

PRINCIPLES AND RULES FOR DEFINING OF COMMON CONSOLIDATED TAX BASE IN THE EUROPEAN UNION

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1. Introduction

The "Common Consolidated Tax Base" involves the consolidate determination of the corporate taxable income, as common accounting rules.

Concrete actions for building this system started at the ECOFIN Council in September 2004, when most EU Member States have accepted the usefulness of some progress towards creating a common tax base and have decided to set up a working group of experts representing the Member States and chaired by the European Commission for examination in detail the possible solutions to implement this database¹.

The main objectives of the Common Consolidated Corporate Tax Base Working Group - CCCTB WG, established in 2004, are:

- to discuss on the principles that will govern the "Common Consolidated Tax Base" system;
- to examine the technical definition of a common consolidated tax base for companies doing business within the European Union Member States;
- to establish fundamental structural elements of a consolidated tax base;
- to formulate a mechanism for allocating the consolidated tax base between entitled Member States.

The resulting documents from discussions in the working group are prepared by the Directorate General for

Taxation and Customs and are published on the Web site of the European Commission after each meeting. Until now there were 13 working group meetings.

In the late of 2008, the European Commission hopes to achieve the working group work in a legislative proposal, with effect from 2010, but this objective has not yet been reached.

2. Objectives of the "Common Consolidated Tax Base" system

In 2000, the European Council in Lisbon set the strategic goal for the EU economy "to become the most competitive and dynamic knowledge-based world" Achieving of this objectives requires the creation of a supportive framework for economic activity in the EU, in which the corporate taxation can play an important role. This general framework and the impending enlargement of the European Union required the adoption of company tax strategy. This strategy presented as a foundation, the changes made in general economic context in which companies operate from 1990:

- the large number of international mergers and acquisitions;
- the emergence of electronic commerce and increased mobility of production factors that have led to serious difficulties in defining and protecting the tax base plan;;
- economic, technological and institutional non-tax barriers continued to hamper the cross-border trade, while it

¹Information about the working group is available on http://europa.eu.int/comm/taxation_customs/taxation/common_tax_base/index_en.htm

was desired the further integration in the Internal Market and Economic and Monetary Union;

- large companies began to approach across the EU as "home market" and sought therefore to establish a pan-European business structures;

- taxpayers, individual or corporate, began to require the removal of preferential tax regimes that operate in the single market.

Because many of these developments would be accelerated due to the enlargement process has been identified clearly the need to adapt the EU company tax to the changing environment. To assess the overall importance of these issues and identify possible solutions, it was necessary to take into account the economic efficiency². Of economically, the taxation of companies on the internal market must meet the following requirements:

- to help at the growth of the international competitiveness of EU companies in accordance with the strategic objective set by the Lisbon European Council;

- to ensure the neutrality of taxation: fiscal considerations to affect economic decision-making process little as possible;

- to avoid unnecessary compliance costs or unreasonably tax barriers for the cross-border economic activity;

- to do not prevent the possibility of tax competition manifestation in general, but to allow the elimination of "harmful tax competition" effects.

A consolidated tax base of revenue of companies with cross-border activities in the Member States have contributed at the growth of the efficiency, effectiveness and transparency of national tax systems and, by extension, at the growth of the competitiveness in the European Union. This context may be a relevant basis for

the achieving of the objectives set by the Lisbon European Council³. Specifically, the common consolidated tax base should contribute to achieving the following objectives:

- *the reduction of administrative costs* for both companies and tax administrations that must to monitor the transfer pricing process, because according with tax laws, a group member companies operating in multiple tax jurisdictions in the EU are treated as independent units in terms of tax;

- *the reduction of compliance costs* of corporations, which are required to know the tax and accounting laws of all countries in which it operates, to determine the tax base or to calculate any tax refunds;

- *the strengthening and comprehensive compensation of corporate profits and losses;*

- *the simplification of the restructuring of international operations;*

- *the avoid of double taxation risk* because in the absence of any unifying or Community harmonization measures, Member States have competence regarding the establish of income tax criteria to eliminate double taxation; this power means that a Member State cannot be required to consider when applying its tax law, any unfavorable outcomes resulting from a particular regulations of another Member State, applicable to a permanent establishment situated in its territory and belonging to a company whose headquarters are located in the first State;

- *the elimination of some discriminatory situations and restrictions for companies.*

² Hellerstein, W., *The Case for Formulary Apportionment*, International Transfer Pricing Journal, 2005, Vol. 3, p. 103-111

³ Agúndez-García, A., *The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a review of issues and options*, Taxation Papers, 2006, p. 7

3. General principles of the "Common Consolidated Tax Base" system

The fundamental aim of the corporate tax base is to provide a measure of the profit that can be subjected to a tax rate determined by national states in order to mobilize some public revenues. For the achieve of objectives set by the European Commission when she brought the proposal for the a common consolidated tax base introduction in the European Union, the working group set the general principles of "common consolidated tax base", in 2004, as follows⁴:

1. *The principle of vertical equity*

Under this principle, the tax burden should be shared according to the pay capacity of each taxpayer. This does not mean that higher profits would be taxed at higher rates, because such a practice is not common in Member States (except fixed rates set according to the size of turnover).

2. *The principle of horizontal equity*

Under this principle, taxpayers have the same economic circumstances should receive the equivalent tax treatment. In the particularly situation of transnational economic activity taxation, this principle refers to the proper allocation of the tax base between the States on whose territory corporations operate. Traditionally this principle is satisfied if: (1) state in which corporations were obtained income is entitled to tax benefits obtained under its jurisdiction and (2) a government of a state shall not discriminate in terms of tax a foreign company operating on whose territory.

3. *The principle of efficiency*

Generally, taxes should be neutral for the ensuring of investment decisions based on the best "economic locations". So, it is avoided the situations in where investments are not placed in areas with

the highest capital productivity. To correct "market failures", tax policy frequently enter distortion by the use of tax incentives. In these circumstances it is very difficult to determine whether a fiscal policy is effective or ineffective.

Common consolidated tax base will ensure the compliance of efficiency principle in the European Union economy, since all investors will be able easily to determine the tax burden they will bear (opting for the "common consolidated tax base") and will compare the level of effective taxation of States to which they want to orient your capital.

4. *The principle of effectiveness*

Essentially, the effectiveness is the ability of the tax base to achieve its main objectives (to generate public revenue and economic incentives for investors). Depending on the current characteristics of national tax systems of member countries, the introduction of the common consolidated tax base will generate losses of incentives for some states and gains of incentives for other states, on short-term. The "Common Consolidated Tax Base" system will limit distortions in the choosing of economic activities, caused by the existence of different rules for determining corporate income tax base, on long term. The implementation of the common consolidated tax base will, also, discourage the using of transfer pricing mechanism for intra-group transactions in order to avoid the taxation in countries with a high corporate tax rate. It will create the premises for collection to the public budgets of all income tax revenues due to these states.

5. *The principle of simplicity, transparency and certainty*

A simpler tax base involves smaller administrative and compliance costs for both companies and tax administrations. These costs are difficult to quantify, so that international comparisons on measurement of the incentive generated by a simpler tax base is not easy. Rules for determining the tax base should be clear for the

⁴ Common consolidated corporate tax base working group (CCCTB WG), General Tax Principles, Brussels, 10 December 2004.

satisfaction of the transparency requirement. The context of certainty created by the common consolidated tax base facilitates the planning process both at companies and the government.

6. *The principle of flexibility*

The economic context in which companies operate changes over time so that the tax base should be able to adapt to these changes. The common consolidated tax base could be less capable of rapid change, but in terms of business a great flexibility can damage certainty.

4. Rules for defining of the common tax base

The common tax base involves the use of unique rules for the calculation of the consolidated base for taxation of profits made by companies with cross-border activity. For example, the treatment of tax losses will be the same in all Member States if the company has opted for the "Common Consolidated Tax Base" system. A specific element of the system is the fact that tax losses can be carried forward for an indefinite period, respectively they cannot be compensated with profits made in the past.

The problem for which in the present has not found a convenient solution refers to the accounting rules that should be used to define the common base. In discussions at the level of the working group, frequently circulated the idea of using International Financial Reporting Standards (IFRS). They have the advantage, in addition to their wide international recognition, of the light adaptation of taxpayers, because - with effect from January 1, 2005 - at Community level is applied a Regulation requiring listed companies on regulated capital markets to prepare their consolidated balance sheets under International Financial Reporting

Standards requirements⁵. Comparing tax and accounting rules in EU Member States on international financial reporting standards, a number of scholars⁶ have shown that such standards could provide the basics for creating a common tax base in EU. Thus, areas such as the recognition of assets and liabilities, determining the amount of costs, amortization, depreciation and treatment of onerous contracts are now governed by the International Financial Reporting Standards in all countries. Results of a study by Oestreicher A. and Spengel C. shows that a common tax base in the European Union would require common standards for the compensation of losses and profits, and the elimination of tax incentives in the tax base (particularly in depreciation). Incentives in the tax base could be replaced by tax credits or subsidies. The adapting of the tax-accounting rules applied in different countries to the provisions of International Financial Reporting Standards would not generate major effects on the fiscal burden that taxpayers currently bear.

According to the opinion of Brussels officials, the use of these standards is not very easy because in many countries the local firms cannot use these standards and not all standards are compatible with tax requirements. For this reason, it was established that will start from the generally accepted accounting regulations in all countries that will suffer some changes to meet rules set for the operation of "Common Consolidated Tax Base" system.

This approach is shared by a number of other specialists⁷ who opines

⁵ The European Parliament and Council Regulation no. 1606/2002 for the application of International Accounting Standards

⁶ Oestreicher, A., Spengel, C., *Tax Harmonisation in Europe. The Determination of Corporate Taxable Income in the EU Member States*, ZEW Discussion Paper No.07-035, June 2007, p.34

⁷ Freedman, J., Macdonald, G., *The tax base for CCCTB: the role of principles*, Oxford University Centre for Business Taxation, w.p. no. 7, 2008, p. 5

that the use of International Financial Reporting Standards, without the adjustment of them, would generate a number of legitimacy issues for the operation of "Common Consolidated Tax Base" system, if these standards are not promulgated by public authorities in Member States.

The following examples illustrate possible scenarios for strengthening of the corporate income tax base.

Example 1: Sale of goods without stocks

Company A and company B belong to the same CCCTB group. Company A produces intermediate products that are sold to B for 4000. To produce these goods A needs third party inputs as electricity (60), raw materials (1000) and wages (2000). Company B purchases intermediate products from A (4000) and from third parties (500). In addition, B uses third party electricity (30) and wages (1000) to produce goods that are sold to third parties for 6000.

Company A		Company B	
Cost of electricity	-60 m.u.	Cost of electricity	-30 m.u.
Cost of raw materials	-1000 m.u.	Cost of purchase	-(4000 + 500) m.u.
Cost of wages	-2000 m.u.	Cost of wages	-1000 m.u.
Sales to B	+4000 m.u.	Sales to third	+6000 m.u.

- Option (i): the determination of the consolidated tax base by subtracting total expenses from total revenues of its group

Company A		Company B	
Cost of electricity	-60 m.u.	Cost of electricity	-30 m.u.
Cost of raw materials	-1000 m.u.	Cost of purchase	-(4000 +500) m.u.
Cost of wages	-2000 m.u.	Cost of wages	-1000 m.u.
Sales to B	+4000 m.u.	Sales to third	+6000 m.u.

For determining the consolidated tax base, representing 1410 um, total cost of group subtracted from sales of B (i.e. 6000-60-30-1000-500-2000-1000). The value of the tax base remains unchanged regardless of the price at which the company A sells intermediate products of company B. Thus, transfer pricing influence is eliminated, company A has the potential to sell at a price equal to costs incurred (um 3060).

- Option (ii): the determination of the consolidated tax base by adding individual tax base of companies

Company A		Company B	
Cost of electricity	-60 m.u.	Cost of electricity	-60 m.u.
Cost of raw materials	-1000 m.u.	Cost of raw materials	-1000 m.u.
Cost of wages	-2000 m.u.	Cost of wages	-2000 m.u.
Sales to B	+4000 m.u.	Sales to B	+4000 m.u.
Tax base	940 m.u.	Tax base	470 m.u.

Summing values of the two tax bases get the same amount of consolidate tax base: 1410 um, but the transfer pricing problem will not be eliminated. So, if in the country where the company A operate the corporate tax rate is higher than in the country where the company B operate, the use of some lower transfer prices will generate a lower tax base in the country with a high level of the profit rate and a higher tax base in the country with a low level of the profit rate.

Example 1: Sale of goods with stocks

For the same data as in example 1, is considered the existence of stocks at company B.

Company A		Company B	
Cost of electricity	-60 m.u.	Cost of electricity	-30 m.u.
Cost of raw materials	-1000 m.u.	Cost of raw materials	-(4000 + 500) m.u.
Cost of wages	-2000 m.u.	Cost of wages	-1000 m.u.
Valuation of stocks	0	Valuation of stocks	+5300 m.u.
Sales to B	+4000 m.u.	Sales to third	0

- **Option (i): the determination of the consolidated tax base by subtracting total expenses from total revenues of its group**

Stocks are valued at the group level, representing: 60+30+1000+500+2000+1000 = 4590 m.u. If the company B did not sell finished products (they are stored), consolidated tax base is 0.

Company A		Company B	
Cost of electricity	-60 m.u.	Cost of electricity	-30 m.u.
Cost of raw materials	-1000 m.u.	Cost of raw materials	-(4000 + 500) m.u.
Cost of wages	-2000 m.u.	Cost of wages	-1000 m.u.
Valuation of stocks	0	Valuation of stocks	+4590 m.u.
Sales to B	+4000 m.u.	Sales to third	0

If the intra-group transaction is done at the amount of costs, the consolidated tax base will be all 0.

Company A		Company B	
Cost of electricity	-60 m.u.	Cost of electricity	-30 m.u.
Cost of raw materials	-1000 m.u.	Cost of raw materials	-(3060 + 500) m.u.
Cost of wages	-2000 m.u.	Cost of wages	-1000 m.u.
Valuation of stocks	0	Valuation of stocks	+4590 m.u.
Sales to B	+3060 m.u.	Sales to third	0

- **Option (ii): the determination of the consolidated tax base by adding individual tax base of companies**

Company A		Company B	
Cost of electricity	-60 m.u.	Cost of electricity	-30 m.u.
Cost of raw materials	-1000 m.u.	Cost of raw materials	-(4000 + 500) m.u.
Cost of wages	-2000 m.u.	Cost of wages	-1000 m.u.
Valuation of stocks	0	Valuation of stocks	+5300 m.u.
Sales to B	+4000 m.u.	Sales to B	0
Tax base	+940 m.u.	Tax base	0

In this situation, the consolidated tax base will have a value of 940 m.u. If the intra-group transaction is made at the amount of costs we have:

Company A		Company B	
Cost of electricity	-60 m.u.	Cost of electricity	-30 m.u.
Cost of raw materials	-1000 m.u.	Cost of raw materials	-(3060 + 500) m.u.
Cost of wages	-2000 m.u.	Cost of wages	-1000 m.u.
Valuation of stocks	0	Valuation of stocks	+4590 m.u.
Sales to B	+3060 m.u.	Sales to B	0
Tax base	0	Tax base	0

This time the consolidated tax base will be 0, and companies will be interested to made intra-group transactions at prices equal to costs, in order of to reducing income tax costs.

Considering implications on income of VAT, so far the European Commission did not express a favorable position for one of two options for determining the consolidated tax base.

5. Conclusions

A tax mechanism that fully comply the principles of efficiency and equity is difficult to achieve, especially for companies with business-border taxation, because in many cases the national interest proves more important for politicians than the interest for the growth of business efficiency. This is the reason for there are many conflicting discussions on the effects of this system on the Member States economies, despite the undeniable benefits that the "Common Consolidated Tax Base" system would bring of the EU economy.

The possible options of consolidation of the corporate income tax base that we have illustrated above shows that the "Common Consolidated Tax Base" system will be able to eliminate the intra-group transfer pricing problem, helping to reduce the erosion of the national tax bases phenomenon. This

phenomenon is generated by the corporate tax optimization strategies. Prices within the group are used frequently as a means of money funds moving in the groups of companies in order to reduce the overall corporate tax burden. Transfer pricing refers to those transactions between companies of same group, where prices of sold goods or services do not accurately reflect their value. The increase or the decrease artificially the price paid has the effect of reducing or increasing reported profits in a given tax jurisdiction. If the differences between the tax rates are higher, saving of groups of companies are larger. It is clear that the manipulation of corporate income tax systems through mechanisms such as that described above creates inequity between the states participating in cross-border corporate transactions thanks losses of revenues for countries engaged in high rates of profit tax.

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