

**Multi-National Enterprises taxation in the European Union:
some views on options for an overhaul**

Stefano Micossi and Paola Parascandolo¹

1. Shortcomings of the actual taxation system for Multi-National Enterprises in the Eu

As a rule, multi-national enterprises (MNEs) are taxed separately by the countries in which they operate on the basis of the income produced in each jurisdiction ("source" taxation)². To this end, they must keep separate accounts for business units in each country ("separate accounting", SA) ascribing each item of expenses and revenues to each business unit on the basis – by universally accepted convention – of "arm's-length" pricing (ALP), that is of comparable or estimated prices for similar market transactions between unrelated companies.

While being in operation for several decades, the system has never worked satisfactorily^{3/4}. Integration is amplifying these difficulties since intra-firm transactions take on increasing importance in the operations of MNEs, and financial market integration expands the opportunities for tax-planning in profit allocation and the debt-financing of capital spending.

¹ Stefano Micossi is General Director of Assonime - Associazione fra le Società Italiane per Azioni. Paola Parascandolo is a member of Economic Analysis Department of Assonime - Associazione fra le Società Italiane per Azioni.

² Often, the source principle is combined with a residence principle for at-least-partial taxation of income earned by foreign subsidiaries and branches of resident corporations.

³ Klemm A. (2001), "Economic Review of Formulary Methods in EU Corporate Tax Reform", in CEPS, EU Corporate Tax Reform, Report of a CEPS Working Party, Brussels.

⁴ McLure C.E. and J.M. Weiner (2000), "Deciding whether the European Union should adopt Formula Apportionment of Company Income", in S. Cnossen (editor), Taxing Capital Income in the European Union – Issues and Options for Reform, Oxford University Press.

Concerning the ALP principle applied by tax authorities to prevent profit shifting manipulation, Devereux and Keuschnigg have recently developed and estimated a model that show that arm's length prices systematically differ from independent party prices⁵. They conclude that the application of ALP distorts multinational activity by reducing debt capacity and investment of foreign affiliates and by distorting organizational choice between direct investment and outsourcing.

Conceptual difficulties are compounded by intractable monitoring problems, since each and every transaction has to be valued and controlled by tax authorities⁶. Of course, this is precisely where profit-shifting may arise. When tax authorities' opinions differ on what may be the acceptable treatment of a particular transaction, double taxation or tax-loopholes may be engendered.

Double taxation and tax-loopholes may also result from the different combination of source and residence treatment of cross-border dividend and interest payments accruing to the parent company or shareholders. Loss offsetting is in general not allowed for subsidiaries, and only permitted within (varying) limits for branches. Deferral of taxation of profits of branches is normally not allowed whereas it is allowed for subsidiaries; conflicting tax claims may arise from control-foreign-companies (CFC) legislation enacted by several countries to counter the booking of profits in "tax heavens".

In sum, MNEs in the EU are confronted with huge compliance costs in trying to meet the requirements of twenty-seven different tax systems and considerable uncertainty as to the correct application of the rules; tax authorities are confronted with similarly intractable problems in verifying the proper application of ALP; conflicting claims on tax bases, double taxation and tax loopholes are rife.

⁵ Devereux M. and Keuschnigg C. (2009), "The distorting arm's length principle", Working paper no.10 Oxford University Centre for Business Taxation.

⁶ McLure C. (2002), "Replacing separate entity accounting and the arm's length principle with formulary apportionment", International Bureau of Fiscal Documentation.

Therefore, there are growing calls for an overhaul of the current rules on corporate taxation from EU companies and national tax authorities, not least in view of the stated goal of strengthening the global competitiveness of European companies and making the Union an attractive location for business.

The overhaul of the corporate taxation system should constitute an opportunity to reduce distortions and a consequent inefficiencies. A recent paper exhaustively reviews this topic, both from a domestic and an international point of view, and reports recent estimates of distortions in the economic literature. The paper ranks shifting between capital and labour income at the top of the list of distortions. Profit shifting among jurisdictions set up the second most relevant source of distortions. Finally, the effects of taxation on business location and foreign direct investment are a third source of distortions⁷.

The academic and expert debate has already identified and discussed a number of approaches to reform the actual rules that can be explored. Considerable support at EU level has developed for some kind of common-base, consolidated taxation of corporate income. Formula apportionment would then be used to allocate income among the different tax jurisdictions.

We will argue that a radically different approach may also be considered that offers great advantages of efficiency, simplicity and decentralisation. It entails abandoning corporate income as the relevant tax base and taxing at a moderate rate some broad measure of business activity.

2. Coordination of corporate taxation in the EU

The EC Treaty makes no explicit reference to the harmonisation of direct taxation, but Article 94 opens the way for Community initiatives “for the approximation of such laws, regulations or administrative provisions of the

⁷ Nicodème G. (2009), “Corporate income taxations and economic distortions”, Taxation Paper European Commission.

member states as directly affect the establishment and functioning of the common market”⁸, which has provided the legal basis for existing directives in the field of direct taxation. Decisions require unanimity of votes in the Council.

However some proposals for the harmonization of corporate tax have been debated within the European Community for over 30 years⁹. On the whole the arguments for harmonisation of business taxation policies did not appear very convincing; at all events they didn’t find sufficiently broad support among the member states in the European Union. At the beginning of the nineties the Commission decided to concentrate on more limited measures essential for the implementation of the Single Market: several steps were taken to reduce the tax obstacles to cross-border operations, including the Merger Directive (90/434)¹⁰, the Parent-Subsidiary Directive (90/435)¹¹ and the Arbitration Convention on dispute resolution in transfer pricing (90/436)¹².

Harmful tax competition was first addressed by the OECD Committee on Fiscal Affairs in a Report submitted to the organisation’s Council of Ministers in 1998; the Council endorsed the proposed (non binding) Guidelines for restraining harmful tax practices and established a Forum for their implementation in member and non-member states. The OECD report focused on geographically mobile financial and service activities, not specifically on business taxation, and provides criteria for the identification of harmful preferential tax regimes as well as measures for counteracting their effects.

In the European Union, the European Council agreed in Dublin in December 1996 on the need to address the question of tax competition, which led a year later to the European Commission communication “Towards tax coordination in the

⁸ EC Treaty.

⁹ The Neuman Report of 1962 and the Van den Tempel Report of 1970 both advocated harmonization, even though with different systems. In 1975 the Commission published a draft of Directive proposing the introduction in all member states of a common corporate taxation system with an alignment of rate between 45% and 55%.

¹⁰ Council Directive 434/90/EC, now Council Directive 2009/133/EC.

¹¹ Council Directive 435/90/EC.

¹² Arbitration Convention 436/90/EC.

European Union – a package to tackle harmful tax competition” (European Commission 1997)¹³. The communication envisaged a coordinated set of measures, known as the ‘Monti package’: a Code of Conduct on harmful tax competition, measures to harmonise the taxation of savings and the elimination of withholding taxes on inter-firm payments of interest and royalties. The original package clearly had ambitions going beyond tackling harmful tax competition well into the domain of tax policy harmonisation but the ensuing negotiation has brought it back within its ‘headline’ goal. The Code of Conduct was approved in 1998, the rest of the package only in 2003.

In the Code of Conduct¹⁴, the factors for identifying harmful tax competition were basically the same as those proposed by the OECD, with certain additional details concerning discriminatory administrative practices. In some respects the scope of the Code was broader than the OECD Guidelines, while in others it was narrower. It was broader in that it applied to any measure capable of influencing the localisation of business activities, including those carried on within groups. It was narrower because, in conformity with Article 90 of the Treaty¹⁵, it focused on discriminatory preferential tax treatments and not on the level of tax rates. Even though the Code was not legally binding, it required member states to refrain from introducing new harmful competition measures concerning the taxation of business income and to remove the existing ones.

At the end of the nineties, member states asked to the Commission to prepare an analytical study of company taxation in the European Union. The EC Commission study (2001a)¹⁶, published in 2001, was accompanied by a Commission Communication (2001b) “Towards an Internal Market without tax obstacles: a strategy for providing companies with a consolidated corporate tax base for their Eu wide activities”¹⁷. These documents observed that growing integration of goods, services and capital markets, are magnifying the costs and

¹³ COM (97) 495/final.

¹⁴ Code of Conduct, 1st December 1997, 98/C 2/01.

¹⁵ EC Treaty.

¹⁶ Commission Study, COM (2001) 582 final.

¹⁷ COM (2001) 582 final.

distortions of maintaining different tax systems. It provided strong evidence on the size of these distortions, as reflected in very large divergences in rates of effective taxation differences in tax bases that multiply opportunities for evasion and abuse, and attendant loopholes and duplications of taxation.

The Commission proposed several approaches for providing company with a consolidated tax base for Eu-wide activities. The two principal methods alternatives to the current SA/ALP system that gained consensus at Eu level are the Home State Taxation (HST) and Common Consolidated Tax base (CCTB); both entail common-base consolidated taxation of MNEs corporate income.

Under HST the common tax base is that of the state of legal residence of the parent company; in practice, it is a system of mutual recognition of national tax bases for the taxation of MNEs whereby companies subject to different tax laws would operate side-to-side within the same (national) market. Consequently, each tax jurisdiction may be required to assess and collect taxes on businesses operating under different laws and administrative traditions in twenty-seven different countries. For this reason even its proponents have acknowledged that HST will not work in practice unless the tax (and legal) systems of the participating countries can be fairly closely aligned¹⁸.

Under CCBT, on the other hand, EU member states would have to agree on a common definition of taxable income, and MNEs would be allowed to opt for this definition of taxable income – consolidated at Union level, and then apportioned amongst jurisdictions with an agreed formula and taxed with national rates – instead of separate taxation in each country under SA/ALP. In this case, each tax administration would only have to deal, within its borders, with its own system and that of the Union.

¹⁸ Klemm A. (2001), "Economic Review of Formulary Methods in EU Corporate Tax Reform", in CEPS, EU Corporate Tax Reform, Report of a CEPS Working Party, Brussels.

Fuest summarize the main elements of the CCCTB proposal reflecting the work of a CCTB working group set up by the Commission in 2004¹⁹: a common set of rules for the calculation of taxable profits, the common base will be consolidated and apportioned to the member states. It should be optional and member states will retain autonomy in setting the tax rate. The working group recommends introducing the CCTB in the framework of enhanced cooperation, which means that a subgroup of Eu member countries could start and other countries may join later²⁰.

The main advantages of this approach are that there would be full loss offset within company groups and transfer prices would no longer matter (although the new system would necessarily stop at the Union's borders, with SA-ALP still applying to intra-group activities with business units established in non-EU countries). This proposal has some potential to reduce administrations and compliance cost²¹. It is less clear what would happen to the efficiency of the allocation of capital²². It has been observed that it is " still missing up a convincing evidence of direct economic benefits from introducing the CCCTB which are significant enough to convince member states government that the project is worth the effort"²³.

The main hurdle with this approach concerns intra-group consolidation, since a uniform juridical/accounting model of company group and group taxation is not available. Indeed, intra-group profit and loss consolidation exists only in some member states of the Union, and consolidation rules vary considerably among them. Critical issues in this regard are the identification of the group, with associated notions of controlling and controlled companies, and attendant criteria

¹⁹ Workshop Report "Common Consolidated Corporate Tax Base Working Group (CCCTB)", 2004.

²⁰ Fuest C. (2008), "The European Commission's proposal for a Common consolidated Corporate Tax Base", Working paper no.23 Oxford University Centre for Business Taxation.

²¹ Spengel C. and Wendt C. (2007), "A common consolidated corporate tax base for multinational companies in the European Union: some issue and options", Working paper no.17 Oxford University Centre for Business Taxation.

²² Devereux M. (2004), "Debating proposed reforms of taxation of corporate income in the European Union, International Tax and Public finance no.11.

²³ Fuest C. (2008), "The European Commission's proposal for a Common consolidated Corporate Tax Base", Working paper no.23 Oxford University Centre for Business Taxation.

for asset and liability consolidation; in addition, all countries have specific anti-abuse legislation interfering with such matters as loss offsetting or the definition of reserves. In some countries a parent company will include the income of its subsidiaries in its own, and pay tax accordingly; in others the losses of one company may be "surrendered" to another company in the group. Given these differences, setting common standards for group taxation will not be any easier than agreeing on a common tax base.

Another critical element concerns formula apportionment (FA)²⁴. FA is a tool for the allocation of income generated by a company that operates in more than one jurisdiction, and does not involve the consolidation of the profits and losses of related companies. Rather, it basically is a "presumptive" alternative to SA/ALP that uses variables such as assets, sales and the number of workers to apportion corporate profits between business units; to function properly, it presupposes agreement across tax jurisdictions on the definition of business units and the taxable base²⁵.

The contribution of each business unit to overall profits is assumed to be proportional to the factors included in the formula, with two consequences: first, estimated profit shares for each business unit may deviate significantly from the actual distribution; and, second, inclusion of a variable in the formula is equivalent to taxing that factor of production. On both accounts, perverse incentives, distortions and efficiency losses may arise. Under formulary apportionment, the factors included in the formula would in practice be taxed at the national rates, therefore reinstating fresh incentives for factor and profit shifting. The main benefit would be a dramatic reduction in red tape and the uncertainties inherent in SA/ALP.

²⁴ In the United States formula variation across jurisdictions is permitted. Its drawback is that the sum of profit shares may then not add up to unity, leading to double taxation or tax loopholes, thus reintroducing incentives for profit shifting.

²⁵ Weiner J. (2005), "Formulary apportionment and group taxation in the European Union: insights from the United States and Canada", Taxation paper no.8 European Commission.

Finally, in spite of remarkable efforts and work over years, the Commission model was never fully tested with the member states to assess the revenue and administrative mechanisms. On the whole, it is not surprising thereby that the commissioner in charge did not managed to achieve the Commission's endorsement and that the proposal was not sent to the Council and the Parliament for consideration. The project now looks all sort dead.

3. Decentralised presumptive taxation of trans-national businesses

Even if it were possible to find satisfactory solutions to all the hurdles involved in defining a common consolidated base for corporate taxation, a specific difficulty would still remain concerning the very definition of corporate income. Corporate income is a largely conventional accounting magnitude, whose definition varies depending on the purpose one wants to serve. The increased importance of intangibles and human capital in company assets are blurring the traditional distinction between current and capital spending and changing the nature of risks and attendant allowances. Furthermore, the definition of taxable income often reflects implicit or explicit decisions to favour certain factors of production, form of investment and financing, and investment locations. Referring to corporate income made sense when company taxation was a "backstop" for individual taxation within a system aiming at comprehensive progressive taxation of personal incomes; however, most countries have now renounced such ambitions and adopted "dual" income taxation that treat capital income more leniently than other types of personal incomes.

And yet, corporate income is not the only possible tax base: some form of taxation related to corporate inputs or outputs may provide a simpler and more efficient way to collect taxes from firms operating cross-border. Sadka and Tanzi once proposed to tax gross physical assets of enterprises as an indicator of normal or average income²⁶. However, today their proposal is not likely to

²⁶ Sadka E. and V. Tanzi (1993), "A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation", Bulletin of the International Bureau of Fiscal Documentation.

provide a reliable indicator of income due to the larger weight of intangibles and services in value added.²⁷ A more meaningful base could be offered by total gross liabilities, including capital and reserves. All discrimination between types of financing would then disappear, since equity and debt would be taxed alike. However, this variable could only be utilised for determining the total consolidated income of MNEs at EU level, since there would be no simple way of allocating assets and liabilities to decentralised business units within a group.

Another alternative to taxing business through income is the one proposed by Bradford known as "X Tax" for business activity which is a consumption-type tax, with a broad base that make possible a substantial simplification of the tax system and greater neutrality of taxation with respect to decisions about how much, where and in what form to invest²⁸.

A radically different approach is also available that seem to offer considerable advantages in terms of efficiency, simplicity and decentralisation, including full administrative autonomy of national tax authorities: it entails taxing at a moderate rate some agreed presumptive measure of business activity such as company value added, sales or employment. Of course, these are precisely the variables usually considered in formula apportionment; here, however, they would apply directly without having first to go through the complications of finding a common-base definition and consolidating company results at EU level. Reference to a broad base, with no exemptions or deductions, would allow to set low statutory rates.

Application of this model requires the adoption of pure source taxation. Ideally, further taxation of savings income in the recipient country should also be avoided; however, agreement on this may prove elusive, since it pertains to the

²⁷ The authors were aware of the problem, but still chose physical assets precisely because they wanted to encourage investment in intangibles (p. 69). However, they did not probably foresee at that time that intangibles and services would take up overwhelming importance in value-generation on many new activities, and that sole reference to gross assets in their case would really leave little to tax.

²⁸ Bradford D. (2004), "The X tax in the world economy", American Enterprise Institute of Public Policy Research, Washington D.C.

domain of personal income taxation, a closely guarded reserve of national tax policies.

The choice of the common tax base should avoid introducing unwanted incentives or penalties for different productive factors, assets and forms of financing. There would be no allowance for losses, in accordance with a "benefit view" of corporate taxation and the stated goal of encouraging productive uses of assets. Taxes paid would not be deductible against any other tax liability. Interest rate payments on debt would also be taxed on an equal basis with earnings and the commonly observed bias in favour of debt financing would be removed.

Of course, business value added includes profits, and to this extent the incentive for companies to manipulate transfer prices may well reappear; however, this incentive would be much weakened, as profits typically represent a fairly small share of total value added. A further reason for scrapping income-related taxation and shifting to some other, output-related taxation stems from the federal-decentralised nature of the Union. While taxing the returns on capital at national level can discourage investment, taxing companies in exchange for location advantages in each country might not entail any similar disincentives, and indeed would appear to be "horizontally" efficient. Countries offering world class infrastructures, high-skilled staff and simple business rules could legitimately require companies to pay tax commensurate to the benefits provided. Ultimately, different tax rates would tend to reflect the quality of local institutions, infrastructures and business climate.

4. Conclusions

The existing system for trans-border taxation of corporate income in the European Union produces large distortions in the allocation of capital and perverse incentives to engage in profit shifting across member states and tax avoidance. With growing integration in the internal market, compliance costs and

the erosion of tax bases are likely to increase. This hampers the proper functioning of the internal market and justifies initiatives at Community level.

An efficient tax system should have three features: as much as possible, it should do away with separate income accounting by tax jurisdiction and arm's length pricing of intra-firms transactions; it should have a single common definition of the corporate tax base; and it should abandon effective income as the target variable in favour of normal income or some other presumptive measure of corporate activity.

There is no need to harmonise tax rates within the European Union since tax competition between jurisdictions to attract productive capital is efficiency enhancing. Over time, corporate tax-rate disparities across countries are likely to diminish but will not disappear, since the location of investment responds to many factors, of which taxation is only one. In equilibrium, corporate taxes will tend to approximate, or at least not significantly exceed, the net overall benefits of each location. National tax policies and administrative autonomy in tax administration can be preserved, with resulting benefits of flexibility, accountability to national electorates and fiscal discipline.

There are two possible approaches in designing an efficient trans-border corporate tax system for the European Union. The first is to consolidate the EU-wide operations of MNEs, using the agreed common base as the reference variable, and then to apportion this total tax base using some presumptive indicators of activity in each tax jurisdiction – hence, implicitly, of the likely benefits stemming from each location. The apportionment formula should respect requisites of neutrality between productive factors and forms of corporate financing.

A radically different approach would be to design a fully decentralised system whereby each national authority would tax corporate activity at freely chosen statutory rates while using a common definition of the tax base. The common tax

base would have to be an objective, easily measurable indicator of business units activity.

Company taxation would have to follow “pure” source principles, with moderate rates and no exemptions for interest payments or other cost items; all cross-border payments within MNEs or from them to shareholders would be tax-exempt. There would be no EU-wide consolidation; hence profit and loss offsetting would not be allowed. This may not be too serious a drawback, to the extent that one is willing to consider corporate taxation as a sort of counterpart to locational benefits and to recognise that, on efficiency grounds, it is better not to tax actual corporate income.

Bibliography

Bradford D. (2004), *"The X tax in the world economy"*, American Enterprise Institute of Public Policy Research, Washington D.C.

Devereux M. (2004), "Debating proposed reforms of taxation of corporate income in the European Union, *International Tax and Public finance* no.11.

Devereux M. and Keuschnigg C. (2009), "The distorting arm's length principle", Working paper no.10 Oxford University Centre for Business Taxation.

European Commission (1997), *A package to tackle harmful tax competition in the European Union*, COM (97) 495 of 1 October, Brussels.

European Commission (2001a), *Company Taxation in the Internal Market*, a Commission Staff Working paper, SEC (2001) 1681 of 23 October, Brussels.

European Commission (2001b), *Towards an Internal Market Without Tax Obstacles*, COM (2001) 582 of 23 October, Brussels.

Fuest C. (2008), "The European Commission's proposal for a Common consolidated Corporate Tax Base", Working paper no.23 Oxford University Centre for Business Taxation.

Klemm A. (2001), "Economic Review of Formulary Methods in EU Corporate Tax Reform", in CEPS, *EU Corporate Tax Reform*, Report of a CEPS Working Party, Brussels.

McLure C.E. and J.M. Weiner (2000), "Deciding whether the European Union should adopt Formula Apportionment of Company Income", in S. Cnossen (editor), *Taxing Capital Income in the European Union – Issues and Options for Reform*, Oxford University Press.

McLure C. (2002), "Replacing separate entity accounting and the arm's length principle with formulary apportionment", International Bureau of Fiscal Documentation.

Nicodème G. (2009), "Corporate income taxations and economic distortions", Taxation Paper European Commission.

OECD (1998), Harmful tax competition: an emerging global issue, Paris.

Sadka E. and V. Tanzi (1993), "A Tax on Gross Assets of Enterprises as a Form of Presumptive Taxation", Bulletin of the International Bureau of Fiscal Documentation.

Spengel C. and Wendt C. (2007), "A common consolidated corporate tax base for multinational companies in the European Union: some issue and options", Working paper no.17 Oxford University Centre for Business Taxation.

Winer J. (2005), "Formulary apportionment and group taxation in the European Union: insights from the United States and Canada", Taxation paper no.8 European Commission.