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2008

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Recommended Citation
Avi-Yonah, Reuven S. "Commentary: More Open Issues Regarding the Consolidated Corporate Tax Base in the European Union." K. A. Clausing, co-author. Tax L. Rev. 62, no. 1 (2008): 119-24.

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Commentary
More Open Issues Regarding the Consolidated Corporate Tax Base in the European Union

REUVEN AVI-YONAH* & KIMBERLY CLAUSING**

I. Introduction

It is an honor to comment on the article by Jack Mintz and Joann Weiner.[1] Both of the authors have a deeply knowledgeable background in this area. The paper that Jack Mintz published (with Michael Smart) in 2004 on provincial taxation in Canada is one of the most careful and interesting papers in all of international taxation.[2] And Joann Weiner has clearly been studying formulary apportionment for a very long time, from both U.S. and European perspectives.

The article makes some very nice points, and we mention several of them. The main goal of the article is to relate the basic concepts of game theory to the negotiations amongst European Union countries to introduce a Common Consolidated Corporate Tax Base (CCCTB). It also discusses the nature of the apportionment formula and a few technical details.

The discussion of the switch-over clause[3] is noteworthy, and the authors' attention to this is important, as the switch-over clause is likely to be a significant feature of the proposed system. The analysis of the "insurance" feature of country tax revenues under formulary apportionment is also an interesting feature of their article.[4]

II. Is a CCCTB Pareto Improving?

The end conclusion of the article is that "it is possible for the EU to reach a negotiated agreement that is satisfactory to all the players in

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[1] Jack Mintz & Joann Weiner, Some Open Negotiation Issues Involving a Common Consolidated Tax Base in the European Union, 62 Tax L. Rev. 81 (2008).

[2] Jack Mintz & Michael Smart, Income Shifting, Investment, and Tax Competition: Theory and Evidence from Provincial Taxation in Canada, 88 J. Pub. Econ. 1149 (2004).

[3] Mintz & Weiner, note 1, at 93-96.

[4] Id. at 111.

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the 'EU tax cooperation' game. . . . [A]s this analysis has shown, the solution that the Commission may propose may lead the member states to reach a cooperative solution that meets their objectives of creating a company tax system that makes each player in the game better off without making any other player worse off."[5]

This conclusion is possible, and that would be nice indeed. There is nothing in the analysis of Mintz and Weiner, alas, that really supports this finding. On the contrary, much of their analysis stresses substantial ambiguities regarding this conclusion. Most importantly, the article needs to clarify the metric by which a Pareto-improvement would be ascertained. Is it the welfare of the member countries, the revenue of the member governments, or some third consideration?

There can be little doubt that Ireland and Luxembourg, for example, will see their tax revenues and multinational activity substantially reduced if the EU went to a formulary approach, particularly if such a system were not optional. Thus, without substantial side-payments, it is unlikely that a move toward a CCCTB could conceivably be Pareto-improving for the governments involved. The change may occur nonetheless, particularly if the decision is taken through the enhanced cooperation procedure that would allow action to proceed without the unanimous support of member country governments.

At one point early in the article, the authors note that member states have suggested that any move toward CCCTB would have to maintain the existing revenue allocation.[6] Yet clearly this is unlikely, as Mintz and Weiner note themselves in their discussion of likely revenue effects.[7] For low-tax EU countries, their share of European income is almost always larger than their share of economic activity, whether measured in terms of payroll, assets, or sales. For high-tax countries, the reverse is true. Thus, any move toward a formulary approach would unambiguously raise revenue for countries whose activity shares are higher than their income shares, and reduce revenue for countries whose income shares exceed their activity shares. This is unavoidable.

To make their case, there should be more emphasis on the economic pressures that necessitate turning to a CCCTB, in particular the extreme pressures that are put on separate-accounting-based national company taxation. While this is mentioned up front in the article,[8] there is little discussion of these problems. Yet they are absolutely central to the debate. The dramatic increase in income-shifting activ-

[5] Id. at 114.
[6] Id. at 86.
[7] Id. at 112-14.
[8] Id. at 84.

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ity, the increased globalization of business activity, the extreme difficulties (verging on technical infeasibility) of enforcing the arm's length standard, and the large compliance costs placed on multinational businesses all suggest the need for a formulary approach. And it is precisely these sorts of considerations that may enable consensus to emerge in favor of a CCCTB, even though some countries are still likely to lose revenue from this change.

III. The Choice of Formula

A large portion of their subsequent analysis concerns the choice of apportionment formula. They note problematic aspects of many of the formula components,[9] and they eventually recommend a novel six-factor formula that would be based on employees, payroll, tangible assets, intangible assets, destination-based sales, and origin-based sales.[10] Yet this solution is ultimately unsatisfying. Just because many of the possible choices of formula weights are problematic, they are not all equally problematic, and it is implausible that simply including them all in the formula in equal proportion is the optimal solution. Further, there is no connection between this conclusion and their previous game theoretic analysis.

There should be a greater conceptual justification for the formula choice. Two criteria leap to mind. First, it would make good economic sense to include in the formula factors that are relatively insensitive to manipulation or behavioral response. Second, it would be sensible to include in the formula factors that are easy for tax authorities and firms to measure and verify. Implementing these criteria requires an understanding of both the economic elasticities in question and the legal realities associated with implementing international tax rules. Thus, this is an excellent area for collaboration between researchers in economics and law.

In a paper for the Hamilton Project, we argue that using a destination-based sales single-factor formula may best satisfy these criteria.[11] First, destination-based sales are difficult for a firm to manipulate, since multinational firms will always want to serve markets with large economies and rich customers, independent of their corporate tax rates. Second, as we argue, attempts at getting around taxation by using strawmen companies with minimal profits could be avoided by utilizing a look-through rule. (Such a rule would regard any sales

[9] Id. at 102-06.

[10] Id. at 106-07.

[11] Reuven Avi-Yonah & Kimberly A. Clausing, A Proposal to Adopt Formulary Apportionment for Corporate Income Taxation, in Path to Prosperity 319 (Jason Furman & Jason E. Bordoff eds., 2008).

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made by a multinational enterprise (MNE) to an unrelated distributor as sales made to the final destination if the distributor sells the goods into the destination without substantially transforming them.) Third, adopting a sales-based formula might fit well with the ultimate goal of encouraging a compatible trend toward formulary apportionment for international taxation by other countries. For example, there is a well-documented trend among U.S. states to increase the weight on the sales-factor over time, in part due to concerns about losing firm payroll or assets due to the responsiveness of firms to those formula factors. By adopting a sales-based formula up front, this dynamic can be avoided at the international level.

Regardless of what formula is chosen, it is important to avoid including within the formula items that can be easily manipulated. For this reason, including intangible property in the formula is misguided. Omitting intangible property from the formula simply attributes the income earned from intangibles to the entire multinational firm, where it will be taxed based on the other weights in the formula. Including intangible property in the formula begs firms to manipulate the source of intangibles, which multinational firms have already proven themselves very adept at doing.

Also, the authors' original suggestion to include both origin-based sales and destination-based sales in the formula[12] is puzzling. Destination-based sales are likely far more difficult to manipulate, given the fact that the ultimate customers of products are relatively fixed. Further, previous experience suggests that implementing a formula utilizing destination-based sales will prove practical.[13]

IV. An Optional CCCTB

An interesting feature of the EU proposal for a CCCTB is that it is optional.[14] This should lower the revenue received from the change substantially relative to a nonoptional program, as each firm will simply choose the system that is more advantageous for them. Thus, the only firms that would elect CCCTB rather than status quo would do so either because (1) it lowers their tax payments or (2) it saves them enough in compliance and administrative costs to justify somewhat

[12] Mintz & Weiner, note 1, at 107.

[13] For example, existing VATs around the world depend on defining the destination of sales of goods and services. Determining destination for goods is relatively easy because of customs enforcement. In fact, many jurisdictions use harmonized rules for customs, VAT, and income tax collection. Determining destination for services is harder, but countries have developed significant expertise in it under VAT.

[14] CCCTB Working Group, CCCTB: Possible Elements of a Technical Outline, CCCTB/WP/057, at 6 (July 26, 2007), available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/common_tax_base/CCCTBWP057_en.pdf.

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higher tax payments. It is unlikely that (2) would predominate. There needs to be more analysis of this feature of the proposal.

V. Game Theory

In general, the article discusses many of the possible issues that are related to a CCCTB in Europe, without delving carefully into any of them. The sections where elements of game theory are described are not closely related to the subsequent discussion of CCCTB negotiations, and there is almost no direct application of those principles to the questions at hand.

Even with respect to the governments' negotiation objectives, there is little in the way of direct statements regarding their nature. At one point, Mintz and Weiner note that governments may be ultimately concerned with global efficiency and the welfare of all citizens of the world.[15] Upon casual inspection, this appears an implausible starting point for considering the negotiations regarding the CCCTB. Ideally, the authors should be explicit about the aims of government in their model.

VI. International Implications

Our Hamilton Project paper addressed the possibility of adopting formulary apportionment on the international level.[16] Mintz and Weiner do not address this issue directly. Nevertheless, if the EU does adopt CCCTB, it raises interesting issues for the international arena as well.

The most problematic issue facing formulary apportionment has always been the risk of double taxation if countries adopt different formulae or if some countries follow a formula and others maintain separate accounting. In our Hamilton paper we suggested that these risks can be overcome in some scenarios if the United States were to adopt formulary apportionment unilaterally.[17] However, it is clear that a consensual adoption of a formula would be far superior to a unilateral move.

For anyone who has followed the formulary debate for some time, the EU move toward CCCTB is amazing. CCCTB could not move forward without support from Germany, which traditionally has been at the forefront of opposition to any departure from the classic arm's length standard and the traditional transfer pricing methods. CCCTB also could fail if the United Kingdom were opposed, and the United

[15] Mintz & Weiner, note 1, at 85.
[16] Avi-Yonah & Clausing, note 11, at 21.
[17] Id. at 21-22.

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Kingdom spearheaded the opposition to California's use of worldwide formulary apportionment in the 1980's and early 1990's.[18]

Thus, if Mintz and Weiner are correct and the EU does indeed adopt CCCTB, even as an optional measure, this would seem to open new possibilities for negotiating an international formula. After all, EU member states now form the majority of the OECD, and the OECD is the natural forum for such negotiations.

It is true that applying any formula internationally faces hurdles that are steeper than applying it within the EU. But we should keep in mind that multinational enterprises operate on a global basis, and calculate their income for financial reporting purposes on that basis as well. If multinationals are sufficiently integrated to operate globally as a single unit, it should be possible to apply an agreed-upon formula to their worldwide profit.

One of the major achievements of the Advance Pricing Agreement Program has been the global trading APAs, which applied a three-factor formula (not dissimilar from the ones under discussion for CCCTB) to tax banks operating in Japan, the United Kingdom, and the United States. All three tax administrations agreed on the formula, and the result was much simpler and fairer taxation of the parties involved (ironically, one of them was Barclays Bank, which at the same time was litigating against formulary apportionment all the way to the Supreme Court[19]). There was no double taxation and no double nontaxation.

If CCCTB succeeds, the global trading APA story could be replicated on a much bigger scale. The tax administrations of the OECD (where 90% of multinationals are headquartered) could get together and agree on a formula based on the CCCTB formula. This formula then could be applied to multinationals, perhaps as a default (so that they could negotiate another formula, as the U.S. states allow).

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[18] See John Turro, Supreme Court Asks Administration to File Amicus Brief in Barclays (May 18, 1993), 93 TNT 106-3, May 18, 1993, available in LEXIS, Tax Analysts File (stating the United Kingdom has voiced strong dissent against California's formulary apportionment method).

[19] Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 298 (1994).

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