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The Reform of Corporate Taxation in the  
European Union

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# **The Reform of Corporate Taxation in the European Union**

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## I. Introduction

At the European Council in Lisbon in March 2000, the European Union has set itself the strategic goal to become the most competitive and dynamic knowledge-based economy in the world. The Lisbon Council also called for building up a supportive general framework for economic activity in the EU. The Commission of the European Communities<sup>1</sup> responded to this appeal by presenting a comprehensive tax strategy for the Internal Market: The adoption of a common consolidated corporate tax base and the implementation of formulary apportionment for EU multinational enterprises.<sup>2</sup> The goal of this paper is to critically evaluate the EU tax reform proposal by scrutinizing its most important advantages and downsides and by pointing out additional issues of the strategy that should be addressed in the future. The reader shall be enabled to form her own educated view on one of today's most ambitious political projects in the European Union.

My analysis begins with a description of the status quo of corporate taxation in the European Union and a thorough assessment of its major disadvantages from a European perspective. Next, I explain the key features and the current progress of the EU Commission's reform proposal and I discuss whether the proposed system can effectively address the identified problems of cross-border taxation. Considering possible disadvantages and remaining

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<sup>1</sup> In the following informally referred to as "The EU Commission" or "The Commission".

<sup>2</sup> *Commission of the European Communities, Towards an Internal Market without Tax Obstacles: A strategy for Providing Companies with a Consolidated Corporate Tax base for their EU-wide Activities, COM (2001) 582 final.*

uncertainties of the proposal, I focus particularly on the problem of political feasibility and try to offer additional thoughts on the issue. Lastly, I elaborate on a future EU formulary apportionment system by providing insights into the history and current practices of US state corporate income taxation, before I conclude by summarizing my personal assessment of the proposal.

## II. Major Problems of Corporate Taxation in the EU

While important steps have been taken in other European policy areas during the last decades, little has changed with regard to the taxation of EU-wide operating companies and the Member States essentially operate the same company tax systems as they did before the set-up of the Internal Market. Thus, EU businesses today are confronted with a single economic zone in which 27 different taxation systems and tax rates apply.<sup>3</sup>

This is particularly cumbersome for multinational enterprises (“MNE”) which generally operate outside their home markets through subsidiaries. These subsidiaries must report their

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<sup>3</sup> For an overview of the statutory corporate income tax rates in the Member States of 2001 see *Peter Birch Sørensen*, *Company Tax Reform in the European Union*, 2003, page 24. Data from 1999 show that the effective tax rates of subsidiaries located in different host countries can vary for more than 30 percentage points. Likewise, the effective tax rates for subsidiaries operating in a given country can also vary for more than 30 percentage points depending on where their parent company is located, see *Commission of the European Communities*, *Towards an Internal Market without Tax Obstacles: A strategy for Providing Companies with a Consolidated Corporate Tax base for their EU-wide Activities*, COM (2001) 582 final, Annex: Executive Summary of the Commission Services Study on “Company Taxation in the Internal Market”, page 7.

income and are taxed according to the laws of the countries in which they are located. Thus, under the current system a MNE has to calculate a separate tax base in each Member State where one of its subsidiaries is located. The rule for the calculation of these individual tax bases is that each entity within the company's group has to be treated like an independent entity operating at "arm's length" from its affiliates and its parent company. In order to accomplish this, the MRE is obliged to set the prices for internal transfers among controlled entities in the same manner that enterprises operating independently set prices on the market. Hence, the arm's length principle creates the mere fiction that affiliated companies conduct business with each other at general market conditions rather than at favourable conditions in the interest of the group as a whole. A MNE currently has to establish these so called transfer prices for every cross-border transfer of goods, property, services, loans, and leases with its related affiliates in other Member States of the European Union and has to use these prices to calculate the respective taxable income associated with an entity.

This traditional method of separate entity accounting with the arm's length principle pays tribute to the separate legal status of affiliates within a multinational enterprise and has been employed in Europe for about a hundred years. But however reasonable its adoption might have been in the past, it is questionable whether the concept can live up to the standards and realities of the European Union in the 21<sup>st</sup> century. During the last decades, technological innovation and especially the development of e-commerce have enhanced the mobility of certain forms of economic activity as well as the mobility of capital. Businesses in the European Union increasingly operate in more than one Member State and there are more interna-

tional mergers and acquisitions than ever before. However, evidence suggests that the current system of corporate taxation impedes the free movement of capital in this changing environment. This would contravene the EC Treaty that aims at ensuring the free movement of goods, persons, services and capital in the Internal Market and at removing economic and commercial barriers between the Member States. As the executive branch of the European Union, the EU Commission is responsible for upholding the Union's treaties and for initialising the legislative measures necessary to address obstacles to cross-border economic activity. In the following, I will adopt the Commission's perspective in analysing the major disadvantages of the status quo of corporate taxation in the European Union.

First, the existence of a multitude of different taxation systems generates a huge lack of transparency and significant compliance costs for multinational enterprises. The specific compliance costs can be huge and can impede a company's cross-border business activity by making it comparatively more costly. Under the current system of separate accounting, MNE have to comply with different sets of rules for financial accounting and tax reporting in every Member State in which they operate. There is no unified accounting standard in the European Union today and the variation in Member States tax bases is also significant. For example, the modus operandi for depreciation and the depreciation rates differ widely amongst countries. Therefore, MNE have to employ accountants, lawyers, and tax consultants for each jurisdiction in which they conduct business and bear the risk of failure of compliance.

However, the most pestering problems today seem to arise from the need to comply with the arm's length principle. According to a 2003 survey of *Ernst & Young*, 86 percent of

MNE parent company respondents and 93 percent of subsidiary respondents identified transfer pricing as the most important international tax matter they are currently dealing with.<sup>4</sup> Businesses find it increasingly difficult to establish “correct” transfer prices and to meet the growing demand for documentation of the price-setting process. The system of establishing transfer prices in the European Union is indeed very complicated today and is often a source of frustration both for MNEs and for tax authorities. One reason for the growing difficulties that MNE face with regard to transfer pricing is that almost all Member States have been significantly stepping up their enforcement efforts. As the volume of cross-border investment in the EU increases, the Member States seem to fear an increase in tax evasion and fraud that threaten to erode their corporate tax bases. In fact, evidence suggests that MNE indeed tend to shift income from high-tax countries to low-tax countries. *Bartelsman* and *Beetsma*<sup>5</sup> for example have evaluated European data about the correlation of raising tax rates and revenues. They find that revenues do not increase when countries raise their tax rates because reported profits fall. *Zodrow*<sup>6</sup> refers to numerous studies finding that after-tax profitability tends to be high in low-tax countries. And *Grubert*<sup>7</sup> finds that subsidiaries of U.S.

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<sup>4</sup> See *ERNST & YOUNG*, *Transfer Pricing 2003 Global Survey - Practices, Perceptions and Trends in 22 Countries Plus Tax Authority Approaches in 44 Countries*, 2003.

<sup>5</sup> *Eric Bartelsman & Roel Beetsma*, *Why pay more? Corporate tax avoidance through transfer pricing in OECD countries*, 87 *Journal of Public Economics* Nr. 9-10, 2003, pages 2225-2252.

<sup>6</sup> *George R. Zodrow*, *Capital Mobility and Source-Based Taxation of Capital Income in Small Open Economies*, *International Tax and Public Finance*, 13, 2006, pages 269-294.

<sup>7</sup> *Harry Grubert*, *Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location*, 56 *National Tax Journal* Nr. 1, part 2, 2003 pages 221-242.

multinational companies located in high or low tax areas that have a strong incentive to shift income also have significantly larger volume of inter-company transactions. In combination, these findings suggest that multinationals do take advantage of cross-border tax differentials by shifting income through the means of tax-motivated and oftentimes manipulative transfer pricing. For example, a subsidiary located in a low-tax country could sell items to the parent company in a high-tax country at an inflated price, thus making the profits of the subsidiary in the low-tax country look larger while the parents profit look smaller. Therefore, it is understandable that Member States – particularly those with high corporate tax rates – have increased their efforts in enforcing transfer prices during the last decade and impose more and more onerous documentation requirements. Along with the increase in compliance costs for MNE comes an increase in administrative costs to the tax authorities due to complicated administrative procedures like auditing the pricing procedures, settling disputes with companies and agreeing with other affected Member States on transfer prices on cross-border exchanges of services or other intangibles.

On the other hand, MNEs rightfully complain that the application of the various methods for determining the "correct" transfer price for an intra-group transaction is complex and costly. New technologies and business structures that imply more emphasis on intangible goods and on intra-company services make it more and more difficult to identify comparable "uncontrolled" transactions which are needed to establish the arm's length prices. Oftentimes the transfer prices calculated for tax purposes do not serve any underlying commercial rationale at all any more. As a result, MNE face uncertainty as to whether their transfer prices

will be accepted by the tax administrations upon a subsequent audit. In addition, transfer pricing methods and even OECD guidelines on transfer pricing are applied differently across Member States. Thus, different jurisdictions might require different transfer prices to be applied to the same intra-company transaction. As a result, overlapping national tax bases create a real risk for double taxation whereas uncoordinated transfer pricing rules leave gaps in the international tax base. Imagine for example that the tax administration of one Member State examines a pricing, considers it to contravene its rules and unilaterally adjusts the price. If this adjustment is not offset by a corresponding adjustment in the other Member State concerned with the transaction, then the MNE will be taxed double. Unfortunately, this scenario is everything but rare. According to the *Ernst & Young* survey of 2003, an estimated 40 percent of all reported transfer pricing adjustments result in double taxation. Since many business representatives consider the cost and time relating to the dispute settlement procedures to be prohibitively high, they often have to “accept” this kind of double taxation. I believe that the increased compliance costs and risks do not only impede, but might even deter companies from engaging in cross-border economic activity, particularly small and medium sized enterprises. Their marginal benefit from expanding their business across borders might not outweigh their marginal costs because precisely of these compliance costs.

Another downside of the status quo is that Member States are often reluctant to allow relief for losses incurred by associated companies whose profits fall outside the scope of their

taxing rights.<sup>8</sup> The current rules in Member States generally allow only for the offsetting of losses of foreign permanent establishments but not for those of foreign subsidiaries.<sup>9</sup> This situation entails another risk of economic double taxation where losses cannot be absorbed locally and provides a clear incentive in favour of domestic investment.

Lastly, one could argue that the existing differences in effective levels of taxation also pose an impediment to the free movement of capital, a standpoint that the European Commission had taken for a long time. The theory of economic efficiency states that tax systems should ideally be “neutral” in terms of economic choices, meaning that the choice of an investment, its financing or location should in principle not be driven by tax considerations. Thus, to the extent that economic activity moves to particular locations for favourable tax treatment instead of for productive investment opportunities, welfare costs are implied.<sup>10</sup> From this perspective, similar investments should not face markedly different effective levels of taxation purely because of their country location.

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<sup>8</sup> Commission of the European Communities, *supra* footnote 3, page 39.

<sup>9</sup> With the exception of Austria, Denmark, and Italy.

<sup>10</sup> *Joel Slemrod & Jon Bakija, Taxing Ourselves – A Citizen’s Guide to the Debate over Taxes, Third Edition, 2004, page 138.*

### III. The Reform Proposal of the European Commission

The EU Commission has sporadically tried to address some of these tax obstacles in the past. Examples of its “targeted” legislative efforts are the so-called “Merger Directive” that provides for the deferral of taxation on cross-border reorganizations, the “Parent-Subsidiary Directive” that aims at eliminating double taxation on cross-border dividend payments between parent and subsidiary companies, and the “Arbitration Convention” that establishes a dispute resolution procedure in the area of transfer pricing. However, these approaches have been a mere piecemeal, apparently incapable of comprehensively solving the key problems described above.<sup>11</sup> I believe that the underlying reason for this shortfall in introducing a coherent policy on corporate taxation lays in the political structure of the European Union. The EC Treaty empowers the Council to provide for the harmonisation of Member States' rules namely in the area of indirect taxation, acknowledging that indirect taxes like the VAT may create an immediate obstacle to the free movement of goods and the free supply of services within the Internal Market. With regard to other taxes, however, the Council may only provide for the approximation of such laws or regulations as directly affect the establishment or functioning of the common market and it can only adopt rules by a unanimous decision of all 27 Member States. In addition, all EU rules in the field of direct taxation would have to comply with the so-called “subsidiary principle”, meaning that EU legislation is only lawful

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<sup>11</sup> The Parent-Subsidiary Directive, for example, may abolish withholding taxes on dividend payments, but applies solely to direct holdings of 25% or more. See *Commission of the European Communities*, supra footnote 3, for a brief description of more downsides of the Directives.

when no action by individual Member States alone could provide an equally effective solution. Thus, any comprehensive reform of a direct tax such as the corporate tax is extremely difficult to realise and needs mutual political consent.

Despite these predictable adversities, the Commission took a big step forward in 2001 and for the first time proposed a comprehensive solution for corporate taxation in the Internal Market. It presented a concept that allows multinational companies to operate a single consolidated corporate tax base for their EU wide activities. EU enterprises with international subsidiaries shall be allowed to compute the income of the entire group according to one single set of rules and to establish consolidated accounts for tax purposes. This concept of consolidated reporting ignores the separate legal entity structure of subsidiaries once the ownership of a parent company exceeds a certain threshold and combines the income of a group of affiliated corporations into a single measure of taxable income. In a second step, the consolidated tax base is divided among the Member States according to a commonly agreed allocation mechanism. Since the proposal does not aim at harmonizing corporate tax rates in European Union, each Member State would apply their national tax rate to its attributed share of the tax base. The tax base shall be broad and simple, rather than narrow and complex, notwithstanding the Member States right to assign exceptions of the tax liability. Thus, Member States' sovereignty to set and adjust corporate tax rates in their jurisdiction remains untouched.

At first, the Commission presented little more than its general idea of adopting a common consolidated corporate tax base (“CCCTB”) and of some sort of apportionment

system. It took the CCCTB Working Group of the Commission another six years to publish first details in a working document warily titled “possible elements of a technical outline”.<sup>12</sup> This 2007 outline describes the basic structure of a possible CCCTB, presents features of the tax base of individual companies and deals with issues of consolidation,<sup>13</sup> whereas details of a possible sharing mechanism are still missing. However, the Commission has recently confirmed its commitment to present a first official proposal for a Directive in 2008.<sup>14</sup>

I believe that such a Directive would indeed solve the majority of the identified tax obstacles to cross-border business activity in the Internal Market. The introduction of a single consolidated tax base would not only significantly reduce the compliance costs European MNE face today, but would also reduce tax-related investment distortions and would eliminate several tax shelters. Thus, the reform is likely to stimulate economically beneficial cross-border operations, to generate efficiency gains and to increase government revenues in the EU. Compliance costs would be reduced first because a multinational group would only have to report one single income for all related entities in the Internal Market. The MNE

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<sup>12</sup> *European Commission Common Consolidated Corporate Tax Base Working Group (CCCTB WG): Working Document: CCCTB: possible elements of a technical outline, 2007, CCCTB/WP057/doc/en.*

<sup>13</sup> Thus, the Commission now seems to focus only on the creating of a common consolidated corporate tax base. In the very beginning, there had also been a latent discussion of three other possible blueprints for achieving a single tax base in European Union - Home State Taxation, a European Union Company Tax and a Compulsory Harmonised Tax Base.

<sup>14</sup> See *Commission of the European Communities: Implementing the Community Programme for improved growth and employment and the enhanced competitiveness of EU business: Further Progress during 2006 and next steps towards a proposal on the Common Consolidated Corporate Tax Base (CCCTB).*

would only have to apply a single set of rules for computing its European income, thus facing for example the same depreciation time frames and depreciation rates in all Member States. A consolidated tax base would also automatically allow the offset of losses in one EU member state against profits made in another member state. This would eliminate today's risk that Member States refuse to set off a foreign company's losses. Thereby, tax neutrality between national and multinational groups of companies is enhanced and secured and the risk of economical double taxation would be diminished. As a result of all of these features, the reform would eliminate tax base competition for corporate headquarters and would significantly reduce tax-base related distortions with regard to the location of investment in the European Union. Second and most important, by eliminating separate accounting the proposal would also abolish the need to establish arm's length prices for transactions between affiliates. The arm's length principle becomes totally dispensable since it does not matter which affiliate of the MNE does generate what part of the group's income. Thus, all of the described problems related to transfer pricing - including the risk of double taxation - would basically disappear in the EU. It is therefore no surprise that important business interest groups such as the Union of Industrial and Employer's Confederations of Europe strongly support the proposal. An additional advantage from eliminating the need to establish somewhat artificial transfer prices is that opportunities for tax evasion and tax avoidance through distorted transfer prices would be eliminated as well. If the EU decides to use a tax apportionment formula based on labor, property and/or sales, then there would be no tax incentive

to shift income from high-tax countries to low-tax countries anyways.<sup>15</sup> Therefore, the costs of administrating and enforcing the pricing process will vanish.

In my view, these gains from abolishing separate accounting (SA) under the arm's length principle in the European Union would outweigh the advantages of keeping it. Admittedly, the international community has reached near consensus today to use this method for distributing multinational profits across countries. This broad acceptance provides a strong justification for the continued use of SA at the international level because reaching consensus is essential to minimize the risk of double taxation. I also acknowledge several other downsides of the Commission's proposal of adopting a CCCTB with formulary apportionment (FA) like the challenging task to provide a precise and practical definition of the "group". Problems will as well arise with regard to aligning the system to non-EU countries. For example, if a multinational company does not only have affiliates in several European countries, but also in non-EU countries that apply SA, then the coexistence of SA and FA for this one enterprise generates (new) risks of double taxation and new possibilities for tax avoidance.<sup>16</sup> These problems arising from the coexistence of both systems, however, would decline if other countries follow the European Union's example to adopt a system of FA. *Avi-Yonah* and *Clausing* have made a good point arguing that a unilateral adoption of FA by the USA would lead to a tremendous income shift by MNE into the U.S. which would in turn create a

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<sup>15</sup> More on the elements of a possible apportionment formula for European MNE below at IV.

<sup>16</sup> To avoid repetition, please see my policy analysis paper # 5 on the reform of international taxation for a more elaborate argumentation on the problems with coexisting systems of SA and FA.

strong financial incentive for other countries to implement FA as well. The same argument can be made with regard to the EU Commission's proposal.

Since I believe that these conceptual flaws are likely to be offset by the overall gains in efficiency and simplicity coming along with a European CCCTB, the proposal's more dominant problem in my view seems to be political infeasibility. As I have indicated above, a Directive implementing CCCTB in the EU would require the unanimous assent of all 27 Member States and I believe that this unanimity would be very difficult to obtain. Even though the proposal does not infringe with the Member States' right to set corporate tax rates, it still harmonizes the rules for setting the corporate tax base and thus decreases national autonomy in corporate taxation. A couple of Member States do not seem willing to voluntarily transfer this right to the EU legislator. Among the reasons of this reluctance might be the fear that the EU Commission together with the European Court of Justice will use the Directive as a first step to further broaden their influence over matters of direct taxation – for example by suing Member States for national regulations that might impede the full efficacy (“effect utile”) of a possible CCCTB Directive. Therefore, although the proposal is very popular with European businesses, the required approval in the Council seems to be unlikely, at least for the short term.

However, this does not necessarily have to put the implementation of a CCCTB in the EU completely on hold. The Treaty of Nice highlighted the possibility for enhanced cooperation of some Member States where agreement by all States is not achievable. Thus, a “core group” of Member States whose governments' are willing to promote the concept

might take a lead and provide the consolidated tax base rules for MNE based in their countries with regard to the income generated by subsidiaries located in other participating core-group-Member States. Naturally, the success of this approach would depend crucially on the economic importance and influence of the participating countries. Another, more promising way to proceed might be to make the harmonized tax base optional instead of compulsory. The idea is that all companies to which the Directive generally applies should be enabled either to opt for the CCCTB or to remain within the existing domestic rules where they are maintained by Member States. Thus, all Member States must be able to provide CCCTB, but do not have to impose it on MNE. The Commission has considered both the described alternatives, but seems to favour the latter one too.<sup>17</sup>

Admittedly, the co-existence of different tax regimes within one country could create new opportunities for tax arbitrage. But the situation would be the same even if CCCTB was compulsory for MNE, because the companies that do not operate internationally could still be taxed based solely according to the domestic tax base rules. Imagine, for example, a Member State A whose domestic tax base rules allow less generous deductions than the CCCTB tax base. A company which does not yet have any foreign operations might then find it profitable to start up a branch or subsidiary in another member state because this would enable it to switch to the more liberal CCTB rules for taxation of its pre-existing do-

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<sup>17</sup> For a discussion of the first alternative way see *Commission of the European Communities*, supra footnote 2, page 17. Today's commitment towards the latter "option"-alternative is reflected in *European Commission Common Consolidated Corporate Tax Base Working Group*, Working Document: CCCTB: possible elements of a technical outline, 2007, CCCTB/WP057/doc/en, page 6.

mestic activities.<sup>18</sup> The fact that under the original reform and an amended “optional approach” each national tax administration would have to deal with two different tax systems could indeed offset some of the reduction in administration costs which would be gained by abolishing the need for transfer pricing. However, these costs should have already been budgeted for another reason – the implementation of the innovative, genuine European corporation form *Societas Europae* (“European Company”) four years ago. It was always clear that the newly founded *Societas Europae* would need a genuine European tax base and the CCCTB would finally fill this gap.

The last potential conceptual downside of the proposal that I want to address is the fact that the Commission expressly does not aim at abolishing tax rate differentials among the Member States - although many experts claim that tax harmonisation is urgently required to avoid destructive tax competition in the EU.<sup>19</sup> Those who favor tax rate harmonization believe that it is necessary to avoid corporate tax rate-competition among the Member States. Tax rate-competition is considered to be undesirable because it is supposed to lead to what economists call a “race to the bottom” in taxation of corporate income as countries compete to reduce their tax rates to attract more foreign investment.<sup>20</sup> Such a reduction in tax rates allegedly could even have the potential of endangering Europe’s generous welfare states like

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<sup>18</sup> Example taken from *Peter Birch Sørensen, Company Tax Reform in the European Union, 2003.*

<sup>19</sup> On the need for tax rate harmonization see for example *Peter Birch Sørensen, supra footnote 18.*

<sup>20</sup> See the explanation in *Joel Slemrod & Jon Bakija, Taxing Ourselves – A Citizen’s Guide to the Debate over Taxes, Third Edition, 2004, at page 138.*

those that exist in Germany or France. However, even if we put aside the political infeasibility to agree on a uniform EU-wide corporate tax rate, I do not consider it a “failure” of the proposal not to harmonize the tax rates. First of all, I do not agree with the underlying implication that tax competition among governments can be compared to competition among private-sector firms. Many economists believe that in an Internal Market with mostly unfettered commercial relationships, the economic well-being of one country benefits other countries without necessarily making people in the first country worse off. Second, evidence strongly suggests that a race to the bottom, although it sounds inevitably in theory, is truly happening. On the contrary, data presented by *Baldwin*<sup>21</sup> shows that the average tax rate in the EU has increased rather than decreased over a period of 30 years of increasing European integration (1964-1994). *Baldwin* concludes from his data that the growing integration did not in any way induce high-tax nations to reduce their corporate tax rates and he rather sees a “race to the top” in the European Union. A sound explanation for this development might be that the high-tax countries have such a big agglomeration advantage, for example lots of industry and a sophisticated service sector, that the “periphery” and originally poorer countries could never reduce their corporate tax rates so much as to induce firms to move. Thus, these countries do not try to compete head-on-head for the big player’s industry, but rather go for different economic niches and actually set their tax rates mainly with view of their domestic concerns. And thirdly, one could even argue that a little tax competition among the Member

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<sup>21</sup> *Richard E. Baldwin*, Does tighter integration of goods and capital markets call for tax harmonization? The implications of two competing worldviews, HEI Geneve, 2004, [http://hei.unige.ch/~baldwin/PapersBooks/tax\\_NZZ.pdf](http://hei.unige.ch/~baldwin/PapersBooks/tax_NZZ.pdf).

States might actually be beneficial, inducing governments to provide services more efficiently to attract more capital.

#### **IV. An Apportionment System for the Internal Market**

When assessing the major advantages and possible downsides of the second part of the Commission's proposal, one has to be aware of the fact that the key efficiency gains of the reform are the ones described above. They arise from the introduction of a single consolidated tax base rather than from the system of distributing the so-computed income of the group. Consolidation, however, necessitates the distribution of income through some estimate across tax jurisdictions and thus an apportionment system that complements the CCCTB. Thus, the role of the apportioning mechanism in the reform is not to introduce additional arguments in favour of the proposal, but to provide a system that allows a reasonable and fair distribution of taxable profits across taxing jurisdictions and that does neither reintroduce the problems that the reform tries to resolve in the first place nor provoke additional opposition from the Member States. The latter is crucial since most European governments used to be highly critical of formulary apportionment in the past<sup>22</sup> and the Commission's strategy to implement it now is nothing short of a break from conventional tradition in EU corporate taxation.

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<sup>22</sup> Many Member States had the impression that some U.S. states abused the system of formulary apportionment to extend their tax base beyond their natural jurisdiction by apportioning the worldwide income of multinational groups doing business in the state. For a more detailed explanation of these resentments see *Peter Birch Sørensen, Company Tax Reform in the European Union, 2003, page 5.*

Using a formula to distribute a multinational enterprise's profits across jurisdictions might indeed be a new method for the European Union on the whole; it is however, not a new method for distributing profits across sub-national borders. The U.S. states have used formulary apportionment for more than half a century as the principal method to distribute company profits across locations for taxation at the respective state level.<sup>23</sup> They began using the system at the end of the 19th century for purposes of levying the property and capital stock tax on the transcontinental railroad system. Instead of measuring the property value in each state, companies generally measured their total property value including railroad track, rolling stock, and franchise as a single unit and distributed the total across the states according to the value of the railway lines located in each state relative to the total value in all of the states. When Wisconsin became the first state to introduce a corporate income tax in 1911, it chose to apply formulary apportionment using a formula based on the shares of property, cost of manufacture and sales.

One can see from this example that every system of FA must specify the formula for allocating the tax base and rules for measuring the factors in the formula. However, the EU Commission has so far failed to present any details of the possible sharing mechanism. Thus, I will dedicate the remaining space of this paper to introduce some basic ideas about a possible apportioning formula. In my view, there are generally two approaches for allocating a future common consolidated tax base to the Member States of the European Union. First,

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<sup>23</sup> *Joann Martens Weiner*, Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada, European Commission Taxation Papers, Working paper n°8 March 2005.

one could apportion the tax base according to the value-added tax base of the companies involved. However, there are no current experiences from which one could draw conclusions on the practical advantages and disadvantages of using a value added key as an apportioning factor. A second possible method would be to use a FA system like the U.S. states. I believe that the U.S. system can indeed serve as a model for a possible EU approach. Although the political structure in the EU differs greatly from the structures in the United States, from a plain business viewpoint, both economies are integrated markets and the U.S. use a tax system which is designed for an integrated market. When formulary apportionment was adopted in the U.S., the proponents argued that the U.S. States already used the same accounting system and the same currency and that most big companies operated nationwide rather than state-wide. The last two of these arguments hold true for the European Union as well, and the first will soon also hold true because the Commission is currently working on harmonizing accounting standards in the Internal Market. Additionally, FA seems to be perceived as a success in the US and some US-American scholars have currently proposed to even expand the system to the national level.<sup>24</sup>

Nearly all states begin with federal income as the definition of the tax base and this practice leads to certain conformity among state tax bases.<sup>25</sup> However, states vary in their formu-

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<sup>24</sup> See *Reuven S. Avi-Yonah & Kimberly A. Clausing*, A Proposal to adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project, Public Law and Legal Theory Working Paper Series, Working Paper No. 85, June 2007.

<sup>25</sup> *Jack Mintz & Joann Martens Weiner*, Exploring Formula Allocation for the European Union, 2001.

las, definitions, use of the unitary business method, and administrative practices. Although in the early days of formulary apportionment in the United States many formulae consisted of a wide range of elements, a distribution key today usually only employs no more than three factors: payroll, property and sales. Such a three-factor formula has gained wide approval in the USA over the years because the combination of payroll, property, and sales appears to reflect a very large share of the activities by which value is generated. According to *Hellerstein*<sup>26</sup>, the U.S. Supreme Court has considered the economic justification for property and payroll to be “clear enough” since income may be defined as the gain derived from capital, from labor, or from both combined. Income is in fact largely generated by capital and labor, and the property and payroll factors reflect these essential income producing elements. The sales factor, on the other hand, was originally designed to recognize the contribution of the states in which a firm's products are marketed to the generation of the firm's income. When one employs a destination test to assign sales of tangible personal property, then the sales factor attributes income to states in which goods are consumed and serves as a counterbalance to the property and payroll factors that tend to attribute income to states in which goods are produced.

Where these three factors are weighed equally, the formula is called “Massachusetts formula”. The majority of states today, however, double the weight of the sales factor in this formula meaning that they weigh the sales factor by one-half and both the capital and payroll

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<sup>26</sup> *Walter Hellerstein*, State Taxation of Corporate Income from Intangibles: Allied-Signal and beyond, 48 Tax Law Review, 1993, pages 739-877.

factors each by one fourth.<sup>27</sup> This could be a good model for an EU formula because placing a higher weight on the sales factor could increase Member States efforts to stipulate the respective economic activity by making it easier for foreign companies to market and sell their products within its borders. One could even argue to use a formula based on sales *only*, like *Avi-Yonah* and *Clausing* propose it for a worldwide FA.<sup>28</sup> The main advantage of such a sales-only-formula could be that sales are far less responsive to tax differences across markets than assets or employment. Also, even in a high-tax country, firms still have the incentive to sell as much of their products as possible. The incentive to distort the location of sales among markets could be combated by defining “sales” according the destination principle described above.<sup>29</sup> However, since some U.S. analysts today see serious problems arising from the fact that the States do not define “sales” identically,<sup>30</sup> an EU Directive should make sure to use a uniform and precise definition that does not leave any room for different interpretations by the Member States’ tax authorities.

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<sup>27</sup> Today, 14 states employ the “Massachusetts” formula and 23 states employ the double-sales-weight formula. In 2004 the average weight on the property and payroll factors was just under 25 percent, each and that the average weight on the gross receipts factor was just over 50 percent.

<sup>28</sup> See *Reuven S. Avi-Yonah & Kimberly A. Clausing*, A Proposal to adopt Formulary Apportionment for Corporate Income Taxation: The Hamilton Project, Public Law and Legal Theory Working Paper Series, Working Paper No. 85, June 2007, page 11.

<sup>29</sup> *Reuven S. Avi-Yonah & Kimberly A. Clausing*, *supra* footnote 28, page 29.

<sup>30</sup> See *Charles E. McLure Jr.*, Understanding the Nuttiness of State Tax Policy: When States Have Both Too Much Sovereignty and Not Enough, 58 *National Tax Journal*, September 2005, pages 565- 573.

## **V. Conclusion**

The EU Commission's proposal to switch from separate accounting to a consolidated corporate tax base and formula apportionment should be welcomed because it is likely to solve today's most pestering corporate tax obstacles to cross-border economic activity in the Internal Market. Contrary to other scholars, I believe that a respective Directive has good chances of acceptance by the EU Council as long as the adoption of the system would not be strictly imposed on European MNE, but would rather be made optional. With regard to the apportionment formula, I recommend to follow the U.S. states approach of using not more than three apportioning factors and of putting a strong emphasis on a company's sales.