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Harmonizing Corporate Income Taxes in the European Community: Rationale and Implications

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Executive Summary

The member states of the European Community (EC) have systems of taxing corporate income that were designed for nations, not for members of an economic union. This paper describes the problems of the present system, which is based on separate accounting and arm's length pricing, the advantages of one based on consolidation and formula apportionment such as that employed by the U.S. states (and Canadian provinces), the likely characteristics of such a system, the complications caused by income flows to and from the EC, and the implications of harmonization, for both EC member states and non-EC nations and for multinational corporations. It seems virtually certain that a harmonized EC system (like that of Canada) would exhibit far more uniformity than state corporate income taxes in the United States and, like some state taxes (but unlike the Canadian system), would involve consolidation of the activities of corporations characterized by high levels of common ownership and control. Finally, the paper speculates on the prospects for harmonization, given(a) that adoption of tax measures applicable to all member states requires the unanimous approval of all EC member states, but (b) as few as eight member states could harmonize their taxes through enhanced cooperation.

5.1 Introduction

The member states of the European Community (EC, or the Community) impose corporate income taxes[1] that were designed for totally independent nations, not for members of an economically integrated union.[2] The European Court of Justice (ECJ) has underlined this fact repeatedly in decisions ruling that various aspects of the tax policies of Member States violate the EC Treaty, the de facto constitution of the EC.[3]

In March 2000, at its meeting in Lisbon, the European Council (comprised of the Heads of State or Government of EU Member States) adopted what have come to be called the Lisbon goals: "a **new strategic goal** for the next decade: *to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion*."[4] At the end of 2001 the European Commission—the executive body of the EC, hereinafter "the Commission"—stated that "reform of EU company taxation is crucial for achieving the Lisbon-goals"[5] and suggested that the EC Member States should harmonize their corporate income taxes, a view the Commission has reiterated repeatedly since then.[6]

The type of harmonized system currently being considered, called the Common Consolidated Corporate Tax Base (CCCTB), resembles in key respects—but not others—the systems the United States and Canadian provinces employ to tax corporate income.[7] In particular, there would be a common definition of taxable income and an agreed-upon formula would be used to apportion the consolidated income of certain groups of corporations among the EC member states where the members of the corporate group do business.[8] Both the Commission and the European business community have insisted that taxation under the CCCTB scheme could be optional for corporate groups—that is, that corporations and corporate groups should have the option to continue to be taxed under the national tax systems of the various member states where they operate.[9] Significantly, the Commission has stated repeatedly and unequivocally that it would not propose harmonization of statutory tax rates, leaving the setting of rates to the discretion of individual member states. For example, it states (CEC 2001a, 9), "the level of taxation in this area is however a matter for the Member States to decide, in accordance with the principles of subsidiarity."

Thus far the Commission's suggestion that corporate taxes be harmonized has had a cool reception in several member states, most notably in Ireland and the United Kingdom, but also in Latvia, Lithuania, Slovakia, Malta, and Cyprus, all of which joined the EC in 2004. This suggests that a formal proposal for harmonization would not enjoy the unanimous support that would be required for it to be adopted by the EC. Thus, in its 2001 report the Commission (CEC 2001b) suggested that participation in the CCCTB should also be optional for member states. More recently, realizing that merely being able to opt out of the CCCTB system might not satisfy the opponents of harmonization, the Commission (CEC 2004a) has proposed that as few as eight member states could proceed through enhanced cooperation to harmonize their corporate tax systems, and in late 2004 it convened the CCCTB Working Group to begin ironing out the many technical details of a proposal for harmonization that it plans to submit to the Council by the end of 2008.[10]

Corporate tax harmonization is not a sure bet, certainly not in the short term. But the EC member states will find it difficult to continue indefinitely to follow the independent nation paradigm. The next section sets the stage for the discussion that follows, first by providing basic data on corporate tax rates and the percentage of GDP represented by corporate tax revenues in EC member states and then by illustrating in general terms how a system based on consolidation and apportionment would work. Section 3 explains the rationale for harmonization, section 4 describes areas where there seems to be general agreement regarding the proper contours of harmonization, although significant questions remain regarding details, and section 5 discusses international issues, including the role of residence-based taxation in the CCCTB. Section 6 discusses in greater detail whether and why harmonization will eventually occur and section 7 examines some of the implications of harmonization, including those for nations outside the EC. It will be convenient to ignore for the most part—as Commission Services has in most of its analysis—the possibility that only a subset of Member States may initially adopt the CCCTB and that the scheme will likely be optional for firms.

5.2 Setting the Stage: Some Preliminaries

5.2.1 Basic Facts on Corporate Taxes in the EC

Table 5.1 presents basic facts about reliance on corporate income taxes in the EC. Statutory rates vary from 10 percent in Bulgaria and Cyprus and 12.5 percent in Ireland, to 38.7 in Germany and 37.3 percent in Italy. Statutory rates are substantially lower, on average, than in 1995. The unweighted average of statutory rates in all twenty-seven member states has fallen by almost 11 percentage points (from 35.3 percent to 24.5 percent) and that for the thirteen member states that comprise the Euro zone (the fifteen member states as of May 1, 2004, minus Sweden and the United Kingdom) has dropped by 10 percentage points, from 38.5 percent to 28.5 percent. Differences in statutory rates create incentives for income shifting of the type to be described below. The risk of income shifting, in turn, is one of the pressures member states feel to lower statutory rates.

Table 5.1
Adjusted Top Statutory Tax Rate on Corporate Income, 1995 and 2007, and Corporate Income Tax as Percent of GDP, 1995 and 2005

	Top Statutory Tax Rates			Corporate Income Tax as % of GDP		
Member State	1995	2007	Difference	1995	2005	Difference
Belgium	40.2	34.0	–6.2	2.3	3.5	1.1
Bulgaria	40.0	10.0	–30.0	–	3.1	–
Czech Republic	41.0	24.0	–17.0	4.6	4.5	–0.1
Denmark	34.0	28.0	–6.0	2.3	3.8	1.5
Germany	56.8	38.7	–18.1	2.1	2.5	0.5
Estonia	26.0	22.0	–4.0	2.4	1.4	–1.0
Ireland	40.0	12.5	–27.5	2.7	3.4	0.7
Greece	40.0	25.0	–15.0	2.6	3.6	0.9
Spain	35.0	32.5	–2.5	1.9	3.9	2.1
France	36.7	34.4	–2.2	1.8	2.4	0.7
Italy	52.2	37.3	–15.0	2.9	2.9	0.0
Cyprus	25.0	10.0	–15.0	4.2	4.7	0.4
Latvia	25.0	15.0	–10.0	1.8	2.0	0.2
Lithuania	29.0	18.0	–11.0	2.1	2.1	0.0
Luxemburg	40.9	29.6	–11.3	6.6	6.0	–0.6
Hungary	19.6	18.6	–1.1	1.9	2.2	0.3
Malta	35.0	35.0	0.0	2.7	4.0	1.3
Netherlands	35.0	25.5	–9.5	3.3	3.7	0.4
Austria	34.0	25.0	–9.0	1.6	2.3	0.7
Poland	40.0	19.0	–21.0	2.7	2.5	–0.2
Portugal	39.6	26.5	–13.1	2.4	3.0[#]	0.6[#]
Romania	38.0	16.0	–22.0	–	2.7	–
Slovenia	25.0	23.0	–2.0	0.5	2.9	2.3
Slovakia	40.0	19.0	–21.0	6.8	2.8	4.0
Finland	25.0	26.0	1.0	2.3	3.3	1.0
Sweden	28.0	28.0	0.0	2.6	3.8	1.1
United Kingdom	33.0	30.0	–3.0	2.9	3.4	0.6
Average, EU–27	35.3	24.5	–10.8	2.3[+]	3.0[+]	0.7[+]
Average, EU–13	38.5	28.5	–10.0	2.2[+]	2.9[+]	0.7[+]

Source: CEC, Taxation Trends in the European Union, 2007: Main Results, Table B.
[#] 2004
[+] Weighted average

Corporate income tax revenues (as a percent of GDP) in 2005 ranged from 1.4 percent in Estonia, where only income that is distributed to shareholders is subject to tax, to 6 percent in Luxemburg. Between 1995 and 2005 the weighted average of this percentage fell by 0.7 percentage points for all twenty-seven member states, as well as for the thirteen member states in the Euro zone. This suggests that rate reduction was accompanied by base broadening.[11]

5.2.2 *An Illustration of Consolidation cum Apportionment*

The following example shows how apportionment would work, in the context of both two individual corporations that are not consolidated and a consolidated group comprised of the two corporations. Assume (a) that corporation A operates in (and has taxable nexus in) jurisdictions 1 and 2 and that corporation B operates in (and has taxable nexus in) jurisdictions 2 and 3; (b) that the apportionment formula used by all three jurisdictions accords equal weight to payroll and sales, as in Canada; and (c) that the two corporations have the income and the apportionment factors shown in table 5.2.[12]

Suppose, first, that activities of the two corporations are not consolidated. Since corporation A has 40 percent of its payroll and 60 percent of its sales in jurisdiction 1, the equally weighted two-factor formula assigns half of its total income of 1000 to that jurisdiction (and the other half to jurisdiction 2). The calculation is even simpler for corporation B—since it has 40 percent of both payroll and sales in jurisdiction 2 and 60 percent of both in jurisdiction 3, the two jurisdictions are assigned those fractions of its income of 2000.

If the two corporations are consolidated, their payroll and sales are aggregated to calculate the group's two apportionment factors in each of the three jurisdictions and the consolidated income of the group (three thousand dollars) is multiplied by the weighted average of the two apportionment factors of the group (in this case, the simple average since the factors are weighted equally) to determine the division of the tax base among the three jurisdictions.[13]

5.3 The Rationale for Harmonization

The rationale for harmonization lies in the defects of the present method of taxing corporate income in the EC.[14]

Table 5.2
Illustration of Apportionment for Two Separate Entities and for a Consolidated Group

	Income	Payroll				Sales				Average/Distribution of tax base		
Jurisdiction		1	2	3	Total	1	2	3	Total	1	2	3
Corporation A	1,000	600	900	n.a.	1,500	1,200	800	n.a.	2,000			
Dist. of factors (%)		40	60	n.a.	100	60	40	n.a.	100	50	50	
Dist. of tax base	1,000									500	500	
Corporation B	2,000	n.a.	1,000	1,500	2,500	n.a.	1,200	1,800	3,000			
Dist. of factors (%)		n.a.	40	60	100	n.a.	40	60	100		40	60
Dist. of tax base	2,000										800	1,200
Consolidated	3,000	600	1,900	1,500	4,000	1,200	2,000	1,800	5,000			
Dist. of factors (%)		15	47.5	37.5	100	24	40	36	100	19.5	43.75	36.75
Dist. of tax base	3,000									585	1,312.5	1,102.5

5.3.1 *Lack of Uniformity*

The first C in CCCTB stands for common. A common or uniform system would counteract the effects of non uniformity.[15]

Complexity A corporate group operating throughout the EC must comply with the tax laws of twenty-seven member states and must deal with the tax administrations and legal systems of all those jurisdictions. There is no equivalent to the U.S. Internal Revenue Code (which states take as the starting point in defining taxable income) or to the Internal Revenue Service (which the states rely on for the heavy lifting of tax administration).

What Europeans call *negative harmonization* occurs when the ECJ finds that a tax provision contravenes the EC Treaty. But such proscriptive harmonization does not necessarily produce uniformity, as there are usually many ways member states can—and do—respond to a given ECJ decision.

Complexity impedes the functioning of the internal market, especially by discouraging small and medium enterprises from expanding into additional member states. Harmonization of tax laws and administration would reduce complexity.

Uncertainty The existence of twenty-seven separate tax systems also increases uncertainty for taxpayers, likely discouraging investment.[16] The meaning of the tax laws of individual member states may be unclear (especially to outsiders), administrative and judicial interpretations of laws may be arbitrary or even capricious, and laws and interpretations may be subject to frequent change. Even when ECJ decisions appear to benefit taxpayers, they may also increase uncertainty, because of the difficulty of predicting how various member states will react to them.

Harmonization may reduce uncertainty by providing statutes and interpretations that are uniform—and applied uniformly—and by reducing the need for the ECJ to rule on cross-border tax matters. Because of the difficulty of modifying laws legislated jointly by numerous member states, stability is also likely to be enhanced. While stability may generally be desirable, it can (of course) also be problematical if it hinders needed change.

5.3.2 *Reliance on Separate Accounting and the Arm's Length Standard*

The second C in CCCTB stands for consolidated. Consolidation of the activities of corporate groups for tax purposes would alleviate the problems inherent in taxation based on separate accounting and the arm's length standard (SA/ALS), which is the norm in the EC as well as in international taxation more broadly.

One of the key questions that all tax systems must answer is how much of the income of a multijurisdictional corporate group should be attributed to the taxing jurisdiction. In the international arena this is done by application of entity-based SA/ALS. That is, separately incorporated entities are ordinarily treated as distinct taxpayers[17] and—in determining the income of each—it is assumed that transactions between affiliated entities occur at prices that would be observed in transactions between entities operating at arm's length. If separate entities are employed to conduct business in each nation, SA/ALS provides an answer to the income attribution problem.[18] If branches (permanent establishments or PEs) are used to conduct business, jurisdictions where branches are located also employ separate accounting to isolate their income.

Transfer Pricing Applying the methodology of SA/ALS to economic relations in the context of an economically integrated union is fraught with problems. First, because of the nature of the modern multinational corporation there may be few (if any) comparable transactions with unrelated entities involving the goods and services for which transfer prices are sought, and the terms of transactions by competitors may not be observable (even if they would be comparable). These problems are especially serious in sectors where intangible assets are the crown jewels of the corporation, such as computer software and pharmaceuticals.[19] More fundamentally, economic interdependence between various parts of a corporate group may make it conceptually impossible to identify arm's length prices.

Second, since transfer pricing methodologies provide, at best, a range of acceptable transfer prices, taxpayers may be able to manipulate transfer prices to shift income from high-tax to low-tax jurisdictions. This almost certainly helps explain both the extraordinarily high rates of profit reported in Ireland—which until recently had the lowest corporate tax rate in the EC—and Ireland's resistance to corporate tax harmonization. Honohan and Walsh (2002, 39–40) write evocatively regarding industries estimated to have annual rates of return on capital invested in Ireland in excess of 10 percent:

> [T]hese are all industries characterized by highly valuable patented products. Most of the research and development that went into producing these goods

> was conducted in affiliates of these enterprises in other countries, mainly the United States. . . . In effect, since Ireland has by far the lowest standard rate of tax on manufacturing among the advanced economies, these transactions are booked at transfer prices that have the effect of locating a very large fraction of the enterprise's global profits in Ireland. . . . What is clear is that, in many cases, the huge profits recorded by the Irish affiliates have little to do with the manufacturing activities conducted in Ireland.[20]

Third, in an effort to prevent income shifting, many nations have imposed increasingly onerous requirements for documentation of transfer prices. EC parent corporations with subsidiaries in other member states have identified compliance with requirements to document transfer prices as their principal compliance problem. Reporting on the results of a European Tax Survey, a Commission staff working paper (CEC 2004b) states. "The estimates highlight that transfer pricing is an important issue for 82.8% of large companies, in particular when it comes to dealing with documentation requirements, which are a difficulty for 81.9% of the large companies."

Fourth, the tax authorities of member states cannot always agree on transfer prices—despite the existence of advance pricing agreements, mutual agreement procedures, and the recent establishment of the EC Transfer Pricing Forum. When this happens, multiple taxation may occur.

Finally, in a closely integrated economic union it may not make sense from a business point of view to employ a separate legal entity to operate in each member state or to keep separate accounts for branches operating in various member states, even if those qualify as PEs under ordinary definitions and international practices. Doing so could clearly be an unproductive activity, especially for small and medium-sized businesses, and requiring it would be contrary to the Lisbon objectives.

If geographic SA/ALS were used to determine the income to be attributed to each jurisdiction, it would encounter all the problems just described. Beyond that, it would be inefficient and contrary to the Lisbon objectives to require geographic separate accounting for tax purposes, since it would not likely be needed for any other reason.

Consolidation would eliminate the need for transfer pricing of transactions occurring within the consolidated group and, thus, all the problems just described, since all such transactions would be ignored. To the extent that member states or corporate groups did not participate in CC-CTB, transfer pricing problems would remain. And, of course, transfer pricing would still be required and would continue to cause problems for transactions with non-EU entities, including those located in tax havens. Introduction of the CCCTB system would, however, free up administrative resources of participating member states to deal with these problems.

Financial Structure Multinational corporations have an incentive to borrow in member states where tax rates are high, in order to maximize the tax saving from interest deductions.[21] Some countries employ thin capitalization rules to limit interest deductions, but the ECJ has found that such rules violate the EC Treaty if they distinguish between residents of the taxing member state and residents other member states.[22]

Consolidation and formula apportionment would eliminate the incentive to borrow in high-tax member states to finance investments in low-tax member states, by effectively allocating interest deductions among member states, no matter where borrowing occurs. As with transfer pricing, if corporations or low-tax member states did not participate in the CCCTB there would still be an incentive to borrow in high-tax member states (or in participating member states). Moreover, the CCCTB would not eliminate the need for thin capitalization rules to be applied to debt involving non-EU entities.

Different Taxation of Various Types of Income In the present system, different types of income may be taxed differently. Business profits are taxed on a net basis by the member state where they are deemed to originate (the source jurisdiction), but source jurisdictions tax interest, royalties, and dividends on a gross basis (with no deductions for costs of earning the income), if at all.[23] Deductions are allowed for interest and royalties, but not for dividends. The characterization and geographic source of income is, therefore, crucial. By comparison, under consolidation all flows of income (like other transactions) within the consolidated group would be ignored and the aggregate income of the consolidated group would be apportioned by formula. Thus, the nature and geographic source of income within participating member states would no longer matter.

Lack of Loss Offset EC member states allow only very limited ability to offset losses incurred in one member state against profits earned elsewhere in the EC.[24] In a recent decision, the ECJ ruled that member states are not required to allow corporate parents to take deductions for losses subsidiaries incur in other member states, unless all possibility of relief by the other member state has been exhausted.[25] The limited ability to offset losses discourages risky cross-border investment and—because of the difference in size of their internal markets—gives the larger member states an artificial advantage over the smaller ones in attracting investment. Consolidation automatically provides complete loss offset, including horizontal loss offset (i.e., losses of one subsidiary against profits of another), as well as vertical loss offset (losses of a subsidiary against profits of the parent).

Tax Consequences of Reorganizations Despite the existence of the EC directive on mergers, reorganizations of corporate groups that extend across boundaries between member states may have tax consequences (e.g., deemed realization of capital gains) that impede cross-border investment.

Gaps and Overlaps in Taxation Gaps and overlaps in taxation can occur to the extent that tax systems—including definitions of taxable income and administrative practices, especially in regards to transfer prices—are not mutually consistent. The lack of loss offset means that the income of a group is not truly taxed on a net basis. The universal adoption of a common definition of income, a common method of consolidation, and a common apportionment formula would go a long way toward eliminating gaps and overlaps in the taxation of EC-source income.[26] Of course, if not all member states—and not all corporations—were to participate in CCCTB, gaps and overlaps in taxation could remain.

An Example A simple example illustrates some of the problems with SA/ALS and indicates how consolidation and formula apportionment would address these issues.[27] Suppose that a multinational group headquartered in Luxembourg uses legally separate entities chartered in each member state to engage in the following closely integrated activities in the member state indicated: research in the United Kingdom, financing in Germany, production in Ireland, and sales that are profitable (as measured by SA/ALS) in France and Belgium, but unprofitable in Italy. Under current practice, each of the seven member states identified would employ SA/ALS based on relevant domestic law (perhaps as modified by treaties) to determine the income of the entity subject to its jurisdiction. It would, thus, be necessary for each member state to determine the nature and geographic source of all income flows to or from it, and the proper transfer prices (including royalties and interest rates) to employ in valuing transactions occurring between the various members of the corporate group—that is, for headquarters activities, financing, research, and the sale of final products. Transfer prices may be manipulated to shift income to Ireland, which has the lowest corporate tax rate; arm's length prices may not exist for some transactions, for example, for royalties paid for the fruits of research activities; and member states may not agree on particular transfer prices. Absent ECJ prohibition, Germany might apply its thin capitalization rules to limit the revenue effects of interest deductions. Also, the Italian losses cannot be used to offset income earned in other member states. This system is clearly complex and there is little reason to expect that gaps and overlaps in taxation would not occur.

Assuming that these seven member states and the corporate group participated in CCCTB, all activities occurring within the seven member states would be consolidated and the aggregate net income therefrom would be apportioned among the seven through the use of a common formula. Transfer pricing for tax purposes would not be needed for transactions occurring within the group, and the Italian losses would automatically be offset against income earned elsewhere.[28] Under CCCTB the definition of the tax base, the rules for consolidation, and the apportionment formula would all be uniform. CCCTB would be simpler than the present system and, at least within these seven member states, there would be no gaps or overlaps in taxation.

5.3.3 Problems of Consolidation cum Apportionment

Consolidation cum apportionment is not without problems. First, there are no scientifically defensible *and* easily implemented answers to two crucial questions: the proper definition of the group whose activities are to be consolidated and the best apportionment formula to use to divide consolidated income among member states. These issues are discussed further in the next section.

Second, the outcome of apportionment is inevitably arbitrary. Thus, while this methodology may, on average, produce a division of income among jurisdictions that approximates the true division, it may not do so for any particular taxpayer under all circumstances. In deciding whether this is an acceptable price to pay to avoid the problems of SA/ALS described previously, it is necessary to remember that—despite its conceptual attractiveness—SA/ALS also may not accurately determine the true source of income.

Third, taxation based on formula apportionment may distort the location of economic activity. This is most easily understood by appreciating that a tax that is apportioned according to a formula is economically similar to a tax levied on the factors in the apportionment formula.[29] If, for example, payroll and property are used to apportion income, a tax on apportioned income resembles a tax on payroll and property. This is, however, an incomplete diagnosis of the distortionary effects of replacing SA/ALS with consolidation cum apportionment. After all, a tax based on SA/ALS that accurately captures the geographic source of income may also distort the location of economic activity, although perhaps in a different manner. Only if—and to the extent that—a tax based on SA/ALS falls on location-specific economic profits or can be avoided by shifting income for tax purposes—for example, by manipulating transfer prices—will it not affect the location of economic activity. Note that an apportioned tax on economic profits does distort locational choices. Many would consider the ease of avoiding a tax based on SA/ALS through income shifting an anomalous reason to prefer SA/ALS over consolidation cum apportionment from the viewpoint of neutrality toward economic location.

Finally, the use of consolidation cum apportionment within a limited geographic area such as the EC may not be easily reconciled with the worldwide use of SA/ALS to determine the source of income. There are three types of issues. The first is whether, in principle, the two systems can be reconciled. The second is whether they can be reconciled in practice, given both that the various EC member states treat foreign-source income differently and that they have double taxation treaties based on SA/ALS with many foreign nations. Section 5 examines these. Issues that arise if not all EC member states participate in the CCCTB (consideration of which the working group has deferred) are mentioned at various points, but not examined in detail.[30]

5.3.4 Corporate Tax Rates: the Elephant in the Room.

It may seem rather anomalous that the Commission has repeatedly stated explicitly that it has no intention of harmonizing corporate tax rates, given (a) that differences in marginal effective tax rates can distort the location of economic activity, (b) that a large portion of the staff paper accompanying the Commission's 2001 communication was devoted to quantifying the large differences in marginal effective tax rates prevailing in various member states, (c) that differences in statutory tax rates were by far the most important reason for differences in effective tax rates, and (d) that differences in marginal effective tax rates would become even greater if tax bases were harmonized, but rates were not changed.[31] Sørensen (2004, 103) notes, ". . . many tax experts find it paradoxical that the commission emphatically rejects any form of coordination of corporate tax rates, despite the finding in the report that about three fourths of the current dispersion of effective corporate tax rates in the EU are due to differences on statutory tax rates." Some argue that rates, as well as tax bases, should be harmonized in order to reduce distortions of the location of economic activity and to reduce tax competition.

By comparison, both the Commission and the business community have insisted strongly on member state sovereignty over rates, as a means of promoting tax competition among member states, keeping tax rates down, restraining the growth of government, and avoiding adverse effects on the competitive capacity of EU business. The Commission has stated:

> a reasonable degree of tax competition within the EU is healthy and should be allowed to operate. Tax competition may strengthen fiscal discipline to the extent that it encourages Member States to streamline their public expenditure, thus allowing a durable reduction in the overall tax burden.[32]

It is possible that—by increasing transparency—harmonization of tax bases will induce greater tax competition, which would then be confined to tax rates. As explained further in the following, competitive effects would depend (in part) on the apportionment formula chosen; tax competition would be greater if apportionment were based on the location of payroll or property, the origin of value added, or the origin of sales than if it were based on macro factors or the destination of sales.[33] Note that macro factors and value added at origin should probably be omitted from this comparison because of the fatal defects identified below.

Some fear that once the tax base is harmonized, the Commission will move on to advocate rate harmonization. For example, Graetz and Warren (2006, 1229) write, "One cannot help but ask whether the Commission's ongoing efforts to harmonize corporate tax bases is—despite its protestations—simply a stalking horse for a subsequent push to conform rates." These authors, along with many others, decry the loss of sovereignty over tax policy implied by harmonization of tax bases—noting that member states could no longer use tax policy (except as expressed in the level of rates) to further their economic objectives. Critics of this view argue that the exercise of sovereignty in the corporate tax area, except in regard to rates, seems often to run counter to the creation of a single market.[34]

5.4 The Likely Contours of Harmonization

It seems virtually certain that any proposal for a Common Consolidated Corporate Tax Base would contain three key elements: a common tax base, consolidation, and formula apportionment.[35] Unlike the situation in the United States, where the states are allowed—and exercise—great latitude in regard to these matters, in the EC uniformity would likely extend beyond the tax base to include the criterion (or criteria) for consolidation and the apportionment formula (or formulas) used to divide income, including the definition of the factors in the formula (sometimes called keys in the EC). But the definition of apportionable income, the basis for consolidation, and the apportionment formula are still unsettled. Even so, it is possible to discern some aspects of the form harmonization is likely to take.[36]

5.4.1 Optional Corporate Participation

As noted earlier, there is general agreement that corporate participation in the CCCTB system should be optional. In order to prevent a situation where some members of a group of affiliated corporations participate and others do not, in order to game the system, Commission Services has proposed that all members of groups linked by more than 50 percent common ownership must either opt in or opt out of CCCTB.[37] As noted later, where common ownership exceeds 75 percent, mandatory consolidation would be required of those opting in.

5.4.2 Common Tax Base

In order to reduce complexity substantially, it is necessary that there be a common tax base. This is a tall order, and not only because the income tax laws of the twenty-seven member states currently differ significantly in important respects. First, contrary to the situation with free trade or the taxation of value added, there is no single objectively defensible definition of income for tax purposes. Second, and probably more important, contrary to the situation in the United States and Canada, there is no higher-level government in the EC that provides a definition of income from which EC member states can start in defining apportionable income.

Commission Services favors taking International Financial Reporting Standards (IFRS, formerly called International Accounting Standards or IAS, the international equivalent of GAAP) as the starting point for the measurement of income, but recognizes that "it is not possible to make a formal link between the base and IAS/IFRS." Rather, the tax base would be computed by reference to national GAAP in the various member states.[38] Commission Services supports basing taxation on accrual but with somewhat more emphasis on realization than is found in IFRS. Also, the Commission believes that the definition of income should be chosen with the Lisbon objectives in mind.

Among the many issues in this area the CCCTB Working Group has addressed, depreciation allowances are among the most important. Commission Services has suggested that separate accounts be maintained for individual buildings and other long term tangible assets, which would be depreciated on a straight-line basis (2.5 percent per year for buildings, 4 percent per year for other long-term assets). By comparison, short- and medium-term assets would be pooled, with 20 percent of the undepreciated basis written off each year.[39]

It will be necessary to employ arm's length prices for transactions between related parties that are not part of a consolidated group. Commission Services has suggested that for this purpose related parties should be defined as those related by a minimum of 20 percent common ownership, as measured by voting rights.[40]

An issue that arises much more prominently in the EC than in the United States is how to treat taxes the member states collect to finance social insurance. If such taxes are deductible, because of apportionment, all member states would (in effect) share in the cost of social insurance provided by any member state.[41] Actually, the same issue arises with any tax that is used to finance an extraordinarily high level of public service in a particular member state. Commission Services has suggested that certain local taxes should be deducted from member state shares of the consolidated tax base, which would be calculated without allowing deductions for such taxes.[42]

It may be worthwhile to mention several areas in which the EC seems unlikely to follow U.S. state practice in defining the tax base. First, Commission Services has suggested that the EC not distinguish between business income (apportioned in the United States) and non business income (assigned to particular states)—choosing instead to apportion all consolidated group income.[43]

Second, depending on the degree of common ownership of the payor, intercorporate dividends may be subjected to three taxing regimes that can differ from those in the United States.[44] Dividends flowing between members of a consolidated group would be ignored, as by U.S. states that provide for combined reports (the U.S. equivalent of consolidation). As noted below, consolidation would be mandatory under certain circumstances—unlike the situation in many U.S. states. Consistent with the parent-subsidiary directive, the EC seems likely to exempt intercorporate dividends paid by majority-owned EC subsidiaries that are not part of a consolidated group. Finally, Commission Services has suggested that dividends from portfolio investment in EC corporations be subject to a tax and credit scheme. See the discussion accompanying table 5.3. In the United States, the federal government exempts most intercorporate dividends but the states commonly do not.[45]

5.4.3 Consolidation

It seems virtually certain that the activities of certain related entities would be consolidated for tax purposes. The Commission and its staff have repeatedly expressed a preference for consolidation (CEC 2006a, 7; 2007c, 21). As noted earlier, consolidation would eliminate several of the problems of SA/ALS: those associated with transfer pricing, differences in the tax treatment of various types of income, the use of financial structure to shift income, and lack of loss offset. With consolidation, flows of income (and other transactions) between members of the consolidated group would be ignored, there would be no need to calculate transfer prices on such transactions, and losses of one member of the group would automatically be offset against profits of other members of the group.

Commission Services favors a criterion for consolidation based on common ownership or control. Consolidation would be mandatory for parents, PEs located in the EC, and EC subsidiaries with more than 75 percent common ownership, either direct or indirect (termed qualified subsidiaries).[46] While the favored approach might be susceptible to tax planning, it would be relatively simple and objective, unlike a more subjective criterion based on the existence of a unitary business, which is required under U.S. jurisprudence for mandatory combination.[47]

5.4.4 Formula Apportionment

Under the CCCTB, a formula (rather than SA/ALS) would be used to divide the income of corporate groups—which could consist of a single corporation with branches in various member states—among the various member states in which the members of a group operate. In Canada, for example, all the provinces use a formula that accords equal weight to the fractions of the taxpayer's total payroll and sales located in the province. Significantly, in Canada, the provinces—following the lead of the federal government—do not allow or require consolidation. By comparison, the formulas that most U.S. states employ consider the in-state fractions of payroll, property, and sales, but not all states apply the same weights to the three factors and some use only sales to apportion corporate income.

The choice of apportionment formula involves the balancing of several objectives, including (a) the reflection of where income originates, (b) the distortion of decisions on the location of economic activities, (c) the likelihood of tax competition (which some see as positive and others see as negative), (d) the risk that the taxpayer will manipulate apportionment factors to shift income to low-tax member states, (e) the distribution of revenues among member states, and (f) the ease of implementation.[48] For example, a formula that reflects the origin of income is likely to distort the location of economic activity and give rise to tax competition.

Commission Services has discussed three basic approaches, only one of which seems viable. Under the macro approach, the consolidated income of a corporate group would be divided among member states in proportion to their shares in some EC wide variable such as GDP. For example, if the GDP of member state X was 15 percent of the GDP of the EC, 15 percent of the tax base of all corporate groups opting for CCTB would be attributed to that member state.[49] While this approach would be simple and eliminate all locational distortions, tax competition, and opportunities for manipulation, it has the obvious and perhaps fatal flaw that the amount of a group's taxable income attributed to a particular member state would bear no necessary relationship to its economic activity there. Besides failing to accord with common notions of fairness, this approach would create a perverse incentive for member states to raise their tax rates, since doing so would not greatly discourage economic activity within their borders. But the implied race-to-the-top in tax rates would discourage investment in the EC and clearly be contrary to the Lisbon goals. Commission Services has shelved this alternative for now.[50]

A second approach would apportion a group's taxable income among member states in proportion to the group's value added in the various jurisdictions, with value added being measured on an origin basis. This approach would be conceptually attractive, as it may reflect fairly accurately where (on average) income originates. It may also be consistent with benefit-based taxation, but to the extent that it is not, it would distort the location of economic activity and encourage undesirable tax competition. Moreover, the necessity of valuing exports and imports would reintroduce transfer pricing problems, one of the shortcomings of SA/ALS that the CCCTB is intended to overcome. This approach has also been shelved.[51]

The final alternative, and the only one under active consideration, is to employ arbitrary factors such as payroll, property, and sales to apportion income, as in the United States and Canada. Commission Services and the CCCTB Working Group are currently discussing which factors to use, what weights to attach to them, and how to define them. While there seems to be strong support for using payroll and property to apportion income, support for also using sales appears to be much weaker.[52]

Among the key issues being discussed regarding the definition of the payroll factor are whether to have a common definition of employees or to rely on definitions of the various member states; the value to be placed on payroll, with Commission Services suggesting the amount that is allowed as a tax-deductible expense; the treatment of outsourced services; the treatment of temporary or interim staff; the basis for assigning payroll to particular member states (e.g., where services are performed); and whether adjustments should be made to reflect differences in wage rates in the various member states. A possible compromise on the last issue would involve temporarily using the number of employees in conjunction with payrolls.[53]

Commission Services has suggested that property be measured as a stock, rather than as a flow.[54] Among the most intractable problems in this area is how to reflect the contribution of intangibles such as intellectual property in an apportionment formula (McLure 1997). That is, what value should be placed on such intangibles and what is their location? Recognizing these problems, the fact that the payroll and property factors may reflect the location of intangibles, and the risk that the location of intangibles could be manipulated, Commission Services has suggested that intangibles (as well as financial assets) be excluded from the property factor. Other issues being discussed are where property should be assigned, its valuation (e.g., historical costs, as in the United States, or historical cost written down for depreciation), and the treatment of rented and leased assets.[55]

Inclusion of a sales factor in the apportionment formula, and on what basis, has been the most controversial issue in the choice of the apportionment formula.[56] Some believe that sales at destination should be included to reflect the contribution of demand to the earning of corporate income.[57] Others counter that sales at destination have no place in the formula, because income is created where production occurs. They also note that current international rules for dividing income place no weight on demand and that sales are already being taxed under the destination-based VAT.

Determining the destination of sales of tangible products would seem to be relatively straightforward, since destination can be defined as the place where goods are physically delivered. Even so, some representatives of business prefer that sales be excluded from the apportionment formula, because of concerns that the destination of sales can be manipulated and anti-abuse methods required to prevent manipulation would seriously complicate compliance. By comparison, it is much more difficult to determine the destination of services and products that are delivered electronically—a point that has received considerable attention in the context of taxing electronic commerce.[58]

Some argue that sales at origin would be largely redundant, but others note that payroll and property factors do not capture the contribution of intermediate inputs. Including sales at origin would create opportunities for manipulation and reintroduce transfer pricing problems, one of the issues that motivates interest in the CCCTB and caused rejection of apportionment based on value added at origin.

However these issues are resolved, it appears to be agreed that only receipts received from the sale of goods and services in the normal course of business should be included in the sales factor—and, thus, that sales of financial assets (except by financial institutions), as well as dividends and interest, should not be included.

5.4.5 Administrative Streamlining

If one were designing, anew, a CCCTB that all twenty-seven member states would apply to all corporations—without the constraints imposed by existing legal and administrative structures—there would probably be a single set of laws and interpretations and common administrative rules and procedures. Moreover, to simplify compliance and administration, there would probably also be a one-stop-shop approach to tax administration so that a group parent could register and file the tax return for the entire group with the tax administration where it is headquartered.[59]

In fact, each member state has laws—including those governing tax administration—that must be taken into account in designing the legal and administrative aspects of the CCCTB.[60] For example, there are twenty-seven sets of laws and rules covering such crucial issues as registration with tax authorities, filing requirements, the nature and form of documents and documentation to be submitted, assessment of tax liabilities, audit, interpretation of statutes, dispute resolution, the disclosure of taxpayer information, and statutes of limitations. It seems unlikely that all of these are to be swept away and replaced by a single set of laws and rules, especially if participation in CCCTB is optional for both member states and corporations. Moreover, member states may be reluctant to give up the symbolism of requiring resident corporations and PEs to file tax returns. Commission Services has concluded that, "harmonising rules for calculating the corporate tax base does not necessarily require an overall harmonisation of the tax administration and procedural rules." It continues, however, "since the CCCTB is being designed as consolidated some procedures will need to be done in the same way by all participating MS and it is important to identify these."[61] Even so, this work remains at an early stage, in part because decisions in this area may be dependent on decisions on substantive issues.[62]

Implementation of the CCCTB—however it is achieved—would likely involve unprecedented reliance on the tax authorities of other member states, something that some member states (especially the large ones, which would have the most revenue at stake) may be loath to accept. This concern is heightened by the fact that a corporation would have an incentive to locate group headquarters in member states where administrative procedures (e.g., the statute of limitations) are lax or where it has little other economic activity, because the tax administration of such a member state would have relatively little reason to care about the accuracy of its tax returns or to audit those returns with diligence.[63] It, thus, seems likely that member states will insist on the power to object to the decisions of the tax authorities of other member states and perhaps perform their own audits. Similarly, member states may be reluctant to entrust their fiscal health to the courts of other member states. Thus, regardless how other administrative issues are handled, a specialized EC tax court may develop.[64]

5.4.6 Jurisdiction to Tax: A Largely Neglected Issue

If the rule for jurisdiction to tax and the formula used to apportion income are not mutually consistent, there may be *nowhere income*—income that would be apportioned to a member state that lacks jurisdiction to tax it. Under the terms of many tax treaties and the domestic laws of many countries, a nation can tax the business income of a corporation only if the corporation maintains a permanent establishment (PE) in the nation. If a corporate group makes sales in a member state where it lacks a PE, the interplay of this nexus rule and the use of sales to apportion income could clearly result in nowhere income. It is possible, but less likely, that the group could have payroll and property in the member state without having a PE there. On the other hand, substitution of a different rule for jurisdiction to tax would run counter to existing treaties with non-EC countries, as well as long-standing practices.

This issue seems to have been overlooked until recently. However, in late September 2007, Commission Services asked, "is a 'physical presence' in the form of a subsidiary or permanent establishment required or is an 'economic presence' in the form of a minimum presence of at least one of the factors in the allocation formula sufficient?"[65] It went on to observe:

> Revolutionary as it may look at first sight, this concept: (i) is coherent with the idea that "demand" is one of the income generating factors (thus, demand, beyond a certain threshold, would give to the marketing jurisdiction the rights to tax part of the corporate income of the selling company); (ii) would make any attempt from companies to manipulate the place of shipment less effective in terms of factor shifting; (iii) would reflect the increasing economic importance of e-commerce and trans-border provision of services and (iv) would eliminate or at least significantly reduce the need for "throw-back" or "throw-out rules".[66]

Commission Services ultimately concluded at that time, "while an approach based on 'economic presence' may have conceptual appeal and would be the most coherent one when a 'sales by destination' factor was introduced, it may at this point in time be a step too far. Taxable nexus might at least initially therefore continue to be based on a physical presence in a MS (i.e., a subsidiary or PE) to attribute a share of the tax base to that MS."[67] It would address the issue of a "nowhere income" by allocating sales made into a member state where a group does not have a subsidiary or a PE or to a non-EU country among the members of the group in proportion to the other two apportionment factors (payroll and property).[68]

5.5 International Issues

Flows of income that cross borders between EC members states participating in CCCTB and other nations, including non-participating EC member states, pose mind-boggling problems. Indeed, the problems are so daunting that the CCCCTB working group has deferred consideration of the issues raised by the possibility that not all member states may participate in CCCTB, focusing instead on income flows to and from non-EC nations.

International issues arise in two different situations: income is earned outside the CCCTB bloc by entities resident in the bloc (foreign-source income from out-bound investment) and EC-source income is earned on in-bound investment in the CCCTB bloc by entities resident elsewhere. Income flowing across borders can be either active (i.e., income from direct investments) or passive (e.g., interest and dividends on portfolio investments and royalties). Either in-bound or out-bound direct investment can be made through subsidiaries or through branches (PEs).

Part 5.5.1 examines the taxation of foreign-source income under the CCCTB. Part 5.5.2 discusses the proper role of residence-based taxation within the EC, an issue that would arise even if all member states participated in CCCTB and only intra-EC income flows were at issue. Part 5.5.3 discusses the tax treatment of income from inbound investment under the CCCTB, and part 5.5.4 the need to renegotiate treaties.

5.5.1 Taxation of Income from Foreign Investment

If it is assumed that the non-EC country where income originates (the source country) taxes business income that crosses international borders, there are two ways to avoid double taxation of such foreign-source income, by both the source country and the country of residence of the corporate recipient of the income. The residence country can exempt foreign-source income or it can tax the income but allow credits (commonly called foreign tax credits or FTCs) for taxes paid to source countries. The OECD Model Tax Treaty provides both methods of avoiding double taxation, without expressing preference for either.

Reaching agreement on how to treat foreign-source income in the

CCCTB is complicated by two facts: (a) not all member states currently tax such income in the same way (if at all), and (b) most member states currently have foreign tax treaties with many other nations that restrict their room to maneuver. About half of member states do not tax foreign-source business income; they achieve this either by employing an explicitly territorial system under which only domestic-source income is taxed or by exempting foreign-source business income—despite ostensibly taxing the worldwide income of their residents. The other half tax foreign-source income, preventing double taxation by allowing credits for taxes paid to source countries.[69] Commission Services has suggested that the choice between these approaches represents such a fundamental element of national tax policy that an obligation to switch methods might limit the number of member states interested in adopting the CCCTB.[70]

In principle, there seem to be three basic ways foreign-source income could be treated under the CCCTB. In fact, the first two—which involve no taxation by member states of residence of corporate groups—may be political non starters because member states that currently tax the worldwide income of their residents are unlikely to accept the implied revenue loss. First, foreign-source income could simply be exempt from taxation in the EC. That is, only income earned in (participating) EC member states would be included in CCCTB, as under the territorial system. Besides reflecting current trends in thinking on taxation of international income flows, this approach has the virtue of simplicity.[71]

Second, foreign-source income could be included in the CCCTB and thus apportioned among Member States.[72] No economic model would suggest using apportionment values based on activities in the EC to apportion foreign-source income, particularly that from foreign direct investment. More important, in addition to the political problems noted above, there would be technical problems in implementing it. In particular, providing relief from double taxation would be extremely complicated, as bilateral treaties signed by the country of residence of the corporation receiving income would have no relevance for other member states, to which some income would be apportioned.

The third approach—which many experts seem to favor for practical reasons—would exclude foreign-source income from the CCCTB, leaving it for member states of residence of corporations receiving such income to decide whether or not to tax it and how to relieve double taxation.[73] While this approach has the considerable political advantages of preserving the taxing powers of member states that tax the worldwide income of their residents and the technical advantage of meshing most

Table 5.3
Proposed Tax Treatment of Foreign-source Income Received by EC Resident or PE

	Income from EC Member State	Income from non-EC Country
Income from PE Income from major share-holding	Consolidated Share ownership > 75 percent: Consolidated Share ownership of 10-75 percent: Exemption	Basic rule: exemption Secondary rule (for income from low-tax countries): taxation under CCCTB, with shared foreign tax credits (or CFC regime for subsidiaries)
Portfolio dividends Other passive income	Taxation under CCCTB, with shared foreign tax credits for withholding taxes (unless consolidated, e.g., in case of interest and royalties)	Taxation under CCCTB, with shared foreign tax credits

Source: CEC (2007c, 30–35)

easily with current treaty obligations, it may become increasingly untenable in the long run, because of its implications for the role of residence-based taxation, discussed in the next subsection.

In late September 2007, Commission Services revealed its current (albeit tentative) thinking on these issues, which is summarized in table 5.3. The first column distinguishes four types of income and the first row whether the income has its source in the EC or elsewhere.

Exemption would be the basic rule for the income of non-EC PEs and dividends from major shareholdings outside the EC (direct foreign investment). Exemption is chosen over taxation with foreign tax credits to avoid the complexity of the latter, which requires recalculation of the profits of foreign subsidiaries under the income tax rules of the country granting the credit. If, however, the tax rate in the source country fell below some minimum, exemption might be replaced by either taxation under the CCCBT, with foreign tax credits for corporate income taxes and withholding taxes levied by the source country (the cost of which would be shared in the same way as the tax base) or (for income from foreign subsidiaries) a controlled foreign corporation (CFC) regime—under which foreign-source income would be taxed currently, rather than when received as dividends.

Income of PEs located in the EC would automatically be included in consolidated income, and dividends from EC subsidiaries where shareholding exceeds 75 percent would be ignored, because of consolidation. In the case of shareholding between 10 and 75 percent, dividends would be exempt. Commission Services does not propose that the secondary rule proposed for income from investment in low-tax non-EC countries also be applied to dividends from low-tax EC member states, because it is unclear whether its application would be legal.[74]

Portfolio dividends (those where shareholding falls below the 10 percent threshold) and other passive income received from non-EC sources would be included in the CCCTB and credits (shared in the same way) would be allowed for withholding taxes of source countries. The same rule would apply to portfolio dividends and other passive income received from EC sources, except in the case of passive income (e.g., interest and royalties) flowing between two members of a consolidated group, which would be ignored.

5.5.2 The Role of Residence-based Taxation within the EC

Many believe that residence-based taxation has no place within an economically integrated union. They argue that residence is meaningless in such a context, that residence can easily be manipulated if taxation depends on it, that it would be extraordinarily difficult to implement the foreign tax credits that would be required to avoid double taxation, and that the economic effects of residence-based taxation are less desirable than those of source-based taxation.[75] The last of these arguments deserves further consideration.

Academic economists have long favored capital export neutrality (CEN) over capital import neutrality (CIN).[76] Under CEN, the tax paid on income from business and capital would depend only on the place of residence of the investor, not the location of investment. Thus, it would lead to the optimal allocation of investment and thereby the maximization of worldwide income. CEN could be achieved either (a) if there were no source-based taxation, or (b) if residence countries taxed worldwide income, but gave credits for source-country taxes.

CIN would occur if all investment in a given jurisdiction were taxed identically, without regard to the residence of the investor. It would be achieved if only source-based taxes were levied, as under territorial systems. CIN has commonly been advocated primarily by representatives of business, who note that it is necessary for the creation of a level playing field for business operating within any one country. An apportionment-based system of taxing corporate income that attempts to tax income where it is deemed to originate is inherently a source-based tax and thus consistent with CIN but not CEN.

Recent years have seen a remarkable change in the viewpoint of many economists, especially those writing about taxation in economic unions.

They have come to recognize that it would be highly anomalous for those competing in a particular jurisdiction to pay different amounts of tax on a given amount of income derived from investment in that jurisdiction, depending merely on their place of residence.[77] Some have also argued that residence-based taxation violates the freedoms guaranteed by the EC Treaty.

Regardless how these conceptual and theoretical arguments play out, it seems unlikely that EC member states that currently tax the worldwide income of their residents—in particular the United Kingdom, which dislikes CCCTB on other grounds—will gladly give up doing so. A more interesting question is whether member states that are interested in participating in CCCTB would be willing to forego residence-based taxation of business income and adopt one of the first two options for taxing foreign-source income described above.

5.5.3 *Taxation of Income from In-Bound Investment*

There is relatively little disagreement that most business income originating in participating member states of the EC should be included in the CCCTB. Rather, questions in this area involve the definition of consolidated groups and treaty issues. For example, if a foreign parent has sister subsidiaries in different member states, should those subsidiaries be consolidated into one group, or should there be multiple groups? If a parent headquartered in the EC has a foreign subsidiary that owns a subsidiary in the EC, should the EC subsidiary be included in the same consolidated group as the EC parent? Should PEs operating in the EC be lumped together with EC subsidiaries of foreign corporations? More inclusive definitions may impede tax planning, but may encounter objections from treaty partners since virtually all treaties are based on SA/ALS.

Commission Services has recently provided its views on the ownership arrangements described above. Consolidation would be mandatory for parents, qualified subsidiaries (those with 75 percent or more of voting rights commonly owned, either directly or indirectly), and PEs in the following situations:

- An EU resident parent and its EU resident subsidiaries and PEs:
- A group of EU resident subsidiaries and/or PEs under the common control of a non-EU resident parent; and
- A parent that owns a non-EU resident subsidiary and a second tier EU resident subsidiary owned by the first-tier non-EU resident subsidiary.[78]

The use of apportionment, rather than the arm's length standard, to allocate income among member states may raise treaty issues, even if the CCCTB is limited to the "water's edge" of the EC, as Commission Services proposes. Sorensen (2004, 95) provides the example of an increase in the transfer price of sales by a U.S. parent to its French subsidiary mandated by the U.S. IRS. Under present rules for mutual adjustment procedures, France should reduce the taxable profits of the French subsidiary in order to prevent double taxation. But under CCCTB, if France were to agree to an adjustment, the reduction in profits would be spread among all participating member states where the subsidiary's consolidated group does business. As Sorensen notes, to prevent such fiscal externalities, "a far-reaching rethinking of tax treaty relations may be needed."

As a second example, suppose that a foreign corporation owns branches or subsidiaries in two member states. Compared to the situation under SA/ALS, CCCTB may reallocate income from a branch or subsidiary in one member state to a branch or subsidiary in another member state.[79]

5.5.4 Renegotiating Treaties

As the preceding discussion indicates, the CCCTB project raises important and difficult treaty issues. Solving some of them may require renegotiation of treaties—a long, difficult, and uncertain process. Commission Services has recognized that it may be necessary to provide temporary derogations from some of the proposed rules described above.[80] It would perhaps be most efficient—but probably also take longer—if renegotiation were to occur in a multilateral context in which all member states interested in CCCTB entered into a single set of negotiations with a given treaty partner. Under an extreme scenario, a single EC treaty would replace bilateral treaties.

At this point it is premature to speculate on the substantive issues that would need to be renegotiated, as these depend on decisions taken about the international aspects of CCCTB. But the likely contours of CCCTB may also depend on the unknown prospects of renegotiating treaties to accommodate CCCTB.

5.6 The Political-Juridical Context

In order to create a single internal market, the EC Treaty guarantees freedom of movement of goods, capital, people, and services; freedom of establishment; and equality of treatment. In interpreting these guarantees, the ECJ has struck down various aspects of the tax laws of member states, including thin capitalization rules and imputation systems (which provide relief from double taxation of dividends). While such actions are sometimes said to involve negative harmonization (in contradistinction to legislated positive harmonization), it is clear that the result is not necessarily a harmonized system. True harmonization requires legislative action.

The EC Treaty provides that unanimous agreement of all member states is required to enact EC tax policies. Since this implies that each member state has a veto, it is hardly surprising that only a few directives involving direct taxation have ever been adopted. The unanimity rule also suggests that the prospects for corporate tax harmonization initially involving all member states are not bright.

Recognizing this reality, László Kovács, European Commissioner for Taxation and Customs, has said, "the best-case scenario would be a unanimous agreement on a common consolidated tax base and its EC-wide application by all member states. If unanimity will not be achieved, the Commission will examine the possibility of resorting to the enhanced cooperation mechanism.[81] Under this approach as few as eight member states could agree to harmonize their corporate tax systems.[82] It is in this context that the Commission launched the CCCTB Working Group in 2004, promising to have a legislative proposal ready for introduction by the end of 2008.

It may be useful to describe briefly the role of the Commission (and its staff), since it has no analog in the United States. The EC Treaty assigns to the Commission, as the executive body of the European Union, exclusive responsibility for preparing proposals for legislation to be enacted by the Council (which shares legislative power with the European Parliament in some matters, but not taxation). Commission Services, the staff of the Commission, chairs meetings of the Working Group, sets the agenda, and prepares the documents to be discussed. These documents represent only the preliminary views of Commission Services, which may change in response to both further analysis and input from experts, including members of the Working Group. Of course, Commission Services makes only technical judgements; it does not make political decisions. The position of the Commission will not be known until it presents its final proposals for harmonization.

The mechanism of enhanced cooperation creates an interesting dynamic.[83] Although some member states may prefer that harmonization not proceed and may try to block it, they may not be able to prevent its initiation via enhanced cooperation. It seems clear that if eight or more states can agree to implement a mutually acceptable version of the CCCTB, that action will cast a long shadow—that corporate tax harmonization will, for the foreseeable future, take that version as its starting point. Thus even member states that oppose harmonization have an incentive to participate in the CCCTB Working Group, if only as a defensive measure, in order to try to forestall inclusion of provisions that they would find objectionable, either now or in the event that they decide later to join the CCCTB club. This conjecture is borne out by the fact that representatives of all member states have been participating in the activities of the Working Group.

Supposing that at least eight member states can agree to adopt the CCCTB, it is conceivable that a judicial hurdle may remain. The ECJ has defined discrimination as treating similar situations differently or different situations similarly. One can imagine that non participating member states will argue that application of the CCCTB among participating member states is discriminatory.[84]

It is impossible to know whether, when, or how the CCCTB will ever be enacted and whether the ECJ will sustain it, if enacted. In another context (McLure forthcoming) I offered the following (somewhat redacted) prediction:

> [T]he fact that the corporate income tax systems of Member States differ so dramatically from what is required for an internal market may actually turn out to be positive. . . . [I]t seems almost inconceivable that the Member States will continue indefinitely to employ SA/ALS to isolate income earned in various locations; at some point even the most diehard advocates of SA/ALS are likely to admit that "this ain't working" and agree that a shift to consolidation and formula apportionment is needed. At that point much of the rest of the source-based system . . . (a uniform system of apportionment, agreement on whether all income should be apportioned, the criteria for consolidation, etc.) may fall into place and the need for a common definition of income and the artificiality of continuing residence-based taxation will become more apparent. In the meantime preparatory work initiated by the Commission (notably via the CCCTB Working Group) will have greased the skids for this to happen, perhaps initially via enhanced cooperation.

This optimistic appraisal is confirmed by a recent survey of the tax officials of 403 large corporations doing business in more than one EC member state. Seventy-eight percent of respondents favored adoption of the CCCTB, even though details of the scheme have not been made public, and almost as many (69 percent) would like to see a single rate applied throughout the EC. In some countries 100 percent of those surveyed favored harmonization of the tax base. Even in Ireland (and in Slovakia) half or respondents favored it. Sixty-six percent of interviewees thought CCCTB would be in place by 2015, and 85 expected to see it by 2020. Only 15 percent thought harmonization would never occur (KPMG 2007).

5.7 Implications of Harmonization

To a large degree the implications of harmonization are inherent in the description of the problems that plague SA/ALS and the characteristics of consolidation/formula apportionment.

5.7.1 Simplification

Adoption of CCCTB would bring considerable simplification, and with it significant reductions in costs of compliance and administration. The availability of a single definition of apportionable income and elimination of the need to document, defend, and monitor transfer prices on transactions among members of a participating corporate group doing business in participating member states and subject to consolidation would be particularly important sources of simplification. Simplification and cost savings will be greater, the larger the number of countries that participate in CCCTB. And, of course, they will exist only for corporate groups that opt to participate in the harmonized system and be greatest for groups subject to consolidation.

5.7.2 Loss Offset/Elimination of Double Taxation

Like simplification, the automatic availability of full loss offset and the elimination of double taxation, all inherent in CCCTB, would reduce impediments to cross-border economic activity—at least among participating member states and groups subject to consolidation.

5.7.3 Effects on Revenues

Member states participating in CCCTB are likely to experience several types of effects on revenues.[85] First, substitution of consolidation cum apportionment for SA/ALS will reduce opportunities to shift income to low-tax member states and interest deductions to high-tax member states. Of course, this is true only to the extent that low-tax and high-tax member states participate in CCCTB. Since it seems fairly likely that the member states with the lowest tax rates (e.g., Ireland) will not initially participate and some high-tax member states may not, substantial opportunities for income shifting and borrowing in high-tax member states will likely remain. But, as noted earlier, participation in CCCTB would free up administrative resources for more aggressive monitoring of transfer prices.

Leaving aside the revenue effects associated with the reduction of opportunities for tax planning just mentioned, the shift from SA/ALS to consolidation cum apportionment will also likely cause some redistribution of tax bases among participating member states. It is difficult to generalize about the directions and amount of such redistribution, as it would depend on the apportionment formula chosen.[86] Lack of certainty on this score may be fueling some preference for an apportionment formula based on macro factors.

If adoption of CCCTB were to foster rate-based tax competition, aggregate tax revenues of member states—including those that chose not to participate in CCCTB—might be adversely affected. Of course, tax competition might also be manifested in redistribution of tax bases among member states.

5.7.4 Economic Effects

A reduction in economic distortions—other than those caused by elimination of tax-related impediments to cross-border investment such as complexity, compliance costs, lack of loss offset, and double taxation—may be the "dog that did not bark" in the tax harmonization story.[87] That is, if corporate income taxes are harmonized and tax rates are not changed, distortions of the location of economic activity (as indicated by differences in marginal effective tax rates; METRs) might increase, not decrease. This would depend crucially on the apportionment formula chosen. For example, the greater the weight placed on property, relative to sales, the higher the METR for a given statutory tax rate. Any increase in differences in METRs could, of course, be offset—or more than offset—by corresponding changes in tax rates. But that is a question of tax rate policy, not tax harmonization. It thus seems that tax harmonization's most certain contribution to achievement of the Lisbon goal "to become the most competitive and dynamic knowledge-based economy" would be elimination of the aforementioned impediments to cross-border investment.

5.7.5 *Effects on EC Competitors*

The EC's Lisbon goal that ostensibly motivates interest in the CCCTB might suggest that non-EC nations should not welcome adoption of the CCCTB—indeed, that they should try to undermine it, for example, through intransigence in treaty negotiations. It seems, however, that this is wrong on several counts. First, the rest of the world probably does not benefit much, if at all, from the economic inefficiencies caused by tax-induced impediments to the creation of a single market in the European Community. Rather, it may benefit from the spillovers generated if corporate tax harmonization helps foster a more dynamic business environment within the EC.

Second, if—as seems likely—statutory tax rates were adjusted to keep revenues more or less constant, competitive effects are likely to be minimal. EC Member States will be more competitive, for a given constellation of statutory tax rates, the greater the weight placed on destination-based factors such as sales, relative to origin-based factors such as payroll, property, and value added at origin.[88]

Finally, if all member states were to participate in CCCTB, the incentive to move real economic activity or to shift income (with no change in the location of economic activity) to low-tax member states such as Ireland would be blunted, as any income earned in (or shifted to) any EC Member State would be apportioned among the member states and thus subject to an average tax rate of the member states, not that of the member state to which economic activity or income was shifted. While this would be good news for fiscal authorities of non-EC nations, it would not be such good news for foreign multinational enterprises. Of course, if low-tax member states do not join the CCCTB system, the incentives to shift economic activity or income from both participating member states and outside the EC to those non participating member states would not be much affected, except to the extent that high-tax member states might be more competitive than now. And the CCCTB would do nothing to reduce opportunities and incentives to shift income to non-EC tax havens; indeed, these incentives would be relatively greater if all member states were to participate in the CCCTB.

In short, while generalization is difficult, in the absence of knowledge of the apportionment formula to be chosen, it seems unlikely that tax harmonization would create strong incentives for non-EC nations to reduce their statutory tax rates.

5.7.6 *Transition Costs*

Switching from SA/ALS to consolidation cum apportionment would entail enormous transition costs that might last over many years, if not decades. Transition costs may be somewhat eased by making participation optional for corporate groups. On the other hand, making it optional for member states may aggravate these costs by stretching out transition over several episodes of adoption. Thus far the CCCTB Working Group seems not to have devoted much attention to this issue. Of course, it is impossible to work out rules for transition until the basic decisions have been reached on the form CCCTB will take.

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Notes

1. The terms *corporate income tax* and *corporations* are employed here to refer to what are sometimes called company income taxes and companies in European literature. Commission Services defines eligible companies as those subject to the types of taxes listed in an annex that it does not include; see CEC (2007c, 5).

2. For elaboration of this argument, see McLure (2007; forthcoming), as well as CEC (2001b; 2002). Because tax reform involves only the first (economic) "pillar" of the European Union (EU), most references in this article are to the European Community, rather than to the EU, which would be equally accurate.

As explained in section 5.6, it is important to distinguish (as is done here) between the views of the European Commission and those of its staff, Commission Services. Both appear in publications of the Commission. For convenience, references in the text and footnotes to publications attributed to the Commission of the European Communities in the list of references have been shortened to CEC.

3. For a somewhat outdated compendium of decisions of the ECJ involving direct taxation and the creation of a single market, see Mason (2005). All ECJ decisions issued in the last ten years are available on the Court's website, http://curia.europa.eu/index.htm, which also provides references to previous decisions.

4. The conclusions of the Lisbon meeting are available at: http://europa.eu.int/ISPO/docs/services/docs/2000/jan-march/doc_00_8_en.html#A. Emphasis in original.

5. CEC (2001b, 3).

6. See CEC (2003, 3; 2004a, 1).

7. Avi-Yonah and Clausing (2007) have proposed a similar system for use by the United States in the taxation of corporate income. For analyses of such a system, see McLure (2002) and Roin (2007).

8. CEC (2001b). As Sørensen (2004) notes, this is a very different form of harmonization from what the Commission has suggested in the past. Devereux (2004) describes earlier Commission efforts at harmonization. The Commission also outlined three other alternatives in this communication, only the third of which (home-state taxation) it thought might be viable at this time: a community-level corporate tax; mandatory application of a system similar to the CCCTB to all corporate taxpayers; and a system in which an agreed-upon formula would be used to apportion group income, which would be measured under the tax laws of the home state of the parent of each corporate group. Interest in the CCCTB has far out-distanced that in home-state taxation. There is, however, some interest in making home state taxation available to small and medium-sized enterprises. That option is not discussed here.

9. See CEC (2001b; 2004a). Expressing the views of business, Andersson (2007) and Barenfeld (2007) strongly advocate making taxation under the CCCTB optional. But they, like many others, believe that participation by a corporate group should be an all-or-nothing choice—that is, that the entire group should be subject to CCCTB or none of it should be. Otherwise, many of the problems of SA/ALS described below would remain.

10. See CEC (2004c). The reports of the working group and its subgroups are available on the website of the Taxation and Customs Union Directorate of the European Commission.

11. Of course, many other factors could be at play—including cyclical developments, economic growth spurred by rate reductions, and the fact that figures reported for tax rates and tax revenues as a percent of GDP do not cover the same years. A detailed analysis of the causes of the divergent trends in statutory tax rates and tax revenues as a percent of GDP is well beyond the scope of this chapter.

12. The example could easily be complicated by (a) inserting figures for the division of income of the two corporations (and thus the consolidated group) among the three jurisdictions, as determined by separate accounting; and (b) comparing those with the distribution of the tax base under apportionment, with or without consolidation. Since the focus of the illustration is on the mechanics of apportionment and consolidation, this is not done.

13. It could be noted that jurisdiction 1 benefits significantly from consolidation, relative to non consolidation (a 17 percent increase in the tax base of the group), while jurisdiction 2

gains a small amount (just under one percent), and jurisdiction 3 loses a significant amount (roughly 8.5 percent). This is not a particularly interesting finding, even aside from the fact that is depends on the underlying assumptions, as it seems quite unlikely that the EC will seriously consider adopting apportionment without consolidation.

14. See CEC (2001b; 2002); Mintz (1999); Devereux (2004); Sorensen (2004); McLure (2007; forthcoming); Andersson (2007); and Barenfeld (2007). Despite cataloging these defects, Roin (2007) is skeptical that a formula-based system would perform any better if adopted as the international norm.

15. Mintz (2004) argues that simplification—not reductions in tax-induced distortions of economic decisions—is the primary reason to undertake harmonization of corporate income taxes in the EC. Barenfeld (2007) focuses on the potential for the CCCTB to reduce complexity and uncertainty and warns that, as adopted, the CCCTB may not be as simple as it could be.

16. Andersson (2007) reviews literature on the relationship between uncertainty and investment.

17. As a result, the income of controlled foreign corporations (CFCs) is ordinarily taxed by the country where the corporate parent is resident only when distributed (if at all). Under certain circumstances—in order to prevent abusive deferral of home-country taxation—the income of certain CFCs is treated as though distributed to the parent and is thus taxed currently. For example, under the U.S. tax code Subpart F income of certain CFCs is accorded this treatment. See Arnold and Dibout (2001).

18. This is somewhat of an overstatement. In the case of imports and exports, rules are required to determine where sales are deemed to occur for tax purposes.

19. See McLure (1997) and references cited there. Not surprisingly these are two of the four industries listed in note 20.

20. As Weiner (2006) notes, Honohan and Walsh (2002, 54) describe the industries involved (cola concentrate manufacturers, pharmaceuticals, software reproduction, and computer components) as having the "unusual characteristics of the entrepôt economy," namely "large . . . quantities of goods are imported and then reexported, often with minimal or no processing." Huizinga and Laeven (2006) provide estimates of profit shifting in the EC and provide references to related literature.

21. See Huizinga, Laeven, and Nicodéme (2006) for estimates of the use of debt to shift income within Europe.

22. *Lankhorst-Hohorst GMBH v. Finanzamt Steinfurt*, Case C-324/00, 12 December 2002.

23. Source-based taxation of business profits, found in the tax laws of virtually all countries, is consistent with the OECD Model Tax Treaty. As noted in section 5 below, residence countries commonly avoid double taxation of such income by exempting it or by allowing credits for income and withholding taxes paid to source countries. The EC interest and royalties directive (Council Directive 2003/49/EC of 3 June 2003) and the parent-subsidiary directive (Directive 90/435/EEC, as amended by Council Directive 2003/123/EC of 22 December 2003) provide that member states where these types of payments originate will not impose withholding taxes on them when paid to a company organized in another member state.

24. Relief is automatically available in all member states for domestic losses within *one* company. In eighteen member states, offset is also available under specific rules for domestic losses within a group of companies, and in seventeen offset is available for cross-

border losses within a single company. (Some of the eighteen member states in the former group do not belong to the latter group of seventeen, and vice versa.) By comparison, loss offset is generally not available for cross-border losses within a group of companies, except in four member states (Austria, Denmark, France, and Italy). This description disregards Bulgaria and Romania, which joined the EC in 2007. See CEC (2006b; 2006c) and, for a summary. Weiner (2006, 18–20).

25. *Marks & Spencer v David Halsey*, Case C-446/03, 13 December 2005.

26. Whether gaps and overlaps in taxation of EC-source income would remain would depend in part on the rules for jurisdiction to tax and the apportionment formula chosen. For example, as noted below, if jurisdiction to tax continues to be based on the presence of a PE, as seems likely, but sales (at destination) is one of the apportionment factors, income may be assigned to a member state that lacks jurisdiction to tax it.

27. This example is taken, with modification, from McLure (2004).

28. If not seven of the member states in this example participated in CCCTB, SA/ALS would be used to divide income between participating and non participating member states, as well as between corporations operating in the EC and those operating elsewhere.

29. See McLure (1980).

30. See McLure (2004) for a discussion of the third type of issues.

31. See CEC (2002, 2).

32. CEC (2004a, 3).

33.Pethig and Wagener (2007) provide a formal analysis of such propositions.

34. McLure (2007) elaborates on this view.

35. For a background discussion of the second and third issues prepared by a member of the Commission staff, see Agúndez-García (2006). There has been some consideration of adopting a common tax base before consolidation and formula apportionment. While a common tax base would, by itself, produce some simplification, this two-step process would fail to achieve many of the most important objectives of the CCCTB. See CEC (2004a, 2–3).

36. Reading the tea leaves to discern the likely contours of harmonization is difficult, and not only because the tea is being brewed in Brussels and the leaves are being read in California. The Commission has not yet announced its final positions on most features of the CCCTB, and the preliminary views of its staff (Commission Services) have no legal force and may shift over time. Moreover, Commission Services reports views expressed by experts, as well as its own, often without attempting to distill a consensus—which would not be binding on it, in any event. See also section 5.6.

37. CEC (2007c)

38. See CEC (2007c, 5) This document is the source for most of the generalizations regarding the definition of income that follow.

39. CEC (2007c, 14–19)

40. CEC (2007c, 19–20)

41. CEC (2007d, 2)

42. CEC (2007c, 29)

43. CEC (2007d, 2)

44. CEC (2007c, 31). This scheme is summarized in section 5.5.1.

45. In the United States, intercorporate dividends are commonly taxed as business income by the state of commercial domicile of the taxpayer receiving them. Of course, states that allow or require combined reporting eliminate dividends flowing within a combined group. On the other hand, states that do not allow combination may include dividends deemed to be part of income from a unitary business in the apportionable income of the recipient.

46. The criteria for opting in and out of CCCTB and for consolidation can be summarized as follows:

- Participation in CCCTB would be optional for all corporations and corporate groups, subject to the following rules:
- Members of corporate groups with common ownership of more than 50 percent must all opt either to participate or not participate.
- Corporate groups that opt to participate must consolidate the activities of corporate members with common ownership of more than 75 percent.
- Corporate groups with common ownership of 50–75 percent would not be allowed to consolidate.

For purposes of calculating the percentage of indirect ownership in multi-tiered organizations, common ownership of 75 percent or more of a given subsidiary would be treated as 100 percent ownership and common ownership of less than 50 percent would be assigned a value of zero; Representatives of business and several member states have questioned the desirability of having two thresholds. Business has suggested having a single threshold of 50 percent for both opting in and for mandatory consolidation. See CEC (2007c, 23). Rules would, of course, be needed to govern situations in which (a) individual entities either enter or exit a consolidated group or (b) levels of ownership change during the year; see CEC (2007c, 6, 24–27).

47. Hellerstein and McLure (2004a; 2004b) examine the pros and cons of the two approaches.

48. Commission Services stresses that "an apportioning formula should be enforceable, simple and cost effective. At the same time the factors to be chosen should not be prone to manipulation and should lead to a fair apportionment of the tax base." See CEC (2007d, 2).

49. This simple example does not allow for the possibility that not all member states participate in CCCTB and that the corporate group may not be active in all (participating) member states. For a more complete criticism of the use of macro factors, see McLure (2004).

50. See CEC (2007a, 3–4; 2007c, 2).

51. See CEC (2007a, 4–5; 2007c, 2).

52. See CEC (2007a, 6–10; 2007d, 7–10).

53. See CEC (2007d, 2–5) and (2007f, 7).

54. See Musgrave (1984) for a discussion of these alternatives.

55. See CEC (2007d, 5–7).

56. See CEC (2007d, 7–10).

57. Musgrave (1984) also discusses this.

58. See, for example, OECD (2004).

59. Business strongly advocates a one-stop-shop approach; see Andersson (2007) and Barenfeld (2007). Commission Services also recognizes its advantages; see CEC (2006g).

60. See CEC (2006f). No member state has laws of the type required to govern the apportionment of the tax base.

61. CEC (2006f)

62. See CEC (2006g).

63. Commission Services has noted

The comfort of the CCCTB taxpayers could be increased by agreeing on a common approach to some elements of the audit procedure, for example, a common maximum length of the audit or common statute of limitation. Such a measure would at the same time decrease the scope for tax planning by choosing an administration with the most generous procedural rules. A common statute of limitation is particularly important for tax administrations in order to avoid being blocked by too generous legislation in one participating MS (CEC 2006f).

64. Commission Services has noted that—since the CCCTB would be specified in EC legislation to be transposed into the national law of member states—the ECJ would be competent to issue preliminary rulings on its legality and its interpretation in national laws. See CEC (2006f).

65. CEC (2007d, 10–11).

66. CEC (2007d, 11). Commission Services notes that in the United States the Multistate Tax Commission (MTC) has endorsed this solution. The MTC (2003) identifies McLure (2000) as the source of this idea.

67. CEC (2007d, 12)

68. CEC (2007d, 14).

69. Two member states (France and Denmark) follow the territorial principle, taxing only income earned on their territory, thus exempting foreign-source income. In principle, all other member states tax the worldwide income of their corporate residents, but diverge in what this means in practical terms. Only about half actually tax foreign-source income and allow foreign tax credits. The other half exempt foreign-source income, producing an effect similar to territorial taxation. The statement in the text lumps together member states employing the territorial system and those that tax worldwide income but exempt foreign-source income. This description, derived from CEC (2005), does not consider the practice of Bulgaria and Romania, which became member states in 2007.

70. CEC (2006g).

71. See Hellerstein and McLure (2004a), Andersson (2007), and Barenfeld (2007). Commission Services has noted, "relieving double taxation before the CCCTB is apportioned to participating MS could represent a less complicated solution, i.e. the application of the

exemption method to income included in the CCCTB would be simpler than using the credit method." See CEC (2006d, 5).

72. The Commission has expressed a preference for this approach (CEC 2007b). Commission Services now seems to favor exemption, at least for income from PEs and major shareholders; see CEC (2007c), as summarized in table 5.3.

73. See CEC (2006e; 2006g). Commission Services has noted:

If some MS were to keep the taxation of the worldwide income of their tax residents and use the credit method for the elimination of double taxation in respect of income included in the CCCTB while other participating MS were to apply the territoriality principle or use an exemption method for the elimination of double taxation in respect of the same type of income, the income would have to be kept outside of the CCCTB and only "pooled" with the tax base after apportionment in MS with credit method (CEC 2006d, 8).

74. Commission Services cites Advocate General Mengozzi's opinion in *Columbus Container,* Case C298/05, 29 March 2007, which questioned the legality of Germany's application of a tax/credit regime, rather than the generally applicable exemption, to profits of a branch in Belgium merely because the profits were subject to a low rate of tax in Belgium. See CEC (2007c, 31).

75. See McLure (2007) and references therein. These arguments would, of course, not apply to residence-based taxation imposed by the European Union, but this seems unlikely to be relevant for the foreseeable future.

76. This preference can be attributed largely to the work of Musgrave; see Richman (1963) and Musgrave (1969). If tax bases and rates are identical both CEN and CIN are achieved. The discussion in the text ignores this possibility.

77. See Vogel (1990), Wattel (1996), Martin (1999, 281–83), Kemmeren (2006), and Bond, Gammie, and Mokkas (2006).

78. CEC (2007c, 22–23). The first-tier non-EU resident subsidy would not be included in the consolidated group.

79. American Chamber of Commerce to the European Union (2006) discusses several possible scenarios and their implications for creditability of EC taxes in the United States.

80. CEC (2007c, 30, 35).

81. Kovács (2006). Enhanced cooperation can only be undertaken as a last resort and "must not, among other things, undermine the Internal Market, constitute a barrier to or a discrimination of trade, distort the conditions of competition, or affect the competences, rights and obligations of the non-participating Member States." CEC (2001a, 23; 2001b, 17).

82. Provisions adopted via enhanced cooperation do not become part of the *acquis communautaire* (the body of EU law accumulated thus far, to which all member states must subscribe). See McLure (2008) for a more complete discussion of the use of enhanced cooperation to initiate corporate tax harmonization.

83. For a theoretical analysis of the dynamics of enhanced cooperation, see Bordignon and Brusco (2006).

84. Taxpayer complaints that the CCCTB discriminates against them may be blunted if they would have the option of whether to participate.

85. Commission Services has asked the tax administrations of member states to provide data that will assist in the assessment of revenue effects of adopting CCCTB (CEC 2007e).

Although Commission Services outlines several scenarios that should be considered, depending on which corporations and corporate groups opt to participate, it does not mention the revenue effects of most of the potential behavioral responses described in the text.

86. In CEC (2007e, 11). Commission Services suggests using the following apportionment formulas to simulate the revenue effects of the CCCTB:

1/2 Payroll – 1/2 Assets

1/4 Payroll – 1/4 Number of Employees – 1/2 Assets

1/3 Payroll – 1/3 Assets – 1/3 Sales by Destination

1/6 Payroll – 1/6 Number of Employees – 1/3 Assets – 1/3 Sales by Destination

1/3 Payroll – 1/3 Assets – 1/3 Sales by Origin

1/6 Payroll – 1/6 Number of Employees – 1/3 Assets – 1/3 Sales by Origin

87. Reference is, of course, to the non-incident in Arthur Conan Doyle's "Silver Blaze." I am indebted to Walter Hellerstein (2007) for this evocative reference.

88. This statement should be qualified by adding, "for a given constellation of exchange rates," since differences in apportionment formulas may, to a great extent, wash out in differences in exchange rates, just like differences in origin- and destination-based value added taxes.

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