree of integration. By introducing flexibility into the tax coordination process, they are con-

sidered more practical and more politically viable than the aforementioned harmonised compulsory approaches. As past experience shows, the latter are heavily constrained by the unanimity decision rule: to make any progress in this field, the Commission is increasingly implementing or proposing the use of flexible coordination tools, as in the case, for example, of the Code of Conduct.

Both HST and CBT share with the Harmonised Tax Base proposal the important feature of leaving member states free to set their tax rates on allocated profits. In addition, HST and CBT introduce further flexibility with regard to the establishment of the tax base, the way in which the system can be agreed upon and implemented by member states, and the choice of countries and companies that may apply the new system. Under HST, branches and subsidiaries of companies operating within the EU would be taxed according to the rules of the parent company's home country, and the system could be agreed upon initially by a subset of member states on the basis of mutual recognition. In the case of CBT, on the other hand, existing national rules would be accompanied by a parallel system established at the EC level, which would be an alternative option to the domestic system for those companies operating at the EU level.

There are important differences between HST and CBT in terms of efficiency, simplicity and political process of implementation

There are a number of pros and cons to these flexible approaches: while they would facilitate the drawing up of agreements among member states, at the same time they usually involve efficiency losses as well as compliance and administrative costs. It might be worth bearing some costs in order to make some progress towards the coordination of corporate taxation. However, these costs have to be carefully assessed against expected benefits.

From this point of view, there are some important differences between the two proposals that are likely to attract the most attention during the future debate on EU corporate tax policy: i.e. HST and CBT. The following examples show some of these differences with regard to the efficiency of the two proposals, their simplicity and the political process of implementation.

Efficiency

As I have already mentioned, a consolidated system with formula apportionment is not globally neutral if there are different tax rates. Furthermore, the different definitions of the tax base under HST and CBT would have other consequences on efficiency that should be taken into account.

1. HST, even more than CBT, is closely intertwined with the formula apportionment system, and as experience in the United States and Canada have shown, with such a system it is better not to allow for divergences from the "federal" tax base and to restrict local autonomy to the granting of tax credits. In the case of HST, the existence of differences in accounting and tax rules leading to different tax bases is likely to result in distortions, complexities and disputes between the member states participating in the system. Moreover, the total tax base to be divided among these countries would depend on the country in which the parent company is located.

2. HST would not be based on a set of clearly defined, consistent common rules within the Community. Such a set of rules might emerge as the spontaneous result of a process of convergence towards the mean, or most favourable, system on the part of those countries who originally signed the agreement. However this would not necessarily be the best solution from the point of view of the economic efficiency of the EU as a whole. Moreover, as the Study points out, the expected convergence "… could equally turn into a 'brake' on future developments towards harmonization as it, to some extent at least, 'fixes' the tax code of participating Member States" (p. 382). With CBT, the course indicated would be a common one from the very start, and although it would not be binding on the companies of the various member states, it would constitute a benchmark for future taxation in the EU member states, and would be based on principles commonly agreed upon by member states.

3. Under HST, firms would be encouraged to locate the parent company in the country with the most generous methods of determining the tax base. Moreover, an important factor in this location choice would be the existence of taxation on a consolidated basis. In the case of HST, unless common rules were established, groups would initially be subject to a variety of tax regimes, with some countries permitting consolidation and others not, and in any case there would be substantial differences in the applicable rules. Convergence would require

amendments to the laws of individual member states, but that would be a lengthy process and in the meantime there would be distortions and complications that need to be researched more thoroughly.

4. The most serious weakness of the CBT proposal would be that by introducing an additional system, parallel to the existing ones, there would be discrimination between those companies operating at the EU level and taxed under the new regime, and purely domestic companies taxed under the national system. This is not the case with the HST proposal, according to which pan-European companies would be taxed according to the same legislation applied to purely domestic ones. On the other hand, however, CBT does not differentiate between companies operating in the same market according to the country of residence of the parent company, while HST does discriminate in this sense, thus violating the Capital Import Neutrality criteria. CBT therefore seems more effective in levelling the field of play for those companies operating at the EU level, and this could be the most urgently important objective in terms of EU international competitiveness and economic growth.

5. When analysing the effects of the CBT option, we must acknowledge that for each individual company there may be different pros and cons to choosing the new system rather than continuing with the present one. These reasons are also likely to change over time, whereas the option would remain the same, at least for a given period of time. In addition, if the proposal were successful in achieving its main goal, i.e. a reduction in the costs of different sets of accounting, administrative and tax rules, then most companies operating at the EU level would be encouraged to adopt the common system, even though it were not as favourable as the domestic system from the general point of view (without taking these compliance costs into account). Thus it is not clear whether CBT would discriminate against purely domestic companies. Were this the case, the discrimination between pan-European and domestic companies implicit in CBT could in the end be easily removed by making the new system available to all companies. If this solution were accepted by the member states, it might also speed up the process of convergence of domestic tax systems towards a common consolidated tax base.

Simplicity and compliance costs

The main advantage claimed in favour of HST is that it does not require participating member states to agree in advance on a common system of accounting and taxation. All that is needed is a sort of "mutual recognition" of national tax laws whereby the member states participating in the system would allow group companies operating within their borders to be taxed (in contrast with the present situation) on the basis of the rules of the country of residence of the parent company. The system would be "single" for each company, but would not be "common" to all companies within the EU.

At first sight the HST proposal appears simpler than the CBT alternative, because it can be implemented "on a current legislation basis". CBT, on the contrary, requires the definition of a new system, with all the complications this may involve not only in defining the items to be included in the tax base, but also in applying a new set of rules by companies and tax administrators too.

HST appears simpler but entails a number of complex problems

However, as the discussion in the Commission's Study makes clear, on closer examination it would seem that HST will require those countries participating in the agreement to find detailed solutions to a series of problems, particularly in the accounting, tax and administrative fields. For example, as underlined in the Study (p. 384e 385), if auditing and assessments were left to the tax authority of the subsidiary's host country, each administration would need to know and apply no less than 15 sets of income tax rules. To avoid this complication, auditing and assessments should be left to the authority of the parent company's home country, but this would limit the jurisdiction of the subsidiary's host country. Another particularly complex problem, once again underlined in the Study, concerns the transnational reorganisation of companies, since a change of ownership could change the method by which the company has to compute its tax base. By going into these details, it appears that the problems to be solved are in the end not very different from, and much less burdensome than, those facing the construction of a Community tax system parallel to those in force in the member states, as envisaged in the CBT proposal. Some of these problems, like the ones mentioned before, seem to be further exacerbated under HST.

Common accounting standard: A good starting point?

The Commission's Study (p. 375) and Communication (p. 18) point out that the progress already made in harmonising accounting methods towards the use of IAS, and the prospect of a speeding-up of this process, along with financial integration and the creation of pan-European stock exchanges, "may generally help the future development of a common corporate tax base and to some extent the IAS may serve as a useful point of reference". Both HST and CBT would greatly benefit from common accounting standards, and the latter could provide a good starting point for discussion of both proposals. Starting from consolidated accounts drawn up in this way, it would be necessary to identify and define the adjustments required to identify groups' consolidated income tax liability. The approach could be more or less flexible. For example, the introduction of common methods could be limited to the main accounting items, and provisions could be made for countries to apply their own legislation (in other words, a sort of HST) provided the differences with respect to the tax base defined at Community level were small, transparent and did not produce any significant distortions. Clearly, the flexibility granted would benefit member states' sovereignty at the expense of the neutrality of the tax, especially if formula apportionment were adopted. The question of which is the best trade-off remains open, and the answer will essentially depend on the compromises needed to reach an agreement among member states.

Common accounting standards are a good starting point for tax harmonization

The political process

The Study recognizes that "a new system, for example Common (Consolidated) Base, would be preferable to the extent that it can be designed to address any particular areas of difficulty. However, implementation of HST is potentially a quicker process…" (p. 379) since it does not require, as CBT does, the agreement and drafting of a new tax code. In fact, another attractive feature of HST is that it does not require the unanimous agreement of all the member states, but can be launched by a subset of countries, thereby avoiding the risk of its introduction being hampered by the decision-making difficulties inherent to the principle of unanimity that still holds in the tax field.

In principle, CBT as well could be implemented by a subset of member states. Here, however, the starting point is an agreement at the Community level on the rules to be used in determining the common tax base. The procedures will be the traditional ones adopted by the EU, requiring unanimity in the Council (p. 402) even though the introduction of the new system is acknowledged as being possible under the enhanced co-operation procedure, too (p. 376).

HST could begin not only by "enhanced co-operation", but also on the basis of a voluntary agreement, a form of "Home State Convention", drawn up by the participating member states. These two institutional approaches would have different consequences, as is recognised in the Study (p. 375). However, either of them would undoubtedly have the advantage of flexibility, and could thus be implemented more rapidly than traditional decisional rules would allow. Nonetheless, it is also true that under HST the initial agreement might only involve those countries with very similar accounting regulations and tax bases, so that it would be difficult for other countries to join at a later date unless they adapted their domestic legislation in order to satisfy the "basic requirements" established in the initial agreement.

The question then arises as to whether it would not be more appropriate for such important rules as those governing productive activities in the Single Market to be discussed and agreed by all the member states. Similarly, the question arises as to whether it would be better to guarantee the flexibility demanded by both companies and member states, by allowing a subset of countries to reach an agreement to proceed on their own, as envisaged in the HST proposal, or by building a parallel system alongside the existing one and leaving individual firms to decide whether or not to participate, as envisaged in the common base proposals. With the CBT approach, once the member states had agreed a set of common rules, the new system would be allowed to function alongside the ones existing within the member states, the idea being that these would tend to converge towards the one established at Community level. Individual firms would be able to join the system (and, if this were introduced in a directive, to exploit the latter's effectiveness even before it was transformed into national law), and individual countries would not have to change their domestic legislation, apart from whatever is needed to

enable companies to choose the new common EU system. In the case of HST, on the contrary, firms would not be able to join the new system until the countries in which they operate had signed the agreement, and these countries might have to make significant changes to their own legislation before being granted membership. In the meanwhile there would be discrimination and distortion of competition between firms in different member states.

The level of tax rates

The quantitative analysis offered by the Commission's Study clearly highlights the important role of national tax rates in determining marginal and average effective tax rates. A move towards a common base system or home state taxation with consolidated profits and formula apportionment would not remove all the distortions of the existing system. On the contrary, as the tax policy scenarios simulated in the Study demonstrate, in some circumstances distortions might even increase.

Despite these results, the Commission's Communication concludes that: "at this point in time there is no convincing evidence for the Commission to recommend specific actions on the appropriation of the national corporate tax rates or the fixing of a minimum tax rate" (p. 9).

The policy suggested by the Commission will lead in the direction of harmonisation of the tax base, without any similar coordination of tax rates. Member states will maintain a great degree of tax autonomy, and be more inclined to agree on some co-ordination, but again the question arises of the cost to be paid in terms of efficiency losses.

Given the flexibility introduced by proposals such as HST and CBT, the distortions produced by existing national tax rates are likely to remain significant. In fact, the existence of different tax rates would undermine neutrality in the allocation of capital and productive activities even if the system were adopted by all companies and all countries, as in the United States and Canada. It is no coincidence that in federal States like the United States or Canada, the fiscal autonomy of member states is limited by the floor effectively provided by federal taxation. Moreover, the variation in rates is much smaller than that seen in the EU. Here, tax rates range from a minimum of 12.5% (in 2003 in Ireland) to over 40%. The comparable state rates for the United States range from 0% to 8%, whereas in Canada the provincial tax rates range from 14% to 17%. (Commission's Study, p. 420).

These considerations, along with the quantitative results we have, strongly suggest that some approximation of rates, together with tax bases, needs to be the next subject of EU corporate tax policy. Given the desire to leave some autonomy to member states with regard to taxation of corporate income as well, the introduction of a floor for corporate taxation, like the minimum VAT rate or that of federal corporate taxation in the United States and Canada, could be the best, most practical solution, for the following reasons.

Firstly, it would prevent excessive competition between rates, which is bound to increase along with the reduced possibility of competing through the tax base, due to the Code of Conduct, and tax-base co-ordination. One well-known example is Ireland's move to reduce the rate to 12.5% at the prospect of abolishing preferential tax regimes.

Differences in national tax rates must be minimised and/or a minimum tax rate introduced

Secondly, a minimum tax rate would be particularly useful in extracting the economic rents of foreign investment in the EU. International economic studies show that foreign investment is mainly driven by non-tax factors, such as the benefits of agglomeration and the extent of the market. Foreign investment in the Internal Market, principally made in order to take advantage of the benefits of this market, would not be discouraged by this minimum tax provided it were internationally competitive and withdrew only part of the rents that could not be produced elsewhere. At the same time, it could guarantee a higher overall tax revenue than the one achieved by the EU as a whole if the various member states were totally free to compete for that investment. This issue is bound to become increasingly more important in view of the future expansion of the EU: among the candidates for membership are countries like Estonia which have already reduced the corporate tax rate to zero. With a minimum tax rate, all countries would be put on a similar footing, but they would still be free to

apply higher rates. The latter would be sustainable as long as they reflected better services or infrastructures offered by the host country, or the presence of location rents that are not wiped out by formula apportionment.

To conclude then, it is encouraging to see that the Commission has launched a general debate on the question and problems of corporate tax co-ordination within the EU, and has proposed a consolidated tax base for EU businesses. However, the question of tax rates must also be addressed, and in fact there is a need to rekindle debate concerning the principles of corporate taxation to be adopted within the European Union (a debate which appears to have currently withered within the Community). This implies extending the scope of the debate to cover the entire question of taxation of investment income (dividends, interest payments and capital gains), and the corresponding rates, *inter alia* compared to those applied to labour income.