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FORMULA APPORTIONMENT IN THE EU: A DREAM COME TRUE OR THE EU'S WORST NIGHTMARE?

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Abstract

The European Commission recently endorsed a future company tax policy that would allow companies to consolidate their tax bases and apportion the income across the EU using an allocation mechanism. This policy would replace the separate accounting method with formula apportionment of EU group profits as the main method of taxing multinational companies in the European Union. However, many details of the approaches remain to be presented, and these details may turn what appears to be a simple solution into an extremely complex one. This paper explores some technical details that arise in adopting formula apportionment in the European Union.

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INTRODUCTION

On October 23, 2001, the European Commission set forth a broad strategy for future company tax policy in the European Union.[1] As foreshadowed in its May Communication, the Commission's company tax study endorses a fundamental long-term reform of EU company tax policy. The Commission study states that in the future companies should be able to achieve a consolidated corporate tax base with cross border loss relief under a single set of tax rules for their EU activities. This consolidated tax base would be distributed across EU member states using a commonly agreed allocation mechanism. Thus, the possibility that the European Union might move to formula apportionment is no longer an abstract, academic idea.

The Study notes that these comprehensive approaches would solve a majority of the tax obstacles facing EU businesses in a "single stroke." However, many details of the approaches remain to be presented, and these details may turn what appears to be a simple solution into an extremely complex one. Thus, while in theory, formula apportionment in the EU may be a dream come true, in practice, formula apportionment may be the EU's worst nightmare.[2] This paper will explore some of these details to help evaluate whether formula apportionment in the EU would be a taxpayer's dream come true of the EU's worst nightmare.

FORMULA APPORTIONMENT IN THE EUROPEAN UNION…

… AN EU TAXPAYER'S DREAM COME TRUE …

In recent years, some EU businesses have highlighted several tax obstacles in the EU that prevent them from operating on a basis consistent with the Single Market. UNICE, for example, has argued that "the continued existence of major tax obstacles to cross-border economic activity is incompatible with the notion of a single market.[3]" Unless these tax obstacles are eliminated, UNICE notes, EU businesses may not organize their operations on the most efficient basis, to the detriment of growth and employment in the EU. The advent of EMU and the pursuit of the four fundamental freedoms of the EU treaty makes it urgent that the taxation of EU companies be consistent with the Single Market.

UNICE has listed a number of key tax obstacles they face when doing business in more than one EU Member State. These obstacles are encapsulated by the existence of 15 different company tax systems and the 15 different sets of rules, regulations, and legislation in the European Union. Other obstacles include the requirement to find transfer prices for complex internal cross-border transactions; the failure to provide

[1] See Commission of the European Communities "Towards and Internal Market without tax obstacles" COM(2001) 582 final and "Company Taxation in the Internal Market" SEC(2001) 1681, 23 October 2001. For a summary and analysis of these documents, see Weiner (2001b). For an evaluation of a broad range of issues that would be involved in adopting formula apportionment at the international perspective, see the conference paper by Weiner (1999). For a report on the U.S. Treasury Department conference on formula apportionment, see *Tax Notes Int'l*, 23 December 1996.
[2] The author addressed many of these issues in Weiner (2001a). See also McLure and Weiner (2000). This article will focus in greater detail a few issues to highlight the complex issues involved.
[3] Union of Industrial and Employers' Confederations of Europe, "Memorandum on cross-border company taxation obstacles in the single market," 3 April 2000.

for cross-border loss offset in the EU; and the tax costs that arise when businesses restructure across borders. UNICE noted that the "essential component" of an optional European system of company taxation would be an EU-wide taxable base.

By providing for a single --- optional --- consolidated income tax base for EU-wide activities, a comprehensive solution to the EU tax problem would solve many of these problems.[4] Transfer pricing and cost allocation within a group would no longer be necessary. The distinction between branches and subsidiaries would no longer be relevant for tax purposes. Cross-border mergers could be made without incurring any tax consequences. Most importantly, cross-border loss offset would automatically occur.[5] Thus, the system may be an EU multinational taxpayer's dream come true, as it *appears* to solve all of these issues at once.

… OR THE EU'S WORST NIGHTMARE?

The devil may be in the details that remain to be defined. The Commission presented four comprehensive methods for the long-term future EU company tax policy, all of which would use formula apportionment instead of the arm's length/separate accounting method now employed in all of the Member States.[6] However, none of those proposals was described fully, leaving many key elements to be defined later. This paper addresses some of these deferred issues by focussing on a few specific issues: distortions that arise when using formula apportionment and consolidated (or unitary) taxation, the definition of the consolidated group, and the treatment of income and operations located outside the European Union.

Distortions caused by using a formula apportionment system

At the outset, it should be recognized that formula apportionment only provides an estimate of the geographic source of income. As has long been recognized in the U.S. states, formula apportionment does not attempt to identify the precise geographic source of a company's profits, but only to provide "a rough approximation of a corporation's income that is reasonably related to the actual profits earned within a State." Multistate companies accept these rough approximates within the U.S. states, where corporate tax rates are relatively low and exhibit relatively little cross-state variation. However, these rough approximations might not be acceptable within the EU, where company tax rates are relatively high and exhibit relatively wide cross-country variation.

One key distortion arises through the interaction of the formula with the statutory tax rate and the firm's factor choices. McLure (1980) was one of the first to take a close look at how the system of apportionment used in the states affects business decisions.

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[4] UNICE notes that the system should be optional because not all companies are so integrated that they need a European system. Once a company chose the EU system, that choice would be irreversible.

[5] The Commission's Study presents an example provided by UNICE where one of its companies would have saved 320 m. ECU over a 3-year-period if it had been able to use its losses of 880 m. ECU in some member states to offset profits of 870 m. ECU in other member states (p. 253).

[6] There is a wide body of literature analyzing the strengths and benefits of both the arm's length approach and formula apportionment. See McDaniel (1994, 2000), Musgrave (2000), and McLure/Weiner (2000), among others. Ten years ago, the author presented a paper suggesting formula apportionment for the European Community; see Weiner (1991). See Amerkhail (2000) for an interesting proposal to combine the best of both systems.

His pioneering work showed that by using a formula to determine state income, the states effectively transformed the formula into a direct tax on whatever factors are included in the formula.

If profits are apportioned to locations according to firm-specific factors, rather than according to factors that are exogenous to the firm's choices, then formula apportionment introduces an additional distortion to the investment decision. This distortion arises because the effective tax rate under apportionment equals not only the direct effect caused by the taxation of capital but also the indirect effect caused by the use of an endogenous factor to allocate profits. This indirect effect can be positive or negative, depending on the relationship between the tax rate in any particular location and the weighted average tax rate over all locations.[7] Thus, apportionment can create an additional 'tax' or a 'subsidy' to new investment, with that tax distortion depending, in part, on the distribution of the factors across locations.

For example, with a formula that apportions income according to the location of capital, the marginal effective tax rate (METR) on capital equals the difference between the state's apportionment-weighted statutory tax rate and the apportionment-weighted average tax rate over all other states. Weiner (1994) calculated these apportionment-adjusted state tax rates and found that the cross-state variation in ETRs (taking into account the formula, federal deductibility, and various other state specific parameters) was not large enough to have a measurable impact on cross-state industrial structure.

With relatively low maximum statutory tax rates and a floor of no taxation, the range of variation in state METRs is limited to a few percentage points and may not have much influence on investment and employment. However, in the EU, where the variation in statutory tax rates ranges from 10 percent to over 40 percent, the range of variation in EU METRs under apportionment could reach double digits. Thus, the formula might have a more noticeable impact on business investment decisions in the European Union than has been the case in the U.S. states.

The traditional formula that includes property and payroll creates another distortion separate from the impact on investment and employment. In this case, because the tax rate is endogenous to the firm's factor choices, the formula will be unstable as states have an incentive to manipulate the formula to stimulate additional investment or employment. For example, a state can reduce the weight on property (capital) and payroll (labor) and increase the weight on sales to encourage inward investment and employment. Experience in the U.S. states shows that many states are pursuing this policy, with nearly half of the states now using a double-weighted sales factor formula (instead of the equally-weighted three factor formula), up from just a handful of states two decades earlier. Empirical evidence suggests that these policies are successful in stimulating new investment, at least until other states adopt the same formula (see Gupta and Hoffman, 2000).

Cross-border loss compensation and consolidation

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[7] For an example that addresses two ideas in the Commission's study, see Mintz and Weiner (2001).

A key objective of EU businesses is obtaining cross-border loss offsetting. The Commission welcomed the Ruding Committee's recommendation that Member States adopt the draft directive dealing with losses of permanent establishments and subsidiaries in another Member State.[8] However, the work has not progressed because a "vast majority" of Member States would like to limit the scope of the directive to losses of permanent establishments. There was no follow-up to the Ruding Committee's recommendation that Member States allow full vertical and horizontal loss offset domestically to be followed by full Community-wide loss offsetting within groups of enterprises.

As Denmark is one of the two Member States allowing foreign subsidiaries to be included in the corporate group, the Commission highlights the Danish "joint taxation" system as providing a "promising way forward" in terms of defining an EU loss offset scheme.[9] Even this scheme, however, imposes several restrictions and would not necessarily provide the loss offset that EU companies desire. For example, the Danish system applies only to wholly-owned subsidiaries, all companies included in the group must have the same taxable year, shares in the subsidiaries must have been owned for the entire year, and foreign subsidiaries will not be allowed to be included in the group if more than half of their share capital has been acquired from related companies.

The Study acknowledges the difficulties in defining a consolidated group across the EU. The internal legislation of Member States varies widely concerning the ownership requirements necessary to obtain domestic loss compensation. These thresholds range from 51 percent in Germany, 75 percent in Austria, Ireland, and the UK, 90 percent in Sweden, Finland, Portugal and Spain, 95 percent in France, 99 percent in Luxembourg and the Netherlands, to 100 percent ownership in Denmark. Three members do not allow group consolidation under domestic law and only two member extend cross-border consolidation to foreign subsidiaries.

One EU Member State has experience with the complications that may arise when considering how to determine the group. Germany allows consolidation for corporate income tax purposes and for trade tax purposes. However, the Tax Reduction Act of 2000 created a situation where the consolidation rules for the corporate income tax differed from those for the trade tax. Evan after a correction that was to occur in the Business Taxation Amendment Act, it may still be possible to employ certain techniques to achieve consolidation for purposes of one tax and not the other.[10] This example points to a difficulty in defining the consolidated group.

Tax planning under consolidated base taxation with formula apportionment

Although it is often stated that tax planning will no longer be possible with consolidated base taxation and formula apportionment, the experience in the U.S.

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[8] See "Proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States (COM (90) 595), see O.J. C 53, 28 February 1991, p. 30.
[9] Commission Study (2001), p. 342.
[10] For details, see Ehlermann and Kowallik (2001).

states shows that tax planning still occurs. Companies doing business in several U.S. states can employ a variety of techniques to minimize their tax liabilities.[11]

All else equal, consolidation is beneficial in cases where it would allow losses in one operation to be offset against profits in another operation so as to reduce the entity's total tax liability. This is the basic benefit that EU businesses argue should be available in the Internal Market. However, consolidation with formula apportionment would also allow companies to shift income from high tax locations to low tax locations if apportionment results in a greater share of the entities' total income being assigned to the low tax state as a result of consolidation than under the separate approach.

This impact of consolidated base taxation with formula apportionment is often not appreciated. This outcome occurs because under apportionment, not only is the income combined within the group but also the elements making up the apportionment factors. Thus, even if the tax base is smaller due to loss offsetting, the share of income apportioned might rise, depending on the distribution of the apportionment factors among the relevant locations, making the overall impact ambiguous.

Should a taxpayer wish to avoid any resulting increase in tax burden that might result from consolidating these operations, the taxpayer could take a subsidiary out of the consolidated group. Suppose, for example, the EU adopts the Danish definition of a corporate group under which only wholly owned subsidiaries are included in the group. If the parent company wished to remove an entity from the group, it would merely need to reduce its ownership share by a small percentage.

Likewise, the parent company could bring an entity into the group by increasing its ownership percentage up to the threshold required for consolidation. A taxpayer may consider employing this strategy during a period in which one of its entities was incurring losses due to the expenses associated with its start up. It could then dilute its ownership share at a point when the tax costs made it worthwhile to do so. Thus, this situation might lead companies to "fracture their identities in a corporate shell game" to avoid taxation.[12]

Furthermore, if these entities were still related to the parent, even though they were not technically considered part of the consolidated group, the parent company could employ transfer pricing techniques to shift income out of the group. Thus, transfer pricing remains an issue even under consolidated base taxation. The upshot of these arguments is that a system of consolidation with apportionment can lead to a situation where companies selectively alter their corporate structure for tax purposes.

Reducing these tax planning opportunities is one reason that many states have turned to the unitary tax method. Under the unitary tax, the economically integrated operations of a business are combined, regardless of the legal ownership. Imposing

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[11] For a general discussion of these opportunities, see Healy (2001).

[12] The U.S. Supreme Court made this argument when it rejected the bright-line unitary test in *Allied-Signal* (1992). *Allied-Signal Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992) and *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980). Of course, U.S. constitutional issues have no legal force in EU law; however, the line of reasoning can help establish the contours of an EU apportionment system.

this restriction curbs the ability of taxpayers to engage in the tax planning strategies described above, but still does not eliminate them. Moreover, there is no simple way to define a unitary business, and the U.S. states, more than half of which have adopted the unitary approach, use a range of different definitions.

As the European Commission has now endorsed the idea of formula apportionment in the European Union, it is appropriate to examine some key technical issues that should be resolved when designing an apportionment system. This analysis will focus on how to define the consolidated, or unitary, group and how to treat non-EU income.

Unitary taxation

Determining the contours of the group to be combined is a central issue in adopting any form of group taxation within the EU.[13] There are many ways to define this group, ranging from a test based solely on ownership to tests that look at the connection of the operation to the parent company. It has been difficult to reach a common definition in the states since there many ways to define a consolidated business. Accurately defining the composition of the group is especially crucial to minimize tax planning opportunities.[14]

The "unitary tax" describes the broad notion of the taxable group under consideration in the Commission study. Under unitary taxation, or unitary combination as it is also known, members of an affiliated group of companies that are part of an economically integrated group are combined and treated as a single entity for tax purposes. Thus, the unitary tax recognizes that it is logical to treat a highly-integrated company as a single operation even though that group may be composed of legally separate entities.

A simple way to define a consolidated business would be to combine all affiliates that exceed a certain ownership threshold. Corrigan (1980) proposed that that any business that was more than 50 percent owned by another, i.e., it was controlled by the other company, would be considered part of the consolidated business. This idea is appealing primarily for its administrative simplicity. However, such a bright line test might be easily circumvented, as a company could reduce its legal ownership below 50 percent but still retain effective control of the entity. Companies might, thus, arrange their corporate structure for tax, rather than business, purposes. A test based on ownership could also lead to different lines of business being combined and apportioned using one formula, even if it might be more appropriate for the different lines of business to use different formulas.

A test based on control would be broader than the ownership ship as it would look not only to whether the parent company had legal control through ownership of a majority of voting rights, but also to whether it had effective control through ownership of a large minority interest. In general, control may exist if the parent entity has the ability

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[13] All of the proposals allow for consolidation, although not unitary taxation. Nevertheless, many of the arguments that apply in determining the unitary group also apply in determining which entities to consolidate in the common group.

[14] See Mintz and Smart (2001) for evidence that Canadian companies that operate as related companies in several jurisdictions but do not allocate income using formula apportionment have a much higher elasticity of the corporate income tax base with respect to changes in corporate income tax rates compared to companies that must allocate income across provincial jurisdictions..

to influence its affiliates to reach its own objectives even if the parent entity does not own a majority of the voting rights.

Another definition looks at several facts. An early definitions of a unitary business arose in California with the "three unities" test. Under this test, a business is unitary if there is (1) unity of ownership; (2) unity of operations as evidenced by central purchasing, advertising, accounting and management divisions, and (3) unity of use in its centralized executive force and general system of operation.

A related notion of unitary is the "dependency or contribution" test, which was developed by Altman and Keesling (1946). Under this test, a business will be unitary if the operation of the business within the state depends on or contributes to the operation of a business outside of the state."

Apart from a test based solely on ownership, all definitions of a unitary group require some sort of evaluation of the relationship between the parent company and its affiliates. If there is an "exchange of value" as shown by functional integration, centralization of management, and economies of scale, for example, then it is likely that the business is unitary and can be consolidated. However, each of these factors requires making a judgment.

Many other definitions of a unitary business are possible, and the U.S. states are far from uniform in how they define a unitary business. As the U.S. Supreme Court has noted: "A final point that needs to be made about the unitary business concept is that it is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach.[15]"

The EU Study does not explicitly evaluate the unitary method. However, the Study does find that "it would seem that for the EU to adopt formula apportionment and/or unitary combination it would require a substantial conformity of definitions of tax bases, apportionment formulae, measures of apportionment factors, and unitary businesses."

Issues concerning operations outside of the European Union

The treatment of income and operations outside of the European Union should also be addressed. At present, the comprehensive solutions appear to be limited to the European Union Water's Edge (EUWE). However, imposing an EUWE limitation effectively means that two systems will need to be maintained: apportionment for internal EU income and operations and separate accounting for income and operations outside of the European Union.

This issue is not trivial, as a significant number of transactions among multinationals in Europe occur with non-EU parent companies or subsidiaries. For example, the fastest growth in mergers and acquisition activity in the EU is occurring between EU and non-EU companies. Much of this activity is occurring with US companies,

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[15] *Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983).*

acquisitions of which accounted for more than 40 percent of total outward direct investment from the EU in 1998. Thus, regardless of any desire to restrict the system to the EU, any comprehensive solution must find a way to deal with these non-EU matters. As presently discussed, the consolidated tax base will be defined as "EU income" making it necessary to find ways to protect that tax base from being shifted outside of the European Union.

To identify some of the problems that might arise, this section discusses the treatment of foreign-source dividends. Dividends received from outside the EU water's edge group could be treated as taxable income (under worldwide combined reporting, similar to consolidation, such dividends would be netted out as intercompany payments). This practice would mean that the dividend income would be treated as taxable income, but the factors that generated that income would not be reflected in the apportionment factors (since the entity was not part of the water'' edge group). This issue has been extremely controversial in the states and has led to many alternative means for providing for "factor representation" of such payments.

In the states, these arguments have centered on whether the dividends should be considered as "foreign source" and thus excluded from the water's edge report or whether they were part of consolidated business income and thus included in the water's edge group. This issue was debated at length by the Treasury Department's Worldwide Unitary Tax Working Group where the views were represented by three groups: purely domestic, U.S.-based multinationals, and foreign-based multinationals.[16] At that time, U.S.-based multinationals argued that if they pay tax on these dividends, while foreign-based companies are exempt, they will be at a competitive disadvantage with their multinational competitors. By contrast, purely domestic companies countered that exempting all foreign-source dividends would put them at a competitive disadvantage relative to multinational companies. In the end, the Working Group was not able to resolve this issue.

This issue continues to remain an unsettled aspect of state practice. States could exempt foreign-source dividends, which would essentially be taxing on a territorial basis.[17] If the company financed its foreign operations with debt, however, additional rules would be necessary to prevent companies from allocating expenses to foreign-source income without providing for a matching taxation of that income when it was received. Most international tax laws disallow deductions for expenses incurred to earn tax exempt income.

States could also treat foreign-source and domestic-source dividends identically, either by exempting both (or giving the same deduction) or by denying the dividends-received deduction for all dividends. Worldwide combined reporting, which eliminates intercompany dividend payments from the combined report is another method that treats foreign- and domestic-source dividends identically.

It is also possible to match the dividend payments with the factors, as occurs under the "Detroit" method of factor representation. This method includes the dividends in the

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[16] See *Final Report of the Worldwide Unitary Taxation Working Group,* US Treasury (1984).
[17] For a detailed analysis of this issue, see McLure (1986).

tax base and adjusting the denominators of the parent company's factors by the ratio of net dividends received to the dividend-paying subsidiaries' net profits.

Worldwide unitary taxation?

Some have noted that the only solution to this problem is to adopt worldwide unitary combination. In this manner, all of the unitary operations of the EU business would be combined into a single tax base and the need to draw an artificial line between EU and non-EU income would be eliminated.

The EU could adopt this method with respect to EU-based parent companies. Given the sustained controversy over the this method when applied to foreign-based parent companies in the U.S. states, however, it is not likely that the EU would propose such a move in the near future. In its consideration of the constitutionality of applying the worldwide unitary tax on a foreign-based parent, for example, the U.S Supreme Court noted in *Barclay's Bank v. California* that a "battalion of foreign governments" had "marched to Barclays" aid, deploring worldwide combined reporting in diplomatic notes, amicus brief, and even retaliatory legislation.[18]" Nearly two dozen major countries filed briefs in support of Barclays and deploring the method of assessing the state worldwide unitary tax on foreign-based parent companies and all of their worldwide affiliates, among others, as being incompatible with accepted international principles of corporate taxation.

None of the above issues is insurmountable. However, these difficulties illustrate that the tax authorities will have to maintain their expertise in enforcing the arm's length system while also increasing their cooperative efforts with other tax authorities and implementing a series of anti-abuse measures under a system of consolidated base taxation.

CONCLUSION

The European Commission has taken a bold step toward fundamental company tax reform in the European Union. By setting forth a strategy providing for consolidated base taxation with formula apportionment within the European Union, the Commission has thrust a once taboo issue to the top of EU policy makers' agendas.

This proposal may fulfill many dreams of EU businesses. In general, allowing companies to consolidate their EU activities under a single corporate tax base means that EU companies will no longer have to establish transfer prices for internal transfers within the EU, losses incurred by an affiliate in one member state will automatically be offset against profits earned in another member state, the tax consequences of cross-border restructurings within the consolidated group will be simplified, and companies doing business in several EU member states will have to contend with just a single company tax system.

[18] The Court ruled in favor of California. See *Barclays Bank v. California Franchise Tax Board*, 114 U.S. 2268 (1994).

A decade ago, many might have feared that moving to formula apportionment in the European Union would be a nightmare. As shown by the experiences in several countries that use the method at the subnational level, formula apportionment creates significant distortions and has its own drawbacks. Should a group of countries decide to adopt formula apportionment, it must find a way to agree on the definition of the common tax base, the composition of the taxable corporate group, and on the formula used to apportion profits within the defined area. Member States must reconcile divergent tax claims that will arise from the interaction of the new system with the separate accounts method used in other countries. Moreover tax authorities will have to maintain expertise in both systems and companies will still have to use the current system for transactions outside the EU.

Given the incomplete economic integration in the European Union, the time may not yet be ripe for formula apportionment. As explained in his consideration of European company tax policy, Sijbren Cnossen (2001) concluded that, "At present, formula apportionment seems a bridge too far." Based on the state of current economic and political integration within the EU, that conclusion may currently hold. However, these issues, while difficult, can be overcome as there are several countries that have used formula apportionment for decades. The answer to whether formula apportionment in the EU is a "dream come true" or the "EU's worst nightmare" is likely to be --- it is both.

ANNEX

A THOUGHT FOR THE FUTURE

This section presents some thoughts for the future that might affect the development of company tax policy in the European Union. The first policy concerns a recurrent idea to treat the European Union (or Community) as a single country for US tax purposes, a notion first raised in the early 1960s following creation of the EEC. Were the US to adopt such a proposal, then the EU might find it easier to move to consolidated base taxation (and vice versa). The second policy concerns an idea presented by an American economist that reaches a compromise between the two approaches.

Treating the European Union as a Single Country

For several decades, U.S. multinationals with operations in Europe have argued that they should be able to treat the member states of the European Union, as it is now known, as a single country for tax purposes. The issue was first presented in the early 1960s when the Congress enacted the Subpart F rules. Under these rules, when a controlled foreign corporation (CFC) of a U.S. company sells goods to a related person located in a different country from the CFC's country of incorporation, that income may be subject to current taxation under the general Subpart F foreign base company sales income rules.[19]

While the general purpose of the Subpart F rules was to limit deferral of US taxes for certain types of income, the specific purpose of this portion of the rules was to restrict the ability of CFCs to reduce their overall tax liability by shifting income from high-tax to low-tax jurisdictions through related party sales. These rules were deemed necessary, in part, as a support for the arm's length transfer pricing system.[20] There was a concern about the potential abuse that could occur if CFCs were in a position to take advantage of the differences in foreign tax systems and artificially shift their income to related parties located in tax havens.

While the need to curb "tax haven abuse" was recognized, some believed that certain exceptions should be made to that rule. Thus, an amendment was introduced to the 1962 bill that would have effectively treated the European Economic Community as a single country for purposes of the foreign base company sales and services rules. Under this proposal, the controlled foreign corporation (CFC) of US companies selling products to related companies located in different member countries of the then six-member EEC would not be subject to the subpart F rules because their operations would be deemed to have occurred within the country where the CFC was

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[19] A controlled foreign corporation is generally any foreign corporation of which more than 50% of its stock by vote or value is owned, directly, indirectly, or constructively, by U.S. shareholders. Under Subpart F, 10 percent or more U.S. shareholders must include currently in their gross income items of the CFC's income that are defined as Subpart F income. Certain exceptions apply to these rules, such as if the income is subject to a high foreign tax rate or if the income qualifies for the manufacturing exception. Subpart F is contained in Sections 951- 964 of the Internal Revenue Code. This discussion of subpart F is necessarily brief and incomplete. For details, see US Treasury, *The deferral of income through U.S. Controlled Foreign Corporations, A Policy Study*, December 2000.

[20] These rules, which encompass the arm's length standard, are contained in Section 482 of the Internal Revenue Code.

incorporated. The reason for this exception was to allow US businesses doing business in the EEC to compete on a favorable footing with EEC companies, who could operate their businesses on a European-wide basis.

The amendment was rejected for several reasons. First, the members of the EEC could not be considered as a single economy as several economic barriers existed among the members. Second each member state continued to operate its own company tax regime with corporate tax rates varying substantially within the EEC. With this cross-border tax rate variations, CFCs would be able to engage in tax-avoidance strategies by shifting income to low-tax member states.[21] Therefore, the Congress concluded that the EEC should not be considered as a single country for purposes of gaining an exemption to the subpart F regime.

As these exceptions were not granted and since the income of the foreign subsidiaries of many US companies doing business in the EU continued to be subject to subpart F, US businesses restructured their EU operations so as to avoid the subpart F rules. However, even though US businesses are able to set up a tax optimal structure, they argue that such a situation does not represent an efficient business structure since the sole reason for this structure is to avoid imposition of the subpart F rules. Moreover, US businesses continue, as the EU is now operating as a Single Market, the subpart F rules for related party sales should no longer apply and their EU operations should qualify for the single country exception to subpart F.[22]

Despite these arguments, the U.S. Treasury has regularly objected to the proposal since the EU (or EEC) could not yet be considered to operate as a single market. Treasury argued that the member states of the EU were no more integrated than any other group of countries; thus, there was no reason to grant an exception to the subpart F rules for US companies doing business in the EU.[23]

It has been noted, however, that if the EU were to operate as a single country, then the US might be more likely to consider treating the EU as a single country for purposes of subpart F. With the Commission considering changes to EU company tax systems that would allow EU businesses to consolidate their tax bases for their EU-wide activities, EU businesses might be able to garner the support of US businesses in achieving this goal.

[21] See US Treasury Policy Study, pp. 114-15.

[22] See Section 206 of S. 2086.

[23] Given failure to enact any of these bills, the most recent incarnation of the idea to treat the EU as a Single Country took a different approach in 1999. At that time, the U.S. Congress considered a bill (the Financial Freedom Act of 1999) that would require the U.S. Treasury Department to study the feasibility of treating all EU member states as a single country for purposes of the same country exception to the Subpart F rules. This bill was not enacted.

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