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COMMON CONSOLIDATED TAX BASE SYSTEM: DIFFICULTIES IN DETERMINING A DISTRIBUTION FORMULA FOR THE COMMON CONSOLIDATED TAX BASE

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ABSTRACT: *Recent trends towards a common European tax policy for the general corporate taxation aim at preventing the negative effects of tax competition, especially those of the national tax base "migration", by moving corporate main offices in countries with more advantageous systems of taxation. The idea of harmonising corporate taxation constitutes one of the most important debate topics on the agenda of the European Commission for the moment, and also within specialists' theoretical approaches. The vast range of such approaches is particularly relevant for the complexity of the problems that hindering the formula, even if it is only at a theoretical level separated from the policy feasibility issues, and from widely shared solutions.*

KEY WORDS: *tax harmonization, consolidated tax base, distribution formula*

1. FOREWORD

Common Consolidated Tax Base (CCBT) is a system based on which multinational companies would determine their consolidated volume of taxable incomes. The actual actions dedicated to building such a system started on the occasion of the ECOFIN Council in September 2004, when the vast majority of the Member States accepted the utility of such progress au towards creating a common taxation base and decided to establish a working group made of experts representing the Member States and presided by the European Commission, in order to examine in detail the possible solutions[1]. According to the objectives proposed in 2004, the activity of this group (the Common Consolidated Corporate Tax Base Working Group

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[1] The information concerning the work of the group is available on http://europa.eu.int/comm/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm

- CCCTB WG) had to be substantiated into a law proposal at the end of 2008; however, this objective has not yet been achieved.

The regulation concerning the common consolidated corporate tax base will be applied to companies that pay corporate income taxes in the European Union Member States (that will be specified in an annex to the regulation that will be annually modified) organised into groups, but that carry out their business according to a sole group strategy. The details related to the definition of the group are not yet finalized due to the fact that the group is facing difficulties in establishing a shareholding threshold meant to prove (by ownership relations) the connections between the companies that are part of the group [7].

However, the existence of complex ownership relations between resident companies of the European Union and companies outside the Union requires that the status of the respective groups be clarified. There are a few more sensitive combinations, the treatment of which should be differentiated [4]:

- *several companies controlled by an entity outside the Community*. In this case it would be desirable that the system be applied to them because otherwise, the application of the CCCTB could be avoided by the companies in the EU by the mere transfer of the entity that controls them outside the Community;
- *a parent company residing in the Community and having a subsidiary in a third country that controls, in its turn, a company residing in the Community*. In this case, the entities having their residence in the Community should be subjected to the CCCTB if the shareholding thresholds sufficiently large as to be defined as legal property, but the consolidation of the tax base with the exclusion of the intermediary entity might create technical difficulties.

Such corporations may choose the CCCTB-based taxation system. This option will be accomplished by the notification of the competent authorities with at least three months before the beginning of the fiscal. It will be valid for 5 years and it will be automatically renewed for 3-year periods in the absence of an official notification from the corporations, and the consolidation shall be made for the incomes and costs of all the members of a group of companies [6].

2. DIFFICULTIES IN IMPLEMENTING THE CCCTB SYSTEM

The problems for which suitable solutions are yet to be found are related to the accounting rules that should be used for the definition of the consolidated base. The debates of the working group frequently involved the idea of using the International Financial Reporting Standards (IFRS). In addition to the fact that they are recognised at the international level, they have the advantage of allowing taxpayers to adjust to them quite easily - starting with 1 January 2005 - at the level of the Community, a Regulation is applied that requests the companies listed in the regulated capital market to draw up their consolidated balance sheets in compliance with the IFRS requests [4].

A number of studies proved the fact that these standards may offer solutions that can be taken over into the rules of drawing up the consolidated base, and can also lead to a decrease in the rates of taxation, which would increase the attractiveness of the whole European Union as location for investments [5].

In the opinion of the officials from Brussels, it may be difficult to use these standards because in many countries, in the case of the local companies, their usage is not allowed and not all the standards are compatible with the taxation requirements. For this reason, the decision was made to start from the accounting rules generally accepted in all the member countries that will undergo certain changes in order to meet the rules established for the CCCTB. Other debates held at the level of the working group, in relation to the implementation of the CCCTB, were related to:

- *Fixed assets and depreciation.* The assets that meet the requirements may be depreciated either individually, which requires an estimation of the service life of each and every asset when it is purchased (in compliance with the common norms applicable in the EU) and an individual depreciation during their service life, either in one or in several categories with a common established service life. The Commission's opinion is that the development of the grouping method within the CCCTB implies considerable advantages.
- *Deductions for provisions*. Provisions may generally be fiscally non-deductible, completed by a list of fiscally deductible exceptions, or may generally be fiscally deductible, completed by a list of fiscally non-deductible exceptions. In the Commission's opinion, the fiscally deductible provisions must be defined and completed by a list of fiscally non-deductible exceptions.
- *General methodology*. For the calculation of the taxation bases for a company, one can start from the comparison between the opening balance sheet with the ending balance sheets or from the profit and loss account of the company. In the first case it is necessary to prepare a model of "fiscal balance" according to commonly defined norms that should also include the profit and loss account. In the second case, only the profit and loss account commonly agreed in the CCCTB legislation is necessary; the information related to the balance can be checked by comparison with the financial accounts. The Commission considers that a fiscal balance is not necessary and that such a balance represents an additional administrative burden.
- *Local taxes.* In certain Member States there are local taxes on business. They may be deductible from the consolidated base and thus included into the distribution mechanism or maintained at the national level and deducted only from the respective part of the consolidated base that due to the respective Member State. In the Commission's opinion, in general, it is preferable to establish a set of norms as vast as possible, in order to avoid national "derogations" or additional taxes as much as possible. However, as additional analysis of all their consequences is necessary, because the "distribution" of the deductions for the local taxes at the EU level but the "non-distribution" of the national taxes at the level of the common base might generate inconsistency.
- *External incomes.* The external/foreign incomes of a company can be totally excluded from the consolidated tax base or can be incorporated into it. In the last situation it is necessary to have a method of including them into the consolidation and distribution mechanism. This issue has been raised due to the fact that the various methods of avoiding double taxation currently used by

the Member Sates according to the national legislation, as well as the bilateral agreements with third countries should be taken into account. The Commission believes that it is preferable to define a method that should incorporate external incomes into the consolidated tax base and that should be completed, where necessary, by some form of exemption in order to avoid double taxation.

- *Intra-group transactions*. Avoiding problems related to transfer prices represents an important advantage of consolidation. However, there are several methods of eliminating intra-group transactions by consolidating the base. Transfer prices can be ignored, recognised at the level of costs or recognised at the price established under full competition conditions. Each method presents advantages and disadvantages, which is why the Commission must decide which is preferable or whether each group may be allowed to choose.

But the problem that generated most of the debates is represented by the distribution formula, among the entitled Member States, of the consolidated revenue determined through the decided tax base. It is necessary that this formula by transparent and simple, and not to involve compliance costs and excessive administration, to decrease the possibility of corporations to transfer allocation factors from one site to another, and not to generate distortions at the level of the business environment in the European Union [1].

3. CONSOLIDATED TAX BASE DISTRIBUTION FORMULA

Starting from the practical experience provided by the countries that use de la such a formula (USA and Canada) some specialists (Hellerstein, McLure 2004: 199-220). have tested the consolidated tax base distribution formula among various tax jurisdictions, based on a series of *factors characteristic to individual company* (size of capital, employed labour, volume of sales on destinations), according to the formula:

$$BFC_i^r = BFC[\alpha\ (Ns_i \times Sbm_i / \Sigma\ Ns_i \times Sbm_i) + \beta\ (K_i / \Sigma\ K_i) + \gamma\ (V_i / \Sigma\ V_i)] \quad (1)$$

where:

BFC_i^r - the tax base allotted to the tax jurisdiction in which company “i”, which is part of the group constituting the object of the consolidation of incomes performs its activity;

BFC - the consolidated tax base of the company;

Ns_i - the number of employees of company “i”;

Sbm_i - the gross salary paid in company “i”;

K_i - the capital of company “i”;

V_i - the volume of sales made by company “i”;

α, β, γ - percentages allotted to each factor, so that $\alpha + \beta + \gamma = 1$

The usage of the above-mentioned factors allows for establishing a correlation between the actual business activity carried out by a certain company on the territory of another state and the consolidated tax base allotted distributed in the respective state. However, the correct reflection of the consolidated tax base depends on the manner in which information related to the factors that compose the distribution formula is

collected. Moreover, any selected distribution key might not affect the incentives for the taxpayer and for this reason there is a risk of manipulation by the authorities. More specifically, they may lead to non-harmonized taxes for the minimization of the level of the respective indicators in their own jurisdiction: for example, if the number of employees is used as a criterion, by decreasing social contributions we can simulate the employment. This could lead to the situation in which, even if the activity of a group is profitable as a whole, the states may try to attract activities – even non-profitable ones, on their territory – just to increase their share in the consolidated tax base [4].

In addition to these shortcomings, there are problems specific to the selection of individual factors.

Capital is a factor the inclusion of which has serious justification because due to the fact that the profits made ultimately represent, the yield of capital investments. Nevertheless, measuring this indicator may have its difficulties. First of all, there are evaluation problems, especially in the case of intangible actives (such as the intellectual property rights), for which there are no relevant market prices.

The problems of evaluation at the market price are present, however, in all the cases, but the book value could be used as a regulating and easily determined factor and, in spite of its conceptual inferiority. Another problem related to the high mobility of this factor that allows for its transfer to jurisdictions with lower rates of taxation. This problem is amplified in the case of intra-group rented assets where the access to a better fiscal treatment is possible without affecting the optimum localization, by registering them in jurisdictions with low rates of taxation and renting them to members of the group activating in other jurisdictions.

There are various implications of the labour factor (number of employees and/or wages fund). The number of employees may have a low relevance, due to the fact that there is no systematic correlation between it and the added value. At the same time, the measurement may create problems in the case of temporary employees. The wages fund has a close correlation with the added value from each site, but we should take into account that in the sites from certain states (especially in the new Member States) the levels of salaries are lower even if there are no differences in point of productivity compared to the sites situated in the countries in Western Europe.

In the case of the "sales volume" factor there are also a number of shortcomings that can be emphasized in relation to the use of sales at the place of destination or at the place of origin. The selection of sales by origin will represent an incentive for the localisation of investments in the jurisdictions with the lowest rates of taxation. The selection of sales by destination will stimulate expenditure and imports to the detriment of exports.

From the point of view of the political feasibility, the solution seems to be the selection of sales by destination that will balance the care distribution of tax revenues among the net manufacturing countries and the net consuming ones. Moreover, sales by destination are less mobile and controllable by taxpayers. Other problems may be generated by the exact identification of the place of sale in the case of certain services, of the intangible property and of the electronic commerce, as well as the method of taking into account sales of semifinished products.

The actual selection from these microeconomic factors may create serious divergences among the Member States because the use of origin-based factors (labour and capital) will generate higher budget revenues for the states with production excess as compared to the expenditure, whereas the selection of sales (measured by destination) favours the states with large consumer markets [4].

Another manner of building the consolidated tax base distribution formula takes into account the *value added by the company* by the business activities carried out on the territory of a country, according to the formula:

$$BFC_i^r = BFC(VA_i / \Sigma\, VA_i) \quad (2)$$

where:
VA_i - the value added by company "i"

Two methods of determining the value added by the business activity were identified in the specialized literature (Hellerstein, McLure 2004: 199-220).

- *The method used for the calculation of the production-based added value* allows for measuring the total economic value generated by the company in a period of time based on the formula:

Added value = Total value of incomings (Production) – Total value of outgoings (expenditure)

The total value of incomings (Production) includes the sales value and the semi-finished product inventory balance at the end of the period of time taken into account.

The total value of outgoings (expenditure) includes the value of purchases and the unprocessed material inventory balance used in the production process.

- *The method used for the calculation of the distribution-based added value* measures the total remuneration of the production factors employed by the company, using the formula:

Added value = Remuneration of labour + interest payment + before-tax profit

In order to distribute the consolidated tax base on fiscal jurisdictions, we can also use *national aggregate (macroeconomic) factors* such as the gross domestic product, the value added tax, and others.

For example, the value added tax can represent a factor for the distribution of consolidate tax base. An argument in favour of this approach is the advantage of a very easy administration, as most of the required information already exists: the EU budgetary rules require that part of the VAT collections be deposed into the common budget, and consequently, there are comparable statements of this indicator all over the European Union. Moreover, it does not need the adoption of specific allocation formulae the business segment, because its application is the same in all the sectors. Problems may occur in relation to the manner of treating segments that are exempt from paying VAT or to which this tax is not applicable (financial segments).

On the other hand, the use of national aggregate factors may seem an unfair practice since it does not take into account, in particular, the economic value created by the group of companies subjected to the consolidation of the tax base in each country.

Table 1 presents on a point scale from 1 to 3, the manner in which the three approaches for the establishment of the consolidated tax base distribution formula meet the principles of the tax policy formulated at the level of the working group:

Table 1. Measuring the level to which formula the consolidated tax base distribution formula meets the principles of the tax policy

	National aggregate factors	**Factors characteristic to individual companies**	**Value added by the company**
The principle of fairness	1	1	2
The principle of the capacity to generate incomes in an equitable manner	1	3	2
The principle of benefits	1	3	2
The principle o neutrality	3	1	2
The principle of adequacy/ stability	3	2	1
The principle of simplicity/low administration costs	3	2	2

Source: 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.87

4. CONCLUSIONS

Consequently, the application of the CCCTB does not eliminate the possibility of the intensification of tax competition, because, in order to attract investments, the national authorities will keep decreasing tax rates as a fiscal incentive. On the other hand, function of the elements than can be used for the distribution of the consolidated tax base among jurisdictions, the competition of the Member States might also be transferred in this field (Negrescu, 2007: 55).

For this reason, in my opinion, in order to avoid profit allocation distortions in the localisation of corporate activities, it is necessary to use a progressive process of convergence of the tax rates used in the tax jurisdictions from the European Union.

The actual solutions selected in order to operate the implementation of the CCCTB system, and especially the methods of distributing the common base are extremely important. It is in Romania's interest to agree a distribution key that should take into account, as much as possible, the relatively abundant factors available in Romania: using the employed labour should thus be a criterion for the consolidated tax base distribution on individual states.

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