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EU Common Consolidated Corporate Tax Base: Guided Variety versus Strict Uniformity - Lessons from the “U. S. States’ Tax Chaos”

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EU Common Consolidated Corporate Tax Base: Guided Variety versus Strict Uniformity
- Lessons from the "U. S. States' Tax Chaos" [1]?

By Johanna Hey[2]

Abstract

Taxation of business profits is not yet harmonized in the European Union. In its first part this article takes the position that the ongoing tax competition and the growing economic integration calls for a common system of the taxation of EU multinationals. At present the European Commission pursues a concept of a fully uniform Common Consolidated Corporate Tax Base (CCCTB). In view of the slender chances that a directive without any leeway for national alterations will receive the necessary unanimous support of all 27 Member States the second part of this article discusses a less ambitious approach of guided variety by an analysis of the US States corporate income tax system which despite many common features is far from being uniform. In the third part economic and legal consequences of a less uniform CCCTB will be scrutinized.

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[1] Charles E. *McLure & J. M. Weiner*, Deciding whether the European Union should adopt formula apportionment of company income, in S. Cnossen (ed.), Taxing Capital Income in the European Union, Oxford 2000, p. 243, 285: "chaos to be avoided".

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I. Introduction

Most integrated economies establish integrated systems for the taxation of business profits for the sake of the avoidance of high compliance costs and the optimal allocation of capital[3]. Not so the European Union. Albeit the degree of European economic integration achieved, the taxation of income is not harmonised; neither at the level of individual nor corporate income taxes. One finds basic similarities as they exist between the tax systems of all industrialised countries, however, EU multinationals are required to comply with 27 different corporate tax systems, meaning with 27 different sets of individual rules to determine the tax base. In general, no cross-border loss offsetting is provided for. Corporate group taxation is limited to domestic corporate groups.

The cumbersome and decades-long adoption of the few EU-directives on direct tax matters[4] has not significantly changed this situation. Instead of collaboration, Member States compete. In doing so, tax competition became the fulcrum for the design of tax systems in the European Union over the past decade[5]. Tax rates on income from capital and business profits are under massive downward pressure. National budgets therefore increasingly rely on tax revenues from less-mobile sources such as consumption, labour and real property. Low-tax jurisdictions such as Ireland and the new Eastern European Member States have been quite successful in pursuing competitive strategies, especially in adopting unbeatably low tax rates, because anti-discrimination provisions require the other Member States to guarantee free movement of goods,

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3 E.g. G. Carlson & H. Galper, Water's Edge Versus Worldwide Unitary Combination, in Charles E. McLure (ed.), The State Corporation Income Tax, Stanford 1984, p. 1, 9; K. A. Clausing & R. Avi-Yonah, Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment, The Brookings Institution, Discussion Paper 2007-08, June 2007, p. 8 et seq., available at http://www.brookings.edu.topics/taxes.aspx.

4 Council Directive 90/434/EEC of 23/7/1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, OJ 1990, No. L 225, p. 1-5; Council Directive 90/435/EEC of 23/7/1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ 1990, No. L 225, p. 6; Council Directive 2003/49/EC of 3/7/2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ 2003, No. L 157, p. 49; Council Directive 2003/48/EC of 6/3/2003 on taxation of income from savings, OJ 2003, No. L 157, p. 38.

5 See e.g. W. Schön (ed.), Tax Competition in Europe, Amsterdam 2003; J. R. Hines, Corporate Taxation and International Competition, in Auerbach/Hines/Slemrod (eds.), Taxing Corporate Income in the 21st Century, New York 2007, p. 268.

persons, services and capital within the Common Market. Due to the ECJ's stringent judicial interpretations, the capability of countries with higher tax rates to defend the national tax base against such tax competition is very restricted.

Taxpayers – asserting the fundamental freedoms and completely legally – take advantage of the significant differences in tax rates in the European Union. To some extent, rate differences might provide a reason for the decisions of where to actually make investments. However, more often, rate differentials are exploited by using accounting to engage in profit-shifting. Taxpayers are able to enjoy the infrastructure of whatever country they wish to and then shift the profits, mainly by way of debt/equity and transfer price arrangements, to lower tax jurisdictions within the European Union.

Against this background, in 2001, after a long period of resignation due to the lack of support by the Member States, the Commission commenced a new attempt to overcome the present distorting tax structures by introducing the concept of a Common Consolidated Corporation Tax Base (CCCTB) for European multinationals[6]. The aim is two-fold: On the one hand, reducing compliance costs, and on the other hand, rendering profit-shifting less attractive. Since harmonisation of the tax base would be only half the battle – failing to mitigate, but due to its transparency, even aggravating the pressure on corporate tax rates - the proposal also contains a revenue-sharing mechanism. Under this so-called formula apportionment (FA), the consolidated tax base of multinationals is shared among the Member States, in which the business activities are conducted, aiming to nullify profit-shifting devices.

The project is markedly ambitious, considering that in the past, much less far-reaching harmonisation proposals failed to bridge the divergent interests of the Member States. Hence, it is not a big surprise that several Member States have already expressed their reluctance to agree on a CCCTB directive. Some of this reluctance may be due to the lack of experience[7] with

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[6] See Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee of 23/10/2001, Towards an Internal Market without Tax Obstacles: A Strategy for Providing Companies with a Consolidated Corporate Tax Base for their EU-wide Activities, COM(2001) 582.

[7] Formula apportionment is applied in Member States with sub-national profit taxation. The German local business tax ("*Gewerbesteuer*"), for example, is apportioned among the municipalities on grounds of a payroll formula (see § 29 GewStG). In Switzerland, the applied apportionment formula depends on the nature of the firm, see *P. Thalmann*, Tax coordination and competition in Switzerland, in: Report of the Committee of Independent Experts on Company Taxation (Ruding Report), Luxembourg 1992, Annex 9 B, p. 397, 402.

formula apportionment. To overcome the fear of the unknown, in its long experience with formula apportionment, the U.S. provides a model upon which to draw inspiration. Hence, numerous articles have drawn conclusions from the American states' corporate income tax system with regard to the development of a formula apportionment system for Europe[8].

However, with this article, I do not wish to join these authors in searching for an apportionment formula which could be acceptable for all European Member States. It is unlikely that such a formula exists. Nevertheless, pros and cons of different formulae can be weighted systematically according to criteria of international equity, efficiency and practicability[9]; even strong advocates of formula apportionment admit that there is no such thing as the "optimal" or "perfect" formula[10]. Hence, I strongly doubt that – even if they manage to agree on the more technical issues of the determination of the tax base – all 27 Member States will unanimously adopt a formula apportionment system. For this reason, I am more interested in one of the biggest flaws of the U.S. system, namely, its lack of uniformity.

To date, the CCCTB discussion in the EU is targeted at uniformity - the adoption of a uniform tax base, uniform rules of consolidation and a uniform apportionment mechanism[11]. For this reason it is – despite the questionable legal basis for this – even discussed to implement the CCCTB by a regulation instead of a directive (as so far proposed by the Commission) meant to

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8 See J. M. Weiner, Tax coordination and competition in the U.S.: some lessons for the European Union, in: Report of the Committee of Independent Experts on Company Taxation (Ruding Report), Luxembourg 1992, Annex 9 C, p. 417; J. M. Weiner, The European Union and Formula Apportionment: Caveat Emptor, 41 European Taxation 380 (2001); J. M. Weiner, Company tax reform in the European Union: Guidance from the United States and Canada on implementing formulary apportionment in the EU, New York 2006; Mintz/Weiner, Exploring Formula Allocation for the European Union, 10 International Tax and Public Finance 695 (2003); W. Hellerstein & Charles E. McLure, The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States, 11 International Tax and Public Finance, 199 (2004); W. Hellerstein & Charles E. McLure, Lost in Translation: Contextual Considerations in Evaluating the Relevance of US Experience for the European Commission's Company Taxation Proposals, 58 Bulletin for International Fiscal Documentation 86 (2004); A. Riecker, Körperschaftsbesteuerung in der Europäischen Union und das US-amerikanische Modell der Unitary Taxation, Baden-Baden 1997; for similar considerations concerning the adoption of formula apportionment in the NAFTA-zone see *R. D. Pomp*, Issues of the Design of Formulary Apportionment in the Context of NAFTA, 49 Tax L. Rev. 795 (1995); *P. R. McDaniel*, Formulary Taxation in the North American Free Trade Zone, 49 Tax L. Rev. 691 (1995).

9 See *A. Agúndez-García*, Taxation Papers – The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: a Review of Issues and Options, ed. by The European Commission, Working paper, No. 9/2006, Luxembourg 2006, p. 32-39.

10 *A. Agúndez-García*, *supra* note 9, p. 46 and 86; *D. Shaviro*, An Economic and Political Look at Federalism in Taxation, 90 Mich. L. Rev. 895, 976 (1992).

11 Working Paper "Possible elements of the sharing mechanism", CCCTB/WP/060, No. 14: "It is extremely important that the formula is uniform across all Member States".

avoid any discretional leeway by the Member States within the implementation process. Since such a degree of uniformity is unlikely to be achieved in the entire Community, enhanced cooperation (Art. 43-45 of the EC-Treaty) has been introduced as a fallback position. This fallback would allow introduction of the CCCTB if at least a subset of eight countries were to find common cause and agree. Another possible means of overcoming the political blockade and to persuade more (if not all) Member States to join the CCCTB has not yet been considered:[12] The adoption of the CCCTB and formula apportionment without full uniformity. Member States could remain the residual capacity to alter some or all elements of the CCCTB involving determination of the tax base, consolidation requirements and apportionment formula. This is the situation found in the U.S. corporation income tax system, which in all aspects (base, consolidation and apportionment) is far from being uniform. By reviewing this aspect of the U.S. system, I wish to answer the question of whether a change to CCCTB and formula apportionment would be advisable, even if it were not to be implemented uniformly by all Member States. To keep the variety under control the capacity to deviate could be restricted by setting upper or lower limits.

In doing so, in the first part, I describe the CCCTB project and its goals in greater detail to obtain the criteria for assessment of whether a less uniform approach would be a viable option. To define the expectations aligned with the adoption of the CCCTB and formula apportionment, it will be necessary to analyse the pressure of ongoing tax competition on the national tax systems. I take the normative position that this competition must be limited, because it does not lead to more efficient public spending. Instead, it results in a distortion of European tax systems. From this standpoint, I understand the CCCTB project not only as an attempt to ease the tax conditions of multinationals, but also to tackle tax competition itself. In a second step, I describe the ECJ's attitude toward tax competition and toward the Member States' defence measures. This is the background to understanding the need for Community action on the one hand and to arriving at the legal framework for the CCCTB directive on the other hand – in view of the fact that all Community law must be compatible with the fundamental freedoms as these are interpreted by the ECJ.

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[12] Only briefly mentioned in R. *Pethig & A. Wagener*, Profit tax competition and formula apportionment, 14 International Tax and Public Finance 631, 646 (2007).

In the second part, I scrutinise the U.S. states corporation tax system, in particular focussing on the effects of U.S. State fiscal autonomy and the outstanding differences.

In the third part, after an analysis of the chances and effect of enhanced cooperation, I seek to answer the question of whether the adoption of the CCCTB and formula apportionment with remaining Member States' sovereignty to modify these could present a viable option to moderate the potential political difficulties of the unanimity requirement.

II. The CCCTB Project as an answer to the highly-integrated European economy

1. The Background of European Tax Competition

The main reason that the European Commission is launching a new attempt to convince Member States to agree on the harmonisation of their corporate income taxes is the persistence of tax competition among Member States[13]. The essential strategies of such tax competition have evolved over the past decade from tax *base* to tax *rate* competition, because the EU Commission began to apply the State Aid provisions of Art. 87, 88 of the EC Treaty to business taxation[14]. Previously, Member States essentially relied upon ring-fenced tax privileges to attract foreign investors, e.g. tax holidays for foreign investors, designated special investment zones and preferential schemes for foreign holding companies. At the end of the 1990s, however, the EU Commission wielded threats of legal action against Member States for a violation of the EC Treaty in order to force them to change their policies. In 1997, Member States also agreed upon a Code of Conduct against unfair tax competition[15]. Commencing at that time, competitive strategies were altered to incorporate substantial cuts to general corporate tax rates in lieu of

[13] See Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee of 23/10/2001, Towards an Internal Market without Tax Obstacles: A Strategy for Providing Companies with a Consolidated Corporate Tax Base for their EU-wide Activities, COM(2001) 582, p. 5.

[14] See the Commission's guidelines on the application of the State Aid rules to measures relating to direct business taxation, Commission notice 98/C 384/03 of 10/12/1998, OJ 1998, No. C 384, p. 3.

[15] Conclusions of the ECOFIN Meeting on 1/12/1997 concerning tax policy, OJ 1998, No. C 2, p. 1 et seq.; *M. Monti*, The Climate is Changing, 7 EC Tax Rev. 2 (1998); *UNICE*, Company Taxation in the Single Market: A Business Perspective, 27 Intertax 76 (1999); *F. Parly*, The Code of Conduct and the Fight against Harmful Tax Competition, 40 European Taxation 406 (2000).

special tax gifts to foreigners[16]. Over the past 25 years, corporate income tax rates have declined on average by 50 % and the race to the bottom continues unchecked to date[17]. Small Member States – such as Ireland or the new Eastern European Member States – have generally been more successful in reducing their tax rates than have larger economies such as Germany, France or Spain. This significantly increases the pressure on the latter ones.

Generally speaking, Member States respond in two different ways to competition pressure - positively and negatively:

On the one hand - and this constitutes the most palpable effect of tax competition - one can notice a considerable trend toward the scheduling of income tax systems, with lower tax rates on mobile income sources and a shift of the burden to immobile or less mobile sources, such as income from labour and consumption. Low corporate income tax rates are an important part of scheduling. The main aim is to attract foreign investors and to avoid giving domestic investors a reason to relocate. Cuts to tax rates must usually be financed by broadening the tax base. This –

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[16] Ireland serves as an often-mentioned example: In the place of its preferential Dublin Docks and Shannon Area schemes, Ireland lowered its general corporate tax rate in 2003 to 12.5% from a previous 32%. This is indicative of the shift in direction to a generalized redesign of the national tax systems within the boundaries of European law as a response to heightened tax competition. Another reaction was the adoption of the widely-publicized dual income tax systems by the Nordic Member States. Furthermore, one of the prerequisites for membership of the Eastern European countries was that these abolish their preferential tax schemes for foreign investors, practiced up until that time. Almost all of these chose to adopt flat direct taxes and to shift the burden to indirect taxation, commensurately raising their VAT rates. In doing so, they exerted pressure on the old Member States to follow suit. This explains the most recent cut in tax rates. Even Germany – as a traditional high tax jurisdiction – could no longer withstand this pressure. The German Tax Reduction Act (*Steuersenkungsgesetz*) of 23 October 2000, Federal Law Gazette 2000, Part I, p. 1433, already resulted in a cut of the corporate income tax rate from 40% to 25%. The next cut to 15% is effective as of 2008, created through the Business Tax Reform Act 2008 (*Unternehmensteuerreformgesetz*) dated 14 August 2007, Federal Law Gazette 2007, Part I, p. 1912. Thus, due to the pressure of international tax competition within the last 20 years, corporate income tax rates went from 56% to 15% as of 2008 (50% in financial years 1990-1993, 45% in 1994-1998, 40% in 1999 and 2000). Of course, with the local business tax added on, Germany will not move into the European low-tax jurisdictions, but remains at a sum level of around 30% for corporate profits. Still, this means a rate cut of over 8% compared with a rate of 38.6% in 2007.

[17] Compared with this, to date, the U.S. has been able to withstand the pressure of international tax competition. After the United States' 1986 tax reform, which achieved worldwide recognition because of its significant rate cuts, the US has apparently not subscribed to a further policy of lowering the corporate income tax rate. One of the reasons might be the geographical situation of the US with its large and largely shielded internal market. Furthermore, for a long time no or only little tax rate competition existed in the NAFTA zone (*Paul R. McDaniel*, *supra* note 8, at 708, who, however, was mistaken in his prognosis that it would be unlikely that tax competition would develop among the NAFTA countries). However, from 2003 on, Mexico continuously lowered its corporate tax rate from a former 35% to 28% in 2007 (2003: 34%, 2004: 33%, 2005: 30%, 2006: 29%; see KPMG's Corporate and indirect tax rate survey 2007, p. 8). Canada went down to 33.99% for the combined tax rate at the federal and provincial level, while the average tax burden in the US falls within a range from 35 % to 41%, depending on the existence and rate of state and local corporation income taxes. To date, the U.S. still tries to defend its high level of taxation by way of an extensive body of anti-avoidance rules.

together with the legal state aid limitations of the EC Treaty – led to a substantial decrease in tax subsidies in Europe. However, because so few tax subsidies remain in existence, Member States recently have started hollowing out and discarding even fundamental principles of their tax systems (such as the net income principle) in order to finance further rate cuts, thereby turning to income taxes with low rates on a gross basis. These restrictions of the net income principle distort business decisions.

On the other hand, Member States aim to safeguard tax revenue by measures which are intended as anti-avoidance rules. At the same time as these measures combat specific avoidance strategies, they also serve base broadening in order to finance the tax rate cuts[18]. One can detect a broad variety of such measures; some are directed only against the shift of profits to low-tax jurisdictions - usually limited to passive foreign investment - while others apply regardless of the other state's level of taxation. In this context, many Member States devised exit taxes, CFC-regimes, rules against thin capitalisation and provisions to avoid treaty-shopping. However, despite similar strategies, the structures vary extensively in their details and therefore have the effect of creating severe distortions to cross-border activities due to resulting double- or non-taxation.

With this rough analysis of the effects of tax competition, I definitely do not want to add a new chapter to the controversial debate of the economic effects and appraisal of tax competition.

[18] One good example is the recently adopted German Business Tax Reform Act 2008 (*supra* note 16). To finance the cut of the corporation income tax rate from 25% to 15%, the German Parliament tightened anti-avoidance provisions (in particular by a reform of the rules on thin capitalization, the introduction of new rules on earnings stripping and by modifying the tax consequences of cross-border reallocations of services and activities). These measures are highly controversial due to their negative economic side effects. At the outset, most of them are not precisely designed to combat tax arbitrage or evasion, but instead involve an unsystematic base broadening in order to finance the costs of the rate cuts. The tax avoidance justification itself is prone to abuse in order to create new tax liabilities, aside from the originally-provided justifications. It might be difficult to define tax avoidance in abstract provisions, however, the German Parliament seems to prefer to use a sledgehammer to crack a nut, causing not only "collateral damage", but distorting business decisions in a very thorough manner. Second, the new so-called anti-avoidance rules cause severe breaches of tax treaty law and undermine fundamental principles of the German tax system. The new cap on interest (*Zinsschranke*) in Sec. 4h of the German Personal Income Tax Code (*Einkommensteuergesetzbuch*) – allegedly similar to the US earnings stripping limitation, but in truth, much more heavy-handed in its execution – will lead to the non-deductibility of interest, no matter if it is paid to a shareholder or a third party and irrespective of whether it is taxed as interest at the recipient level. It is not directed against purely artificial arrangements in the sense adopted by the ECJ. Therefore, to avoid infringement of the EC Treaty, the "cap on interest" rule is applicable without distinction to domestic loans, as well as to cross-border loans, even though, in a purely domestic context, it does not matter if the profit is taxed at the level of the subsidiary and then distributed in a tax-exempt manner to the parent, or if it is deducted as interest from the income of the subsidiary and taxed as interest income at the parent's level.

From a *legal* point of view, the loss of fairness and equality between different groups of taxpayers according to their mobility is striking. Scheduled tax systems infringe with fundamental principles of taxation. Taxpayers are no longer taxed according to their ability to pay, but instead, based on their ability to move. The reactionary adaptation of tax systems to tax competition also increases their complexity. The idealistic view of *Friedrich A. von Hayek*[19] of competition as a fundamental principle of evolution and discovery leading to *better* solutions has thus far not come true in tax law. Member States do not yet compete for the best tax system in terms of equality, fairness, efficiency and administrative feasibility, but instead, for the biggest bite of tax revenues. Tax systems which were constructed in the early 20th century on the grounds of the ability to pay principle are vulnerable to losing their original rationale in the 21st century.

2. The European Court of Justice forcing tax integration

In spite of the Member States' constant protests against giving up fiscal sovereignty, the ECJ compels integration of the European tax systems[20]. Since statutory EC law does not address tax competition issues directly, the ECJ's court practice is of paramount importance. The Court's general approach to tax competition is that it is the natural consequence of the remaining sovereignty of the Member States on the one hand, and that, on the other hand, the fundamental freedoms guarantee the taxpayers' rights to take advantage of rate differences and any preferential tax features. The remaining scope of the national legislators to defend against competitive strategies by enacting domestic laws is tightly restricted. It does not even matter if the provision the taxpayer relies upon is considered to be fair or unfair in terms of the previously-mentioned Code of Conduct[21]. Countervailing measures are reserved for the Community level. Member States defending themselves against such measures on their own authority cannot implicitly claim justification for counteracting discrimination. Very much in

[19] F. A. Hayek, The Meaning of Competition, in: Individualism and Economic Order, Chicago 1972.

[20] See e.g. *J. M. Weiner*, *supra* note 8, at 27: The ECJ's influence stems from the fact that it treats the European Union as a single jurisdiction rather than as a collection of individual Member States.

[21] ECJ of 9/12/2006 Cadbury Schweppes, C 196/04, ECR 2006, I-7995.

favour of the taxpayer, the Member State's power to defend its tax revenue is confined to instances that are (narrowly) defined as abuses[22] of the fundamental freedoms.

This means that at first, the relocation of real business activity may not be restricted by taxation in the event of relocation without realisation[23]. The efficiency goal of the Common Market calls for a free flow of capital and enterprises according to the best investment environment. Even though a mere tax-driven location of business activities might not result in the most efficient allocation, in the case of the transfer of real business activity, the purposes for which an activity is pursued in another Member State are irrelevant according to the ECJ[24].

However, the transfer of real activities exclusively for tax reasons will be a rare exception, since the location of a business is usually determined by many factors, such as natural resources or the supply of public goods. In contrast, the mere shift of book values and profits permits multinationals free choice of the country in which the profits will be taxed, subject to minimal efforts involved in deploying financial constructions (such as debt push-down or debt push-up) and transfer pricing arrangements. Generation of capital income is almost independent from other location factors. Hence, the level of taxation becomes *the* key issue. Nevertheless, the ECJ allows counteractive measures against profit-shifting only if these "specifically relate to *wholly* artificial arrangements aimed at circumventing the application of the Member State concerned"[25]. This will be the case for "fictitious establishments not carrying out any genuine economic activity in the territory of the host Member State", i.e. a letterbox or "front" subsidiary[26]. The argument remains unclear with regard to the relationship between the

22 See at great length *V. R. Almendral*, Tax Avoidance and the European Court of Justice: What is at Stake for European General Anti-Avoidance Rules?, 33 Intertax 562 (2005); and *C. Garcia-Herrera & P. M. Herrera*, Is Fairness in Europe under Siege?, 13 EC Tax Rev. 57 (2004); *W. Schön*, Gestaltungsmissbrauch im europäischen Steuerrecht, 5 Internationales Steuerrecht, Supplement 2 (1996); *W. Schön*, Rechtsmissbrauch und Europäisches Steuerrecht, in Festschrift for W. Reiß, Köln 2008, p. 571 et seq.; *A. Kärgel*, Steuerrechtliche Anti-Missbrauchs-Regeln in Konflikt mit europäischem Gemeinschaftsrecht, Bonn 2003.

23 To date, the ECJ has only ruled on the exit taxation of natural persons with a substantial shareholding. In both the Hughes de Lasteyrie du Saillant case (C-9/02, ECR 2004, I-2409) and the N case (C-470/04, ECR 2006, I-07409), the Court adopted a mediator position, accepting the right of the state of origin to tax the hidden reserves accrued under its tax jurisdiction, but also holding that immediate taxation without realization is unjust because it is disproportionate to the objective pursued. There is no reason why this rationale should not apply to the relocation of a corporation's registered office or a permanent establishment as well.

24 Cadbury Schweppes, *supra* note 21, para 65.

25 Cadbury Schweppes, *supra* note 21, para 51.

26 See ECJ of 2/5/2006 Eurofood IFSC, C-341/04, ECR 2006, I-0000, para 34 and 35; Cadbury Schweppes, *supra* note 21, para 68.

determination of a "fictitious establishment" and the concept of sham[27], but makes quite clear that the Court does not intend to intervene to prohibit the common financial structures of multinationals.

Even though the Court acknowledges a principle of *fair distribution* of the tax base[28], it does not generally take exception to profit-shifting. In particular, the decisions on thin capitalisation[29] demonstrate the Court's restrained approach. It did not address the underlying bias of international tax law between debt and equity financing which cause the thin capitalisation problem, but instead, emphasised the role of the division of tax sources under international tax law[30]. European law should not urge Member States to diverge from these rules. Assuming that the set of rules applied on behalf of the OECD Model Convention contains broadly-accepted fair principles, the Court has not - to date - developed a European concept of international equity.

.[27] See the criticism of *V. R. Almendra*, *supra* note 22, at 562 and 573.

[28] ECJ of 13/12/2005 Marks & Spencer, C-446/03, ECR 2005, I-10835, para 45: "preservation of the allocation of the power to impose taxes between Member States".

[29] ECJ of 12/12/2002 Lankhorst-Hohorst C-324/00, ECR 2002, I-1179; ECJ of 13/3/2007 Test Claimants in the Thin Cap Group case C-524/04, (http://curia.europa.eu). Thin capitalization rules diverge from the general benefit principle, according to which passive investment income such as interest is usually taxed in the country of residence or administration. Even though the Court expressly conceded that a group's decision to fund a subsidiary by way of debt capital (rather than equity capital) can undermine the facility of Member States to exercise their tax jurisdiction in relation to the activities carried out in their territory and hence jeopardizes a balanced allocation of the power to tax, the tests for the justification of thin capitalization rules remain high. Disregarding that any intercompany loan has the effect of a shift of the jurisdiction entitled to tax, requalification by way of a thin capitalization regime is only allowed in cases of intended tax evasion. Hence, the Member State has to set out "objective and verifiable elements" which allow it to identify "the existence of such a purely artificial arrangement, entered into for tax reasons alone". Secondly, even if it is proved that there are no economic reasons besides tax motives for the arrangement, the arrangement may not be totally disregarded. The interest may be treated as a distribution only to the extent it exceeds that which would have been agreed to at arm's length. However, in the Test Claimants case of 2007, the Court's opinion was already more balanced and tried to adhere to the above-mentioned principle, namely, that income should not be shifted to a country which did not contribute to its accrual. The loan can be requalified into equity if „it exceeds what those companies would have agreed upon on an arm's-length basis, that is to say, the commercial terms which those parties would have accepted if they had not formed part of the same group of companies" (para 80 et seq.).

[30] ECJ case N, *supra* note 23: "It is in that context that the Court has already held that, in the absence of any unifying or harmonizing Community measures, Member States retain the power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation", furthermore ECJ of 12/5/1998 Gilly C-336/96, ECR 1998, I-2793, para 24 and 30; ECJ of 21/9/1999 Saint-Gobain C-307/97, ECR 1999, I-6161, para 57; ECJ of 12/12/2002 de Groot C-385/00, ECR 2002, I-11819, para 93; ECJ of 23/2/2006 van Hilten-van der Heijden C-513/03, ECR 2006, I-1957, para 47 and 48; ECJ of 14/11/2006 Kerckhaert and Morres, C-513/04, ECR 2006, I-0000, para 22 and 23; Test Claimants in the Thin Cap Group, *supra* note 29, para 49.

The attribution of profits within the Community was also subject to findings on cross-border group taxation (*Marks & Spencer* and *Oy AA*)[31]. The ECJ's underlying rationale was that the fundamental freedoms do not permit an allocation of profits or losses completely independent from their origin. Multinational groups cannot claim to attribute profits to a foreign entity and have them taxed in a country different from that in which the profits were generated.

Even though the Court did not force the Member States to apply consolidation without restrictions upon cross-border groups – as many authors assumed before the release of *Marks & Spencer*[32] – and therefore did not give the CCCTB project the ultimate boost, the room for manoeuvre to tackle profit-shifting by unilateral provisions has become so limited over the past years that one could expect Member States to surrender their reluctance to collaborate. It has been argued that the ECJ's concept of fundamental freedoms in the field of taxation interferes with the remaining fiscal sovereignty *and responsibility* of the Member States as these are stipulated in the Maastricht Criteria. However, there are always two sides to the story, and the ECJ's practice can be defended through its warning to the Member States not to lose sight of the goal of economic integration which - as other borders have fallen - can no longer exclude direct taxation.

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[31] Marks & Spencer, *supra* note 28; with comments by *S. Douma & C. Naumburg*, Marks & Spencer: Are National Tax Systems Éclairé?, 46 European Taxation 431 (2006); *G. Meussen*, Recent EU Developments in Relation to the Marks & Spencer Case, 46 European Taxation 449 (2006); *M. Lang*, The Marks & Spencer Case – The Open Issues Following the ECJ's Final Word, 46 European Taxation 54 (2006); and very recently ECJ of 18/7/2007 Oy AA C-231/05(http://curia.europa.eu). The Court's rationale in these cases did not address questions of tax avoidance, but obviously attribution of profits in a group tax regime does not reflect real business activity, and hence is a pure tax matter.

[32] Comments on the Reference for a preliminary ruling *D. Gutmann*, The Marks & Spencer Case: proposals for an alternative way of reasoning, 12 EC Tax Rev. 154 et seq. (2003); *G. Meussen*, The Marks & Spencer Case: reaching the boundaries of the EC Treaty, 12 EC Tax Rev. 144 et seq. (2003); *P. Pistone*, Tax treatment of foreign losses: an urgent issue for the European Court of Justice, 12 EC Tax Rev. 149 et seq. (2003); *F. Vanistendael*, The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States, 12 EC Tax Rev. 136 et seq. (2003); *A. Cordewener & M. Dahlberg & P. Pistone & E. Reimer & C. Romano*, The Tax Treatment of Foreign Losses: Ritter, M & S, and the Way Ahead (Part Two), 44 European Taxation 218, 226 et seq. (2004); *P. Martin*, The Marks & Spencer EU group relief case – a rebuttal of the 'taxing jurisdiction' argument, 14 EC Tax Rev. 61 et seq. (2005).

3. Outline of the CCCTB Project

Based upon this background, the Commission commenced its new campaign for harmonisation. After the discouragement of the Member States' harsh reaction to the release of the Ruding Report[33] in 1992, it took almost a decade until the Commission introduced the CCCTB Project in its 2001 Communication to the Council[34]. In the meantime, the Commission has been quite successful in advancing the project: Most issues have been thoroughly debated in working groups and conferences, and a draft of a legislative proposal is envisaged for 2008.

The whole project consists of three main features: (1.) Harmonisation of the tax base; (2.) cross-border consolidation; (3.) formula apportionment of the consolidated tax base.

a. Consolidated Common Tax Base

The harmonisation of the tax base is considered to be a precondition for a common system for the taxation of EU multinationals. In spite of today's major differences in the calculation of income, the discussion on common rules for the determination of corporate profits is already well-advanced[35]. Using International Financial Reporting Standards (IFRS) as stipulated in the IAS Regulation[36] as a springboard assisted in developing at least common language for such discussions (although this is not entirely suitable for tax purposes), whereby no formal connection between IFRS and the CCCTB was imposed[37].

From the very beginning, the project was aimed at a *consolidated* common tax base to accomplish cross-border loss offsetting within one company with a foreign branch, as well as within groups of companies. The treatment of cross-border losses has been a paramount concern

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33 Report of the Committee of Independent Experts on Company Taxation (Ruding Report), *supra* note 7.

34 See Company Taxation in the Internal Market, SEC(2001) 1681; Towards an Internal Market without Tax Obstacles: A Strategy for Providing Companies with a Consolidated Corporate Tax Base for their EU-wide Activities dated 23 October 2001, supra note 6, at 5; An Internal Market without Company Tax Obstacles: Achievements, Ongoing Initiatives and Remaining Challenges of 24/11/2003, COM(2003) 726; Further Progress during 2006 and next steps towards a proposal on the Common Consolidated Corporate Tax Base (CCCTB) of dated 2 May 2007, COM(2007) 223.

35 See Working Paper CCCTB/WP/057.

36 Regulation EC No 1606/2002 of the European Parliament and the Council of 19 July 2002 on the application of international accounting standards.

37 See Working Paper CCCTB/WP/057\doc\en, No. 9.

of the Commission for decades,[38] as this is considered to be one of the most significant impediments to cross-border business activities. Although cross border loss offsetting will decrease the overall tax base in Europe permanently, and therefore costs the Member States in revenue[39], in principle, there is no disagreement on the legitimacy of this premise. Some Member States (such as Austria and Denmark) already unilaterally permit cross-border loss offsetting for foreign branches and even for foreign subsidiaries. This is therefore nothing new.

b. Formula apportionment of the tax base

The most significant change required is from today's separate entity accounting to the adoption of a formulaic sharing mechanism, leading to a totally new system for the division of the tax base among the Member States. Given the potential for controversies, this issue had been disregarded at the outset, but recently the Commission made progress in this area as well[40].

At first, the Commission ruled out macroeconomic formulae[41]. A macroeconomic formula would guarantee the best protection against tax competition, rendering both profit-shifting and factor-shifting worthless[42]. However, it would imply a total departure from the traditional idea of source-based taxation and therefore it would hardly be acceptable. Similarly, value-added apportionment has been discarded[43]. Instead, the Commission promotes a (traditional) multifactor formula apportionment, not least because this method has been "applied for many years in the USA and Canada and both countries appear satisfied by the outcome of the mechanism and are not planning to move to another system"[44]. In order to not depart too far

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38 See Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee: Tax Treatment of Losses in Cross-Border Situations, COM(2006) 824 (final); see also the withdrawn (OJ 2004, No. C 5, p. 20) proposal for a loss directive COM(1990) 595 (final).

39 See *C. Fuest & T. Hemmelgarn & F. Ramb*, How would the introduction of an EU-wide formula apportionment affect the distribution and size of the corporate tax base? An analysis based on German multinationals, 14 International Tax and Public Finance 605 et seq. (2007).

40 See Working Papers "The mechanism for sharing the CCCTB" (CCCTB/WP/047); „Report and overview of the main issues that emerged during the discussion on the sharing mechanism SG6 second meeting - 11 June 2007" (CCCTB/WP/056) and "Possible elements of the sharing mechanism" (CCCTB/WP/060).

41 Working Paper CCCTB/WP/060, No. 11.

42 *J. M. Weiner*, *supra* note 8, at 47.

43 Working Paper CCCTB/WP/056\doc\en.

44 Working Paper No. 9/2006, Luxembourg 2006, p. 46 et seq.; EU Commission, Working Paper of 17 November 2006 CCCTB\WP\047\doc\en, No. 12.

from the existing source-based system of revenue allocation, formula apportionment is supposed to rely on factors which take into consideration the source of the income[45]. Factors which have been discussed were payroll, assets and sales.

Furthermore, the working group agreed that there should be no distinction between business and non-business income,[46] and that apportionment should be limited to the EU income of the group (so called "water's edge limitation" instead of worldwide consolidation). Some industry-specific formulae are considered unavoidable, but these will be strictly limited to what is inevitable. Another major issue will be the definition of the sales factor: By destination or by origin? Only the latter would go conform to today's source principle.

As alluded to above, decisions will have to be made not only with regard to the components of the formula and their weight, but also with respect to the definition of the basis for the factors. In this regard, many technical issues must be dealt with and these have already been discussed. For example, the definition of the wage/payroll factor has disclosed difficulties of defining the factors based on non-harmonised characteristics of Member States' national legal systems, such as the distinction between employees and self-employed persons. Another problem arose in the significant differences in the wage level throughout the Community which would be mirrored in the payroll factor. The argument that lower wages indicate lower profitability might be sound, but for the new Eastern European Member States, it will be hard to agree upon this fact.

This small extract of the topics which have to be decided gives a hint of the difficulties the Member States have to cope with. Decisions will be intricate, since these issues are new to the Member States and directly affect the distribution of tax revenue among them.

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[45] Critical *A. Agúndez-García*, *supra* note 9, at 33-35, questioning whether it is possible to determine the source of income.

[46] See Working Paper CCCTB\WP\060\doc\en, No. 15.

4. Expectations and aims

The delineation of the CCCTB and of formula apportionment depends upon the expectations coupled with the project. These expectations also define the scope for "guided variety" versus "strict uniformity".

a. The Business Community's perspective

By integrating business experts coming from the practical field at a very early stage, the Commission revealed that the project is prominently directed toward the needs of the business community. From this community's perspective, three features of the CCCTB are especially important: (1.) the reduction of compliance costs; (2.) the elimination of international double taxation and (3.) cross-border loss offsetting. Hence, both the business community and the Commission are focusing on the merits of the uniformity of the tax base[47] aimed at decreasing compliance and auditing costs of EU multinationals and at avoiding the double taxation which currently arises from incompatible definitions and classifications.

The adoption of formula apportionment would support further simplification. Today's attribution of the tax base through transfer pricing calculated in accordance with the arm's length standard requires extensive documentation. Legal uncertainty and the risk of double taxation arise due to unresolved transfer pricing conflicts, and transfer pricing issues are likely to increase even more with increasing economic integration. This is not only an issue of quantity, but also one of quality, since it is argued that the arm's length standard of uncontrolled prices is unsuitable within a highly-integrated economic area[48]. Nonetheless, the business community's position vis-à-vis formula apportionment is less obvious, since a formulaic sharing mechanism would nullify today's opportunities for profit-shifting (even though these could be replaced by factor-shifting,

[47] A further simplification effect could be derived from the orientation on the IFRS framework. Even though, no formal link between the IFRS and the tax accounting is planned, the determination of the tax base would correspond to the IFRS framework with which EU multinationals under the conditions of the IAS Regulation have to comply anyhow.

[48] *C. Spengel*, EU-Recht und Harmonisierung der Konzernbesteuerung in Europa, 36 Steuer und Wirtschaft 34, 48 et seq. (2006); *C. Spengel & C. Wendt*, A Common Consolidated Corporate Tax Base for Multinationals in the European Union. Some Issues and Options, Working paper 07/17, Oxford University Centre for Business Taxation, June 2007, p. 14; *Ed Kleinbard*, Throw Territorial Taxation From the Train, 46 Tax Notes International 63, 69-72 (April 2, 2007); *K. A. Clausing & R. Avi-Yonah*, *supra* note 3, at 8.

where the latter is more generous). Formula apportionment seems not to be as welcomed as the other features. The rent-maximising strategy of the business community becomes clear in the strong claim for optionality of the CCCTB, even where this thwarts the alleged desire for simplification.

b. The interest of the Member States

Optionality marks the culmination of the tension between the taxpayers' and the Member States' interests. This is because the project's further – and, from the viewpoint of the Member States' Finance Ministers, most important – goal of tackling tax competition will be jeopardised if the application of the CCCTB and the apportionment procedure is made elective. Hence, this will be a key issue in the political negotiation process.

Increasing the attractiveness of the European business environment by removing obstacles to cross-border activity and administrative difficulties could already be attractive enough by itself to convince the Member States to give up some of their sovereignty in tax matters. However, harmonisation of the tax base could counter the Member States' aims, since the pressure on tax rates might become even worse where tax bases are easier to compare. Transparency of the markets in general increases the pressure on prices[49].

Consolidation and cross-border loss offsetting seems just as unattractive from a Member State Finance Minister's perspective. *Fuest* et al. predicted a significant revenue loss where a common cross-border loss regime is adopted[50]. *Devereux* and *Loretz* pointed out that some of these effects might be temporarily attenuated once accumulated loss carry-forwards are absorbed, but asserted that there is a risk of an overall decrease to the corporate tax base[51]. Additionally, for large national economies, the common practice of almost all Member States to deny the offsetting of profits by foreign losses has been beneficial, in that foreign investors tend to prefer to use large Member States for the purpose of concentrating their investments in order to take advantage of

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49 *Claudio M. Radelli*, *supra* note 58, at 145, 151.

50 *C. Fuest & T. Hemmelgarn & F. Ramb*, *supra* note 39, at 605 et seq.

51 M. Devereux & S. Loretz, The Effect of EU Formula Apportionment on Corporate Tax Revenues, Oxford University Centre for Business Taxation, WP 0706 (http://users.ox.ac.uk/~mast1732/RePEc/pdf/WP0706.pdf), p. 28 et seq.

one economy in which to offset profits and losses[52]. This incentive to place investments in large economies - despite their generally higher tax rates - would be abandoned by the introduction of a general cross-border loss deduction.

Considering the Member States' budget concerns and the usually short-sighted political decision-making process, it seems unlikely that long-term economic welfare gains will convince the Member States to give up sovereignty. Therefore the only cogent reason why Member States might be willing to accept the self-restraint to their sovereignty is the hope that the CCCTB could stop or slow down tax rate competition[53]. Stabilisation of the tax base due to formula apportionment is particular crucial for all Member States with high tax rates. These presumably suffered most from profit-shifting in the past[54]. Furthermore, even though formula apportionment would not offset revenue losses, due to cross-border loss deduction, it would cushion the effects[55].

5. Likelihood of the unanimous adoption of a uniform CCCTB

However, the interest in combating profit-shifting naturally divides the Member States into two groups: Those subject to tax competition pressure and those who are the winners of profit-shifting. The not only divergent but to some extent directly-opposed interests of the Member States present significant obstacles to any compromise. Taking into consideration the extreme and after the Eastern enlargement grown differences in their relative economic development, it is hard to believe that all 27 Member States will be able to agree upon a directive that leaves no scope for alterations and contains one single apportionment formula. So far, Great Britain,

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[52] See *M. Gérard & J. M. Weiner*, Cross-border loss offset and formulary apportionment: How do they affect multinational firm investment spending and interjurisdictional tax competition, CESifo Working Paper No. 1004 (2003), p. 17.

[53] From a theoretical economic position this effect is highly questioned. See *Dietmar Wellisch*, Taxation under formula apportionment – tax competition, tax incidence, and the choice of apportionment factors, 60 Finanzarchiv 24 (2004). *R. Pethig & A. Wagner*, *supra* note 12, at 631 put these results into perspective regarding the characteristic of the chosen formula.

[54] Questioned by *Jack Mintz*, Corporate Tax Harmonization in Europe: It's all about Compliance, 11 International Tax and Public Finance, 221 (2004), who considers neither consolidation nor apportionment as a way out of tax competition. Instead he sees the most important reason in simplification.

[55] For example: The adoption of formula apportionment without cross-border loss offsetting would result in a surplus of 6% of the German corporate tax base. Combined with cross-border loss offsetting, the decrease to the corporate tax base would amount to "only" 17%, see *C. Fuest & T. Hemmelgarn & F. Ramb*, *supra* note 39, at 619.

Ireland and some of the Eastern European Members[56] have already openly given voice to their reluctance to surrender fiscal autonomy. Even though these Member States take part in the proceedings and have joined the working groups and meetings, in the end, it is very unlikely that they will assent.

Against this background is difficult to predict the political future of the CCCTB project. Even after the establishment of the Monetary Union, Member States have continued to defend their independence in tax politics vigorously as an inherent attribute of their sovereignty. The general willingness to make any concessions in this field or to transfer competencies to the EC level is extremely low, as shown by the negotiation of the to-date not yet adopted European Constitution, as well as the compromise Treaty of Lisbon of December, 12, 2007.[57] Furthermore, compared with the harmonisation achieved thus far in the field of direct taxation,[58] the adoption of the CCCTB is a huge step. The prior directives only modified features of international tax law (parent-subsidiary directive[59]; interest and royalty directive[60]) or forced the Member States to apply their domestic tax law equally to cross-border cases (merger directive[61]). The CCCTB project has a different quality, because it would change the applicable domestic tax law itself.

There are no legal means – except the above-discussed decisions of the ECJ – to compel the Member States to achieve mutual consent. Since the EC treaty does not provide a specific article for the harmonisation of direct taxes[62], tax harmonisation can be achieved only by way of the general harmonisation provision of Art. 94 of the EC-Treaty, subject to the precondition that regulations or provisions directly affect the establishment or functioning of the common market. One could argue that tax competition and excessive anti-avoidance measures leading to a distortion of cross-border activities give rise to the legal necessity of harmonisation. However, this is an academic question as long as the principle of unanimity impedes any headway.

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56 Especially Cyprus, Estonia, Lithuania, Latvia, Malta and Slovakia.

57 The new Art. 110-113 of the Treaty of Lisbon took over the Art. 90-93 of the Treaty of Amsterdam without any alterations.

58 For analysis from a political economy viewpoint see *Claudio M. Radelli*, The Political Economy of EU Direct Tax Policy, in Lymer/Salter (eds.), Contemporary Issues in Taxation Research, Aldershot 2000, p. 145 et seq.

59 Council Directive 90/435/EEC, *supra* note 4, p. 6

60 Council Directive 2003/49/EC, *supra* note 4, p. 49.

61 Council Directive 90/434/EEC, *supra* note 4.

62 See J. Englisch, The European Treaties' implications for direct taxes, 33 Intertax 310 (2005).

One of the easier tasks might be to agree upon basic common rules of the tax base. Many of these result in mere timing effects and would - over time - leave the Member States with the same revenue they are able to claim rights to today. However, even in the area of more technical norms, there will probably be a demand for alterations by the Member States. In 1977, when the Member States agreed on the harmonisation of the tax base for VAT, there were only 9 different parties at the table. In spite of this, the tax base for VAT is far from being totally uniform. The adoption of the 6th directive was only made possible by conceding to the Member States several options allowing for substantial deviation.

Cross-border loss offsetting and consolidation, as well as formula apportionment[63], in contrast, constitute the truly intricate questions. Undoubtedly these will produce shifts in today's revenue distribution on the grounds of separate entity accounting. Even though European Member States hardly have other options than collaboration, the likelihood of unanimous adoption ends up being near zero when one considers the most difficult part of the project - the adoption of a uniform apportionment formula. How could the Member States agree on that?

Recent studies on the effects of the introduction of formula apportionment show remarkable differences in revenue distribution relating to the factors selected[64]. Although it is untrue that formula apportionment necessarily cannot be designed according to the source principle,[65] it will be virtually impossible to design a formula which mirrors the status quo of the division of the tax base[66]. This cannot even be the goal of the efforts if formula apportionment is perceived as a means to correct for "unfair" revenue allocation due to profit-shifting under present separate entity accounting.

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63 *J. M. Weiner*, *supra* note 8 at 35: Reconciling the divergent interests of the Member States in defining an apportionment formula is one if the many challenging tasks facing the EU.

64 M. Devereux & S. Loretz, supra note 51; Clemens Fuest, et al. (2006), How would formula apportionment in the EU affect the distribution and the size of the corporate tax base? An analysis based on German multinationals. Discussion Paper Series 1, Economic Studies No. 20.

65 See *Peggy B. Musgrave*, Principles for Dividing the State Corporate Tax Base, in Cahrles E. McLure (ed.), The State Corporation Income Tax. Issues in Worldwide Unitary Combination, Stanford 1984, p. 228, 237 et seq.

66 *J. M. Weiner*, *supra* note 8, at 36; similarly considering implementation of formula apportionment in the NAFTA zone *P. R. McDaniel*, *supra* note 8, at 709. The Commission explicitly expressed that it is not the first goal of the formula's design to replicate today's revenue distribution. See Working Paper CCCTB\WP\060\doc\en, No. 8.

The inevitable revenue changes are already addressed as a transition problem by the CCCTB working groups,[67] and it is posited that these could be mitigated by adjustment payments over a limited period. Indeed, there is a strong need for a sophisticated system of transitional rules to forestall sudden revenue spikes and valleys. Furthermore, since behavioural changes due to the new system are only able to be predicted to a limited extent, there might be a need for adaptations of the formula[68]. If that can also only be achieved with the consent of all 27 Member States, it becomes even more unlikely that Member States will initially approve the implementation of a totally new system with an obvious need for subsequent ongoing amendments[69]. However, even the best instruments of transition will only help to avoid sudden extensive changes in tax revenues. The newly-designated allocation of revenue, however, will be permanent and is therefore not primarily a transitional phenomenon.

Moreover, formula apportionment has a redistributive effect in that a Member State will receive a share of the tax base, provided that a domestically-registered multinational's overall results are positive even if the business in that Member State's jurisdiction only produced losses. Member States which oppose any kind of revenue redistribution within the Community would most likely object to this insurance effect, highlighted by *Marcel Gérard* and *Joann Weiner*[70].

Thus, it is very unlikely that Member States will be able to look beyond their narrow (but legitimate) self-interests and to adopt a uniform formula apportionment system in favour of larger Community benefit[71]. On the other hand, if the matter of the sharing mechanism is factored out of the CCCTB project, there might no longer be a need to agree on a common tax base definition. Harmonisation of the determination of profits and the consolidation mechanism becomes inevitable only if Member States decide to adopt a formula apportionment system[72]. Consolidation would work even without harmonisation of the tax base, as the unilaterally-applied cross-border consolidation of Austria and Denmark proves.

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[67] Working Paper CCCTB\WP\060\doc\en, No. 68.

[68] See Working Paper CCCTB/WP/060, No. 68 suggesting a review after 5 years but without a procedural concept for needed adjustments.

[69] Which, as opposed to merely updating issues, can't be delegated to a simplified Comitology procedure because these are essential.

[70] *M. Gérard* & *J. M. Weiner*, *supra* note 52, at 20

[71] Similarly pessimistic regarding the chance of the US to reach uniformity *Kathryn L. Moore*, State and Local Taxation: When will the Congress Intervene?, 23 Journal of Legislation 171, 205 (1997).

[72] *J. Mintz* & *J. M. Weiner*, *supra* note 8, at 704.

Taking the divergent interests of the Member States into consideration a proposal of a CCCTB directive without sufficient room for domestic modifications could lead the whole project into a political trap, consequently rendering worthless the tremendous efforts expended to date. This raises the question of whether uniformity is an inevitable precondition for the success of whole project. To answer this question, I propose to analyse the US state corporate tax system as follows.

III. The US formula apportionment system as a compromise between states' sovereignty and uniformity

1. Main elements of the US states corporate tax system

Just like the European Member States, the US states enjoy far-reaching sovereignty in fiscal matters and are capable of levying taxes independent of those imposed federally[73]. Congress' theoretical power to set up binding guidelines has barely been exercised to date[74].

At present, 46 out of the 50 US states impose corporate income taxes. Tax rates vary between 4.00% and 12.00%, with some States offering lower tax rates for corporations with marginal profits. Given that State taxes are deductible against the federal corporation income tax, the effective burden of the state corporation income tax ranges between 0% in states which do not impose a corporate income tax at all and 7.8% (Iowa). In almost all states, income which is taxable at the federal level provides the starting point for the calculation of a corporation's total income[75]. None of the states has an entirely independent set of rules for its corporate income tax. Instead, the federal definition of the taxpayer, the tax base, as well as federal concepts of realisation, recognition, and principles of accounting are also relevant for state taxation. However, despite this basic dependency upon federal legislation, virtually all states modify the

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73 *M. D. Gelfand & J. A. Mintz & P. W. Salsich*, State and Local Taxation and Finance, 7. ed., St. Paul 2007, p. 4.

74 Except P.L. 86-272 providing a nexus of standards which, however, causes more distortions than it solves: See the critics of *Carles E. McLure*, The nuttiness of State and Local Taxes – and the Nuttiness of Responses Thereto, 25 State Tax Notes 841, 849 et seq. (September 16, 2002).

75 In detail *Richard D. Pomp & Oliver Oldmann*, State and Local Taxation, 5th ed., Hartford 2005, 10-1; *John C. Healy & Michael S. Schadewald*, 2007 Multistate Corporate Tax Guide, Chicago 2007, Vol. I, Part 3.

federal tax base to some extent, primarily to achieve economic development aims by means of tax incentives.[76]

Of peculiar interest from the viewpoint of the CCCTB project is the question of how the US states treat *inter-state business activities* and *multistate groups*. As a first step, the corporation's income is split into two categories: *business* and *non-business income*. The latter is defined as that which has not been generated in the regular course of the taxpayer's trade or business. Non-business income is usually allocated to particular states,[77] while business income is subject to formula apportionment.[78] Formula apportionment is used to identify which portion of business income may be taxed by a state, provided there is a "minimal connection" or "nexus" between the taxing state and the interstate activity.[79] The term "nexus" defines the state with an entitlement to tax. In contrast to the permanent establishment requirement used in the international context, the nexus concept does not require physical presence, but instead relies on a "doing business" type standard[80]. Public Law 86-272 provides a minimum common standard which prohibits states from taxing if a non-domiciled corporation's only in-state activities consist in the solicitation of orders[81]. In all other aspects, state legislation varies.

For corporate groups, the application of formula apportionment (as opposed to separate entity accounting) depends on whether the income of the group is consolidated (in US state tax parlance, the filing of a "combined return"). Again, one finds a wide variety of consolidation concepts. The only feature identically applied by all states is the so-called "water's edge limitation"[82]. After the highly controversial debate on California's worldwide combined reporting, all US states now limit the combined filings of multinationals to national corporations

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[76] In detail with a critique of their effectiveness *Walter Hellerstein & Dan T. Coenen*, Commerce Clause Restrains on State Business Development Incentives, 81 Cornell L. Rev. 789 (1996); *Peter D. Enrich*, Saving the States From Themselves: Commerce Clause Constrains on State Tax Incentives for Business, 110 Harv. L. Rev. 377 (1996).

[77] Usually to the state in which the property giving rise to the income is located.

[78] See in general on the methods to divide net income from multistate business *Paul J. Hartman & Charles A. Trost*, Federal Limitations on State and Local Taxation. 2d. ed., West 2003, § 10:16-19.

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

[80] See Quill. Corp. v. North Dakota, 504 U.S. 298, 317 (1992); Tax Comm'r of W. Va. v. MBNA, 640 S.E.2d 226, 232 (W.Va. 2006): No physical presence necessary for business and corporation net income taxes.

[81] The shortfalls of this law and the difficulties of defining "solicitation" became evident in Wisconsin Department of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992); See hereto *John C. Healy & Michael S. Schadewald*, *supra* note 75, at Vol. I, I-47-52.

[82] With some expansions to companies in listed tax haven, See Montana Code Annotated 15-31-322 Water's Edge election- inclusion of tax havens.

(water's edge)[83], even though in *Container Corporation of America* v. *Franchise Tax Board*, the Supreme Court held that worldwide combination is constitutional[84]. Apart from this, the variety among the states in the field of consolidation is immense[85]. Although consolidation is provided for at the federal level for affiliated corporations which meet the 80% common ownership threshold (voting rights and capital),[86] four states do not allow the filing of combined returns for state tax purposes at all. Instead, these require separate entity accounting. With respect to all other states, one must distinguish between the *option* to consolidate, which most states provide (*elective* consolidated returns), and *mandated* combined returns, which only a smaller group of states require if the entity belongs to a unitary business[87]. However, this number of States requiring *mandatory* combined returns is growing[88].

Similar to the consolidation requirements, the apportionment methods also differ. In comparison to Canada, where all provinces apply the same formula (which is equally based on sales and payroll[89]), US states apply an extensive variety of different apportionment formulae. Even though all states use formula apportionment, and the applied factors are limited to (1) property in state (2) salary in state (3) sales in state, the weight of the single factors varies significantly. Not only the components of the formulae deviate a great deal; the determination of the factors does as well. The variety is shown in this table:

[83] See to this only *Georg N. Carlson & Harvey Galper*, Water's Edge Versus Worldwide Unitary Combination, in Charles E. McLure (ed.), The State Corporation Income Tax, Stanford 1984, p. 1.

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

[85] Overview *J. M. Weiner*, Approaching an EU Common Consolidated Tax Base, 46 Tax Notes International 647, 651 (May 14, 2007); in detail *John C. Healy & Michael S. Schadewald*, *supra* note 75, at Vol. I, part 4.

[86] Which is reduced by most States which apply combined reporting to 50%.

[87] Defined by various tests like the "three unities test": Presence of the unities of ownership, operation and use, Butler Brothers v. McColgan, 17 Cal.2d 664, 664-678, 111 P.2d 334 (Cal. 1941) or the "contribution or dependency test", Edison California Stores v. McColgan, 30 Cal.2d 472, 481, 183 P.2d 16 (Cal. 1947); Multistate Tax Commission Test, MTC Reg. §IV.1.(b). Federal constitutional law sets up only a few limits upon the definition of the concept of "unitary business", see *Mobil Oil Corp.* v. *Commissioners of Taxes*, 445 U.S. 425, 440 (1980); to the differences between the consolidation conditions at the federal level and the governing "unitary business principle" at state level see *W. Hellerstein & Charles E. McLure*, *supra* note 8, at 93.

[88] *Michael Mazerov*, Growing Number of States Consider Combined Reporting, 30 State Tax Notes 335 (2007).

[89] To the Canadian apportionment system see *M. Daly*, Tax coordination and competition in Canada: some lessons for the European Union, in Report of the Committee of Independent Experts on Company Taxation (Ruding Report), *supra* note 7, Annex 9 A; *J. M. Weiner*, *supra* note 8, at 54-57.

STATE APPORTIONMENT OF CORPORATE INCOME[90]

(Formulas for tax year 2007 -- as of January 1, 2007)

ALABAMA	3 Factor	NEBRASKA	Sales
ALASKA	3 Factor	NEVADA	No State Income Tax
ARIZONA	60% Sales, 20% Property & Payroll	NEW HAMPSHIRE	Double wtd. Sales
		NEW JERSEY	Double wtd. Sales
ARKANSAS	Double wtd. Sales	NEW MEXICO *	Double wtd. sales
CALIFORNIA	Double wtd. Sales	NEW YORK	80% Sales, 10% Property & Payroll
COLORADO	3 Factor/Sales & Property		
CONNECTICUT	Double wtd. sales/Sales	NORTH CAROLINA *	Double wtd. sales
DELAWARE	3 Factor	NORTH DAKOTA *	3 Factor
FLORIDA	Double wtd. Sales	OHIO *	60% Sales, 20% Property & Payroll
GEORGIA	90% Sales, 5% Property & Payroll		
		OKLAHOMA	3 Factor
HAWAII *	3 Factor	OREGON *	Sales
IDAHO *	Double wtd. Sales	PENNSYLVANIA *	Triple wtd. sales
ILLINOIS *	Sales	RHODE ISLAND	Double wtd sales
INDIANA	60% Sales, 20% Property & Payroll	SOUTH CAROLINA	Double wtd. sales/Sales
		SOUTH DAKOTA	No State Income Tax
IOWA	Sales	TENNESSEE *	Double wtd. sales
KANSAS *	3 Factor	TEXAS	Sales
KENTUCKY *	Sales	UTAH *	3 Factor/Double wtd. sales
LOUISIANA	Double wtd. Sales	VERMONT	Double wtd. sales
MAINE *	Double wtd. Sales	VIRGINIA	Double wtd. sales
MARYLAND	Double wtd. sales/Sales	WASHINGTON	No State Income Tax
MASSACHUSETTS	Double wtd. sales/Sales	WEST VIRGINIA *	Double wtd. sales
MICHIGAN	92.5% Sales, 3.75% Property & Payroll	WISCONSIN	80% Sales, 10% Property & Payroll
MINNESOTA	78% Sales,11% Property & Payroll	WYOMING	No State Income Tax
		DIST. OF COLUMBIA	13 Factor
MISSISSIPPI	Accounting/3 Factor		
MISSOURI *	3 Factor/sales		
MONTANA *	3 Factor		

[90] Source: www.taxadmin.org/fta/rate/corp_app.html; further *Jerome R. Hellerstein & Walter Hellerstein,* State and Local Taxation: Cases and Materials, 8th ed., 2005, at 610.

Along with the general formula, most States also apply industry-specific formula[91].

2. Reasons for and problems of the lack of uniformity

a. Historical background

As argued, today's US state corporation income tax is far from being uniform. It never has been uniform, and it seems to be drifting even further apart in the recent past. Neither political wisdom, nor pressure from the business community, nor the case law of the Supreme Court has enabled US states to cooperate in the tax policy field to achieve uniformity. From the viewpoint of the harmonisation efforts in the European Union, this is fairly surprising. Why is it that the US states' corporation income tax policies differ so much? Even though Congress – which is not bound by unanimity requirements as are crucial for any harmonisation in the European Union – has the legal power to oblige the states to adopt uniform rules,[92] it has not exercised such power. Why not[93]?

This is explained in part by the history[94] of state taxation. Most US states had already adopted all kinds of taxes on business activities before the corporation income tax was introduced at the federal level. These state taxes were often imposed not on income, but on the privilege of incorporation, and were therefore calculated according to capital stock (franchise taxes) as opposed to net profits. After implementation of the federal corporate income tax in 1909, US states only turned gradually to the imposition of all kinds of taxes on corporate income.

The moment of greatest convergence was reached after the draft of the "Uniform Division of Income for Tax Purposes Act" (UDITPA) in 1957 and the establishment of the Multi-State Tax Compact in 1967 with the Multi-State Tax Commission (MTC) as its administrative body. This body, however, has no power to make laws, but works only by persuasion. The aim of the Multi-State Tax Compact is to "promote uniformity and compatibility in significant components of tax

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[91] *John C. Healy & Michael S. Schadewald*, *supra* note 75, at Vol. I, p. I-481.

[92] US Const. art. I, § 8, cl. 3: The Congress shall have the power to regulate commerce with foreign Nations, and among the several States, and with the Indian Tribes"

[93] For an empirical analysis of the rare and in the end abortive attempts to introduce at least limited uniformity in some areas see *Kathryn L. Moore*, *supra* note 71.

[94] *J. M. Weiner*, *supra* note 8, at 381 et seq.; *W. Hellerstein & Charles E. McLure*, *supra* note 8, at 90 et seq.; in general to the development of the State corporate income tax system *Edwin R. A. Seligman*, Essays in Taxation, 7th ed., New York 1911, p. 180 et seq.

systems"[95]. In part, it was a response which sought to preclude Congressional legislation as recommended in the Willis Committee Report,[96] promoting a uniform apportionment formula. The majority of the states have joined the Compact[97].

The UDITPA, which has been formally adopted by 21 states and which is duplicated in the statutory provisions of most other US states, contains common definitions and rules for the attribution and allocation of the income of interstate business activities. However, the adoption of the UDITPA does not limit state power to deviate from the UDITPA rules. States may follow the UDITPA only in part and may alter the UDITPA rules for their own purposes. Especially in the field of apportionment, the actual unification has turned out to be quite limited. The majority of the States followed the three-factor formula of equally weighed property, payroll and sales provided for in Sec. 9 of the UDITPA only for a short period. Over the years, the sales factor has been increased by many States.

Not only in formula design but also in the definition of the tax base, a trend to diversification is noticeable. States that piggyback upon the determination of corporate income in the federal corporate Income Tax Code suffered substantial revenue losses due to tax relief provisions adopted by Congress[98]. Hence, some states have decoupled their tax base definitions from that defined as the federal tax base in order to avoid negative revenue effects. At the same time, there is a long tradition of creating tax incentives at the state level in order to promote regional development policy aims.

Absent a common interest, there has never been a very strong movement by all US states to achieve uniformity. The *status quo* can be explained as the result of a development that has taken place over a long period one lacking in a commonly-defined direction. However, comparing the history of US corporate income tax with the situation in Canada, where the provinces introduced corporation income taxes even before the federal government did, and still abandoned great

95 See www.mtc.gov/Uniformity.aspx?id=472.

96 U.S. House of Representatives, Committee on the Judiciary, Special Subcommittee on State Taxation of Interstate Commerce; H.R. Rep. No. 1480, 88th Cong., 2d Sess. (1964); H.R. Reps. Nos. 565 and 952, 89th Cong. (1965).

97 See www.mtc.gov.

98 Especially because of increased depreciation adopted by the federal Job Creation and Worker Assistance Act of 2002 (Pub. L. No. 107-147); see *John C. Healy & Michael S. Schadewald*, *supra* note 75, at Vol. I, I-176; *Jerome R. Hellerstein & Walter Hellerstein, supra* note 90, at 436.

variety in favour of a generally uniform system, the reason for the piecemeal development over time in the US is less clear. Canadian provinces have been able to maintain uniformity of the apportionment formula over a long period of more than 30 years until now[99]. One possible reason for this may be that Canadian provincial corporation income tax rates – in 2007 ranging from 9.9 to 16% *without* deduction from the federal tax base – have been noticeably higher than state corporate tax rates in the US after in 1962, the Canadian federal corporation tax rate was reduced in order to grant the provinces more autonomy in setting provincial rate policy[100]. Double taxation due to overlapping formulae would therefore be responsible for much more harm[101]. On contrary, in the US, there might simply not have been enough money at stake to make it necessary or worthwhile for the states to agree collectively, or to result in the encroachment upon state sovereignty by Congress. However, *Jack Mintz* explains the development of a uniform formula in Canada as a fluke of history after World War II, which would probably no longer be reproducible,[102] and emphasises the difficulty in getting sovereign entities to agree on a common tax policy.

To return back to the initial question: why – if the disadvantages of the differences in US state corporate tax system are so striking – has no unification been possible, one must consider the potential actors in such a process. The business community might be unified in promoting simplification. However, it would also lose the advantages of exploiting the differences in state tax systems to escape or minimise taxation. Given these opportunities, even the contrasting problem of double taxation in the event of overlapping formulae seems less relevant, because in most cases, it is manageable by factor planning. The US states – like European Member States – have divergent interests, considering the differences in their economies. This makes it almost impossible to establish a common denominator. Only very recently, when confronted with a decrease in their corporate tax revenues and the limited effect of piecemeal legislation directed against profit-shifting, has a common interest appeared to emerge in favour of adopting

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99 See *M. Daly*, *supra* note 89, at 384 et seq.

100 See *M. Daly*, *supra* note 89, at 385.

101 So would rate differentials. However *Jack Mintz*, *supra* note 54, 229, mentions that even when the rate differences where higher because of Quebec's low rate of only 5%, there was little pressure on the other provinces to lower their tax rates.

102 *Jack Mintz*, *supra* note 54, at 227.

mandatory combined reporting instead of a case-by-case approach to nullify tax planning strategies[103].

b. Constitutional framework

In the absence of binding requirements at the federal level or binding multi-state treaties, US state power to delineate corporation income taxes is only limited by the US Federal Constitution and the States' own Constitutions. Presenting some similarities to the fundamental freedoms of the EC Treaty,[104] the equal protection clauses provided for in most State Constitutions[105] and the US Constitution,[106] as well as the (dormant) commerce clause and the due process clause, prevent US states from discriminating against inter-state business and limit their taxing jurisdiction. Using these grounds, in *Complete Auto Transit, Inc.* v. *Brady*,[107] the US Supreme Court developed a four-prong test to which every state corporation income tax is subject. A state tax is not prohibited under the commerce clause, if it (1.) applies to an activity with a substantial nexus to the taxing state, (2.) is fairly apportioned, (3.) does not discriminate against interstate commerce, and (4.) is fairly related to the services provided by the state.

Nonetheless, by virtue of the judicial self-restraint of the Supreme Court,[108] US states remain fairly free. The core restriction resulting from the due process and commerce clauses is that a US state may only tax profits if that state contributed in a reasonable way to their generation[109]. Apart from this, the Supreme Court reads the commerce clause in a narrow way, giving only

[103] *M. Mazerov*, *supra* note 88, at *335 et seq*.

[104] In contrast, see *Ruth Mason*, A Theory of Tax Discrimination, Jean Monnet Working Paper 09/2006.

[105] See *M. D. Gelfand & J. A. Mintz & P. W. Salsich*, *supra* note 73, at 8-44; and in greater detail *Jerome R. Hellerstein & Walter Hellerstein*, *supra* note 90, p. 34 *et seq*.

[106] "Similar persons or objects must be taxed in a similar manner". Using this ground, the Supreme Court e.g. invalidated a higher tax on out-of-state insurance companies: *Metropolitan Life Insurance Co.* v. *Ward*, 470 U.S. 869 (1985). However, see: *Stephen W. Mazza and Tracy A. Kaye*, Restricting the Legislative Power of Tax in the United States, 54 American Journal of Comparative Law 641 (2006), indicate that constitutional law has played a relatively minor role in the development of tax law in the United States.

[107] 430 U. S. 274 (1977). However, *Stephen W. Mazza and Tracy A. Kaye*, supra note 106.

[108] Explicitly see e.g. *Moorman MFG Co.* v. *Bair*, 437 U.S. 267, 279 et seq. (1978).

[109] See *Moorman MFG Co.* v. *Bair*, *supra* at note 108, where the Court developed two basic due process requirements for a tax on interstate business: (1.) there must be some minimal connection between the activities being taxed and the taxing state, (2.) the measure must be rationally related to "values connected with the taxing state"; similar: *Container Corporation of America* v. *Franchise Tax Bd.*, *supra* at note 79; *Quill Corp.* v. *North Dakota*, *supra* at note 80.

little guidance to the design of the apportionment system. In particular, the principle of fair apportionment does not encourage the individual states to apply a uniform formula. Double taxation or non-taxation arising from the application of different formula is not generally considered to be discriminatory[110] or a violation of the principle of fair apportionment. In *Container Corp. of America* v. *Franchise Tax Bd.*[111] the Supreme Court upheld an apportionment formula as fair, provided it is both internally and externally consistent. This test is fulfilled if the formula (1) would be applied by every jurisdiction, resulting in no more than all of the unitary business' income being taxed (internal consistency) and (2) would reflect a reasonable sense of how that income is generated (external consistency). Thus, the fairness of the apportionment is judged only from the perspective of the state applying a specific formula. Interplay with other states' formulae is disregarded. The Court refuses to take into consideration the other state's tax regime[112].

Furthermore, the Court does not strike down incentives which favour in-state over out-of-state activities (e.g. credits for a production plant in a certain state), if the provision does not implicate the coercive power of the state at the same time[113]. Hence, tax incentives which do not exempt taxpayers from existing tax liabilities on the grounds of undertaking in-state or out-of-state business, but which are aimed at attracting new business to the state by exempting it from initial tax liability, are not considered to be discriminatory.[114] Nor does any explicit restriction (such as the State Aid provision contained in Art. 87 EC Treaty) exist.

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[110] *Kathryn L. Moore*, *supra* at note 71, at 174; *W. Hellerstein*, Some Reflections on the State Taxation of Nonresident's Personal Income, 72 Mich. L. Rev. 1309, 1310 (1972); *John C. Healy & Michael S. Schadewald*, *supra* at note 75, at Vol. I, p. I-469.

[111] 463 U.S. 159 (1983).

[112] *Walter Hellerstein & Dan T. Coenen*, *supra* note 76, at 807; in depth on the double taxation issue: *Georg W. Kofler & Ruth Mason*, Double Taxation: A European Switch in Time?, 14 Colum. J. Eur. L. 1 (2007).

[113] See the analysis of *Walter Hellerstein & Dan T. Coenen*, *supra* note 112, at 806 *et seq*.

[114] Questioned in *Cuno* v. *DaimlerChrysler, Inc.*, 386 F.3d 738 (6th Cir. 2004) dealing with an investment credit; see for critical analysis *Jerome R. Hellerstein & Walter Hellerstein, supra* note 90, at 288; rejected for procedural reasons by the Supreme Court in *DaimlerChrysler, Inc.* v. *Cuno*, 126 S.Ct. 1854 (2006).

c. Distortions, discrimination, complexity and competition as the result of the lack of uniformity

The described lack of uniformity poses the question of how state differences affect the functioning of the state corporate tax systems.

First of all, it is obvious that the differences add tremendous complexity to the taxation of corporations, making state tax planning a cost-intensive task for businesses engaged in more than one state.

Second, considering that the main motivation for the EU Member States to agree upon the Commission's CCCTB proposal is to reduce tax competition and profit-shifting, it is insightful to analyse if there is – given the higher degree of harmonisation than in Europe, but the lack of uniformity – still significant tax competition among US states. Not bound by any federal framework other than loose constitutional guidance, US states are as free as the European Member States to compete for the mobile corporate tax base and there is evidence that they do so. US states widely exploit their sovereignty to attract investments employing beggar-thy-neighbour-strategies. Even though tax rates on average did not change substantially over the years, in spite of a growth in GDP, state corporate tax revenue has been declining constantly since the mid-1980s[115]. The widespread state tax system allows for diversification in order to reduce the burden on mobile sources by moving to more stable sources[116]. This explains the growing importance of sales taxes in the US,[117] similar to the rise in significance of VAT for European Member States.

[115] In general, a significant growth in state tax revenues must be noted: Overall revenues rose from $ 8 billion in 1950 to $ 370 billion in 1990 and $ 581 billion in 2004. To date, individual income taxes and sales taxes are the major sources of tax revenue (33%), while the share occupied by corporation income tax declined in recent years from its peak in the 1980s of nearly 10% to little more than half the figure of 1980; see: *Jerome R. Hellerstein & Walter Hellerstein*, *supra* note 90, at 39. For explanations, see: *M. Mazerov*, State Corporate Tax Disclosure: The Next Step in Corporate Tax Reform, 30 State Tax Notes, 765, 767-770 (March 19, 2007); *William F. Fox & Luna LeAnn*, State Corporate Tax Revenue Trends: Causes and Possible Solutions, 55 National Tax Journal, 491 (2002); *Richard D. Pomp & Oliver Oldmann*, *supra* note 75, at 10-2, who also give as a further reason the growing number of LLCs and LLPs (flow-through entities), which have been permitted in all states.

[116] *M. D. Gelfand & J. A. Mintz & P. W. Salsich*, *supra* note 73, at 2.

[117] See *Jerome R. Hellerstein & Walter Hellerstein, supra* note 90, at 6, Table 3.

Fox and *LeAnn*[118] advance two major reasons – other than short-term cyclical effects and reflections of changes in the federal tax base – for the decrease of state corporate tax revenue: First, state tax legislators have deliberately narrowed the corporate tax base by implementing of new tax incentives, even though this policy has been constantly criticised because of its ineffectiveness, distortional effects and potential conflicts with the commerce clause[119]. Second, taxpayers have increased their participation in tax evasion strategies[120].

Despite the questionable economic rationale, the main reason why US states compete with one another by offering tax incentives than reductions of tax rates might be that for business interest groups, lobbying efforts for specific tax incentives have been quite successful. These are also less visible (and thus less politically-sensitive) than a general rate reduction, which would benefit competitors as well. Tax incentives are not only built directly into the tax statutes (as investment and employment tax credits or property tax abatements), but also offered in the form of discretionary concessions to attract new business activity ("targeted new-business subsidies")[121].

Those US states which do not impose corporate income taxes at all, such as Nevada, serve as natural tax havens. Other states have enacted special exemptions, like Delaware's tax shelter for holding or passive investment companies (PIC). Under this scheme, corporations with activities limited to owning and collecting income from intangibles are tax-exempt, which unsurprisingly channels remarkable income flows to Delaware out of other States[122]. Although the Supreme Court accentuated the principle of fairness in the context of nexus and apportionment, it apparently did not develop a concept of unfair versus fair tax competition regarding beggar-thy-neighbour-strategies of the states[123] as this is applied in the European Union within the state aid provisions of Art. 87 of the EC Treaty and the Code of Conduct.[124]

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118 *William F. Fox & Luna LeAnn*, *supra* note 115, at 498 *et seq*.

119 See *supra* note 76 and *Carles E. McLure*, *supra* note 74, at 853-854: "Nutty response to nutty tax policy".

120 In particular see *M. Mazerov*, *supra* note 115, at 767 *et seq*.

121 *Walter Hellerstein & Dan T. Coenen*, *supra* note 113, at 849 *et seq*., do not wish to make any difference between "ordinary business subsidies" and "targeted new-business subsidies"; overview on actual state practice: *John C. Healy & Michael S. Schadewald*, *supra* note 75, Vol. I, part. 8.

122 *Michael Mazerov*, *supra* note 88, at 337.

123 As *Ruth Mason*, *supra* note 104, at 10 with footnote 39, indicates, there are no restrictions comparable to Art. 87 of the EC Treaty.

124 See *supra* note 15.

Similar to EU Member States, US states seek to defend against the competitive strategies of their neighbours by adopting claw-back provisions. These deny the deduction of interest or royalty payments to other states.[125] This strategy is restricted in Europe through the anti-discrimination jurisdiction of the ECJ[126]. Interestingly enough, piecemeal defence measures against other states' tax incentives were also challenged very recently in the US as being discriminatory against interstate commerce[127]. Although the Supreme Court has not yet decided on this question, in commentary, such provisions have been held to be unreasonable if they are not exclusively directed against "sham"[128] constructions. This sounds familiar to the reasoning given by the ECJ in the *Cadbury Schweppes* case[129].

Furthermore, US states compete in the composition of their apportionment formula[130]. Formula design is used as an inducement to in-state producers by raising the sales factor over other factors[131]. Destination-based sales factors lower the tax base of producers who sell less than they produce in a state; tax conditions for exporting businesses are thereby eased. At the same time, the trend to sales-based formulae can be perceived as a countervailing reaction to factor planning. The amount of sales represents a factor which - compared with property and payroll - is less sensitive to shifting[132], although this depends to some extent on the definition of the sales' destination. Low factors on property, on the other hand, give an incentive to move these highly-mobile factors into a state. Lowering the payroll factor might increase employment[133]. In spite of the strong recent tendency toward sales-based formulae, *Anand* and *Sansing* have shown that states do not all have the same interests; indeed, these conflict. In a non-cooperative setting, not

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[125] *John C. Healy & Michael S. Schadewald*, *supra* note 75, at Vol. I, p. I-211; *Michael Mazerov*, *supra* note 88, at 337.

[126] See the decisions on thin capitalisation, *supra* note 29.

[127] *Michael Mazerov*, *supra* note 88, 338.

[128] See *Matthew S. Houser & Christopher R. Grissom & Bruce P. Ely*, Alabama Judge Rules for Jeans Manufacturer in Addback Case, 30 State Tax Notes 288 (Feb. 5, 2007).

[129] See *Cadbury Schweppes*, *supra* note 21, para 51 *et seq*.

[130] *J. M. Weiner*, *supra* note 8, at 36; analysis of the pattern of formula competition by *Bharat N. Anand & Richard Sansing*, The Weighting Game: Formula Apportionment as an Instrument of Public Policy, 53 National Tax Journal, 183, 187 *et seq*. (2000).

[131] *William F. Fox & Luna LeAnn*, *supra* note 115, at 499 et seq.; *Kirk J. Stark*, The Quiet Revolution In U.S. Subnational Corporate Income Taxation, 23 State Tax Notes 775, 781 (March 4, 2002).

[132] *Kirk J. Stark*, supra note 131, at 783; *R. D. Pomp*, supra note 8, at 812 states that none of the states' apportionment formulae are based on economic principles; instead, these are a political compromise between the states of production and the market states.

[133] See the evidence of state employment data: *Austan Goolsbee & Edward L. Maydew*, Coveting thy neighbor's manufacturing: the dilemma of state income apportionment, 75 Journal of Public Economics, 125 (2000).

all states have incentives to increase the sales factor. Natural resource export states will tend to increase their production factors instead of sales[134].

States utilise the apportionment formula even though the negative effects of the application of different formulae are striking[135]. The application of different formulae causes deadweight losses[136] and distorts investors' decisions, resulting either in under-taxation or over-taxation[137]. The move to a pure sales formula by some states leaves corporate profits untaxed to the extent that sales are performed in a state in which the business has no nexus (so called "no-where income")[138]. This leads to a decrease in the overall tax revenue of the states' corporation income tax. On the other hand, double taxation occurs if more than 100% of the corporation's income is apportioned. Such double taxation arising from overlapping formulae is not systematically mitigated by credits in the state statutes, nor does the UDITPA provide reliable relief. Applying only to extreme situations, Sec. 18 of the UDITPA contains an opening clause stating that either the taxpayer or the tax authorities may claim either application of separate accounting, a change in the factors the apportionment was based on, or application of any other method that will result in an equitable allocation and apportionment of the taxpayer's income[139]. It is incumbent upon the taxpayer to demonstrate with clear and convincing evidence that the applied apportionment formula grossly misrepresents the amount of income actually earned in that state; an effort which corporations in the past usually failed to demonstrate[140]. In contrast, to prevent non-taxation, numerous states apply rules that reapply state taxation in cases where tax would be avoided altogether (so-called 'throw-back' rules)[141] to avoid non-taxation where the taxpayer has no

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[134] *Bharat N. Anand & Richard Sansing*, *supra* note 130, at 193.

[135] See critics e.g. by *P. R. McDaniel*, *supra* note 8, at 707.

[136] *Bharat N. Anand & Richard Sansing*, *supra* note 130.

[137] See: *General Motors Corp.* v. *District of Columbia*, 380 U.S. 553, 561 (1965); for examples see *J. M. Weiner*, *supra* note 8, at 35.

[138] *Peter Fisher*, Tax Incentives and the Disappearing State Corporate Income Tax, 23 State Tax Notes 767 (March 4, 2002); *R. D. Pomp*, The Future of the State Corporate Income Tax: Reflections (and Confessions) of a Tax Lawyer; in David Brunori (ed.), The Future of State Taxation, Washington 1998, p. 49, has estimated a revenue loss of $ 500 million.

[139] *John C. Healy & Michael S. Schadewald*, *supra* note 75, Vol. I, p. I-469.

[140] *Hans Rees' Sons, Inc.* v. *North Carolina*, 283 U.S. 123 (1991); *Moorman MFG Co.* v. *Bair*, *supra* note 108; *Container Corporation of America* v. *Franchise Tax Bd.*, *supra* note 109; *Unisys Corp.* v. *Pa Bd. of Fin. and Rev.*, 812 A2d 448 (Pa. Sup. Ct. 2002); *Colgate-Palmolive Company, Inc.* v. *Bower* (No. 01 L 50195, III. Cir. Ct., Cook Cty., Oct. 15, 2002).

[141] Controversially discussed, see pro: *Michael Mazerov*, Closing Three Common Corporate Income Tax Loopholes Could Raise Additional Revenue for Many States, 24 State Tax Notes 421 (2002); against: *William F. Fox & Luna LeAnn*, supra note 115, at 505 *et seq.*; *William F. Fox & Matthew N. Murray & Luna LeAnn*, How

nexus in the state of the destination of sales. In that case, the right to tax goes back to the home state of the business.

Differences in state tax structures do not only result in the abrogation of neutrality and distortions, but also offer chances for tax planning.[142] Factor-shifting, which would allow the taxpayer to alter the tax burden under a uniform formula apportionment system, also results in greater effects if taxpayers manage to play on the differences of the formulae. To the extent that not all states apply the same formula, the variety of applied factors renders opportunities for taxpayers to avoid taxes by formula planning. Additionally, the unclear and negotiable nexus concept of US state corporate tax laws allows tax avoidance in creating nowhere-income to the extent no throw-back rule applies[143]. Finally, tax planning opportunities arise from the variety of rules applicable concerning groups and the treatment of unitary businesses. In particular, the eligibility of combined returns allows groups to take advantage of the differences in the systems. This effect explains the trend of several states to move toward more mandatory schemes.

To sum up: While there is little rate competition, US states compete by granting tax incentives and concessions and by the composition of their apportionment formulae. Further tax planning opportunities stem from special features of the highly intricate state tax systems. This is true for the nexus concept, the distinction between business and non-business income and the unitary business principle. Furthermore, the optionality of combined returns facilitates cherry-picking[144].

d. The Claim for Uniformity in US literature

These findings raise questions with respect to harmonisation initiatives in the US and about the appraisal of tax policy scholars.

In Europe - both in politics and also in legal and economic commentary - the case for harmonisation is still heavily disputed. There are strong advocates of regulatory competition,

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Should a Subnational Corporate Income Tax on Multistate Business Be Structured, 58 National Tax Journal 139, 154 et seq. (2005).

[142] *William F. Fox & Matthew N & Murray & Luna LeAnn*, *supra* note 141, 156 (2005).

[143] *William F. Fox & Luna LeAnn*, *supra* note 115, at 502.

[144] *William F. Fox & Luna LeAnn*, supra note 115, at 503; *William F. Fox & Matthew N. Murray & Luna LeAnn*, supra note 141, at 156.

directly or indirectly alluding to *Friedrich A. Hayek*'s theory of competition as a fundamental principle of evolution and discovery[145]. These advocates fear that harmonisation of business taxation will abandon the flexibility of the single Member States to pursue their own fiscal policy. This fear has some validity, if - after harmonisation - any adjustment of the system will require the necessity of unanimous decisions.

Quite differently, in US commentary, there is a strong demand for the uniformity of state corporate tax laws[146]. Most authors value the welfare gains from uniformity higher than the sovereignty of the states and the presumed efficiency gains due to of the competition among these[147]. Scrutinising the reasons for the decline of the State corporate tax revenue, US authors propose to alter the structures - at a minimum - as follows:[148] States should refrain from the practice of undermining the tax base by offering tax credits and concessions. Additionally, they should close existing loopholes, particularly by making combined reporting mandatory. The claim for a uniform apportionment system is almost undisputed. Hence, US authors who draw conclusions from the US states' taxation systems with respect to the developments in Europe unanimously advise against copying the "chaos" of state taxation[149].

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[145] *F. A. v. Hayek*, Der Wettbewerb als Entdeckungsverfahren (1968), in M. Streit (ed.), Friedrich August von Hayek: Rechtsordnung und Handelnsordnung. Aufsätze zur Ordnungsökonomik, Tübingen 2003; s. auch *F. Steibert*, Der Einfluss des Europäischen Rechts auf die Unternehmensbesteuerung, Frankfurt a.M. 2002, p. 26; see also the Tiebout Model of regulatory competition *C. Tiebout*, A PureTheory of Local Expenditure, 64 Journal of Political Economy 416 (1956).

[146] See *D. Shaviro*, *supra* note 10, at 976 *et seq*.; *Carles E. McLure*, *supra* note 74, at 849; *Kathryn L. Moore*, *supra* note 71, at 179-182; *Gordon D. Henderson*, What We Can Do About What's Wrong With the Tax Law, 49 Tax Notes 1349, 1352 (1990); *Charles E. McLure*, Towards Uniformity in Interstate Taxation, in Charles E. McLure (ed.), Economic Perspectives on State Taxation of Multi-Jurisdictional Corporations, Arlington 1987, p.123; *Jerome R. Hellerstein*, State Taxation of Interstate Business: The Times Has Come For Uniformity, 16 Journal of Taxation 246 (1962); *Donald K. Barnes*, Prerequisites of a Federal Statute Regulating State Taxation of Interstate Commerce, 46 Va. L. Rev. 1269, 1271 (1960);*Walter Hellerstein*, Book Review, Federalism in Taxation: The Case for Greater Uniformity, 47 National Tax Journal 225 (1994).

[147] *D. Shaviro*, *supra* note 10, at 959 et seq.

[148] *William F. Fox & Luna LeAnn*, supra note 115, at 503 *et seq*.; *Michael Mazerov*, *supra* note 88.

[149] "Chaos to be avoided", see *Charles E. McLure; J. M. Weiner*, *supra* note 1.

IV. Adoption of CCCTB and Formula Apportionment open to alterations by the Member States?

1. Political Options for the EU

However, the introduction of a uniform CCCTB in near future is theory. Due to the consistent opposition of some Member States and the recalcitrant attitude of others,[150] it is very unlikely that the requirement of unanimity will be reached. In pursuing its efforts, the Commission might believe in the persuasive potential of the project to overcome this opposition, but it also relies on the possibility of enhanced cooperation[151]. In the following, I will show that enhanced cooperation is neither a satisfying solution, nor does it seem especially likely. This leads to the question of whether surrendering the to-date followed path of full uniformity would be more feasible and could help to obtain the participation of more - if not all - Member States.

2. Enhanced Cooperation as a solution?

At least 10 Member States, among them traditionally high-tax countries like Germany and France, explicitly support the harmonisation plans. This would be a number large enough to enact the CCCTB with enhanced cooperation. The procedure of enhanced cooperation, regulated by Art. 43-47 of the EC Treaty, facilitates a group of at least 8 Member States to access the support of the Commission in adopting a common policy, if the Commission has failed to obtain the acceptance of all Member States. Enhanced cooperation serves as an *ultima ratio* back-slide position. Furthermore, the enhanced cooperation must not lead to a discrimination of taxpayers in the non-participating Member States[152].

Is it likely to happen? Even though a sufficiently large group expressed its interest in the CCCTB project, the likelihood of adoption by means of enhanced cooperation depends upon the question of whether an initiative by a smaller group will be viable to achieve the ultimate expectations

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[150] See *supra* II.5.

[151] See European Commission Press Release IP/05/1352 of 26/10/2005; COM(2005) 532 (final): The Contribution of Taxation and Customs Policies to the Lisbon Strategy of 25 October 2005; and at length *Luca Cerioni*, The Possible Introduction of Common Consolidated Base Taxation via Enhanced Cooperation: Some Open Issues, 46 European Taxation 187 (2006).

[152] Art. 43 lit. f EC Treaty; denied by *Luca Ceroni, supra* note 151, at 191 et seq.

which Member States attach to harmonisation. Furthermore, expressing support to a harmonisation proposal still somewhat in the vague is something totally different compared to a commitment to substantial revenue shifts and the acceptance of the – at least temporary – decrease of the tax base due to consolidation and formula apportionment.

And the effects will be huge. *Devereux* and *Loretz* have analysed the revenue effects if only the six founding Member States (Germany, France, Italy, Belgium, Luxembourg and the Netherlands) and Austria and Denmark, which already unilaterally allow consolidation of cross-border groups, would join the CCCTB[153]. Although the choice of apportionment factors becomes less important[154], even in this limited group of participating countries with similar economic conditions, the effects change substantially according to the actual design of the CCCTB. For example: Under an obligatory system, the total tax revenue would remain almost unchanged, but the distribution among the participants would be uneven. Belgium, Germany and Italy would be winners, while smaller countries like Luxembourg and - in particular - the Netherlands would suffer a substantial revenue loss. If consolidation and application of formula apportionment were voluntary, however, the results would change: Now Germany and Italy would lose, while the Netherlands would win. These distributional effects suggest that achieving a consensus of only a minority of the Member States under the umbrella of enhanced cooperation will be also extremely difficult.

An even more important impediment is that stopping profit-shifting and limiting tax competition especially requires the consent of today's winners of the tax competition battle, which have already expressed their lack of intent to collaborate. To curb tax competition, the interaction and cooperation of all Member States is required. Where only one state is reluctant to cooperate, this defeats all of the efforts undertaken. The main inducement for why the above-mentioned (high-tax) Member States could nevertheless come together is the removal of obstacles to cross-border business and the reduction of administrative burdens and compliance costs. The project then, especially – if designed as elective – would turn out to initially be in favour of the business

[153] *M. Devereux & S. Loretz*, *supra* note 51, at 26-28.
[154] *M. Devereux & S. Loretz*, *supra* note 51, at 26.

community[155], but would no longer be an answer to the threat of tax competition from a treasurers' viewpoint.

However, being the first movers under enhanced cooperation bears the risk that those Member States which are not willing to agree on the full package of CCCTB and formula apportionment could still decide to incorporate only the common tax base into their domestic laws to share the attractiveness of simplification, without bearing the risk of revenue losses from formula apportionment. They could even grant the cross-border loss offset unilaterally, as Austria already does. Their defeat of the directive would not hinder them from doing so. Or, from the reverse perspective, for these Member States, there is no need for becoming involved in participating in the Commission's initiative.

This might be a pessimistic approach, but enhanced cooperation seems to also be unlikely, though I would be happy to be mistaken in this point.

3. Common guidelines instead of uniformity?

4. From a theoretical perspective, there is no doubt that Member States should adopt a uniform common tax base and the same apportionment formula[156] to avoid the partial double or non-taxation occurring where different formulae are applied. Uniformity is the first-best solution. In these terms, the Canadian provincial corporate income tax system is clearly superior to the chaotic US system, even though the Canadian system is not absolutely uniform. However – in spite of the US system being suboptimal – no serious arguments are raised to replace the formula apportionment system with a completely different method. Despite all concern with regard to the malfunctioning of the states' formula apportionment system, the alternative of separate accounting and base attribution by way of transfer pricing rules is not a realistic choice for highly-integrated economies. The Canadian provinces and the US states developed formula

[155] See the strong advocacy for optionality by BusinessEurope (formerly UNICE), *Andersson*, An Optional Common Consolidated Corporate Tax Base for the European Union, in Andersson/Eberhartinger/Oxelheim (eds.), National Tax Policy in Europe. To Be or Not to Be?, Heidelberg 2007, p. 85, 95.

[156] *J. M. Weiner*, *supra* note 8, at 37.

apportionment at the same time on the basis of sound reasons, while at the international level separate accounting became the rule of income attribution.

However, since only some of the opposition of the Member States may be due to a general averseness toward any kind of harmonisation, there might be other Member States which agree with the necessity of the CCCTB in general, but find single features objectionable. This would lead to these - in the end - not approving of the directive. In this situation, the concept of full uniformity that the Commission follows to date will make it unnecessarily difficult to achieve the final step of unanimous adoption. To some extent, the permission to deviate from it can help facilitate adoption of the agreement. This is hardly a new approach. As previously mentioned, consensus to adoption of the VAT Directive was made possible by introducing numerous opening clauses[157]. The Parent-Subsidiary Directive[158] and the Savings Directive[159] took a more restrictive approach in allowing specified Member States to depart from the general rules for a limited transitional period.

Another important advantage to an approach containing binding standards, but without demanding full uniformity is that Member States remain flexible to some extent to smooth away faults and to adjust the CCCTB system to their individual needs. This is especially important in the period immediately after the introduction of the CCCTB[160]. Otherwise those Member States whose expectations are not met would face the problem to once again reconvene all 27 Member States.

The experience in the US and Canada teaches us that each of the elements of the CCCTB discussed can be viewed separately[161]. Despite that for optimal functioning, ultimate adoption of the 'full package' is necessary, the examples of Austria and Denmark – both of which

157 See Title XIII. of the Council Directive 2006/112/EC of 28/11/2006 on the common system of value added tax, OJ 2006, No. L 347, p. 1.

158 Preamble of the Council Directive 90/435/EEC of 23/7/1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ 1990, No. L 225, p. 6.

159 See Art. 11 para 5 of the Council Directive 2003/48/EC of 6/3/2003 on taxation of income from savings, OJ 2003, No. L 157, p. 38.

160 Commission tries to solve the problem of adaption by the Comitology process CCCTB/WP/57 (final), No. 8. In order to allow the base to be adapted and kept up to date more easily, it would be wise to make provision in the Directive for some of its more detailed rules to be modified under the Comitology procedure. This would be in addition to providing for more detailed implementation rules to be finalized under that procedure.

161 Also M. Gérard & J. M. Weiner, supra note 52, at 18 point out the difficulties of the discussion of different elements with sometimes contrary effects.

unilaterally apply consolidation to foreign subsidiaries[162] – show that even harmonisation of the tax base is not an inevitable requirement for cross-border consolidation. Formula apportionment can also be adopted without cross-border consolidation, as the Canadian example shows: Provinces – following the rules of federal corporate income tax – do not allow the filing of combined returns. Finally, the example of the US, in which more than half of the States do not mandate combined reporting for unitary businesses, shows that even the coexistence of formula apportionment and separate entity accounting is possible.

The adoption of common guidelines could keep "the chaos" organised. Guidelines setting up a certain range in which the Member States could operate would avoid differences from growing again over time. Furthermore, the number of features where Member States can diverge should be limited to avoid the difficulties that occur in the US system because of the states' vast array of differences. For example, it should be provided that no distinction between business and non-business income is made and the 'nexus' should be defined uniformly by the already commonly-used permanent establishment concept[163]. Finally, differences arising due to different definitions of the apportionment factors should be avoided[164].

Technically opening clauses should be explicitly provided for in the directive. Though the form of an EU directive instead of an EU regulative by itself allows already some flexibility because Member States are not hindered from offering a more favourable treatment than contained in the directive, explicit opening clauses are necessary to undergo the directive's standards. Furthermore they can give some guidance for the design of the deviating measures.

In the following, I touch on some of the issues arising in a not fully-uniform system without intending to be exhaustive.

[162] See *Dieter Endres et al.* (eds.), The Determination of Corporate Taxable Income in the EU Member States, Kluwer 2007, p. 746.

[163] Not yet finally decided, see Working Paper CCCTB\WP\056\doc\en, No. 38-40, but see also executive summary to Working Paper CCCTB\WP\060\doc\en with preference for a permanent establishment requirement.

[164] See *Carles E. McLure*, *supra* note 74, at 850 stressing the importance of avoiding such "small" differences.

5. Possible national alterations of the main elements of the CCCTB Project

a. The tax base

Even though today's national GAAPs vary to a great extent, the mere technical questions of the common determination of the profits might be the easiest part to agree upon. Nonetheless, the definition of non-deductible items, anti-avoidance rules, as well as provisions with an incentive character such as depreciation rules have the potential to become points of debate. Just like the US states, most Member States have a long tradition of utilising depreciation rules as instruments of economic development policies to encourage investments. These Member States will probably see to retain some sovereignty over this field. Hence, even though the Commission has stressed the importance of uniformity of the tax base for purposes of cross-border consolidation and apportionment, it has already admitted that some space in this field must be conceded for national legislation. However, the Commission Services came out in favour of only permitting deviations from the Common Tax Base as incentives where these take the form of tax credits. Such credits can be offset against the Member States tax liability only *after* apportionment[165]. In doing so, the budgetary effects can be limited to the granting Member State and not spread out to all participating States by the apportionment mechanism. Whether a common framework for such incentives should be adopted has not yet been decided.

The risk of Member States making extensive use of such an opening clause is limited. At first, the fundamental freedoms prohibit making such incentives available only to domestic companies or domestic business activities[166]. Member States would therefore have to face a substantial risk that they would be forced by the ECJ to extend such rules to cross-border investments as well. Second, all measures more favourable than ones provided for the in the CCCTB directive would have to be notified to the EU Commission under the state aid provisions according to Art. 87 (1) of the EC Treaty. These would easily meet the test of state aids: They would confer an advantage on recipients which relieves these of charges that are normally borne from their budget; they would affect competition and trade between Member States; and they would also have to be

165 Working Paper CCCTB\WP\057\doc\en, No. 116.

166 ECJ dated 10/3/2005 *Laboratoires Fournier SA*, C-39/04,ECR 2005, I-02057, para 23; ECJ dated 14/9/2006 *Centro di Musicologia Walter Stauffer* v. *Finanzamt München für Körperschaften*, C-386/04, ECR 2006, I-08203.

considered specific or selective in that they favour certain undertakings[167]. The chance of significant deviation within the tax base, and hence, of tax base competition as it occurs in the United States is therefore already precluded by the framework of primary EC law. This applies even if no full harmonisation of the tax base is able to be achieved and the Member States would formally stay entitled to deviate by means of tax incentives.

b. Consolidation

Although all European Member States permit some form of consolidation[168], the requirements and techniques vary extensively. This will cause difficulties to establish common ground on which to base consolidation. First, the revenue effects of cross-border loss offsetting will vary among the Member States in relation to their domestic loss regimes applied to date and to the extent of accumulated loss carry-forwards accrued in the past. Second, moving in and moving out of the CCCTB group will cause the need of the attribution of hidden reserves and losses accrued in pre-group times among the Member States. Third, consolidation, and the definition of a group, closely relates to the concept of the legal nature of the corporate income tax and the core issue of economic double taxation: Is consolidation considered to be a tax privilege or does the ability to pay principle call for a measurement of income which disregards the organisational structure in which it is earned?

To avoid insurmountable dissent in this field, the delineation of the common ownership requirement necessary for consolidation could be left to the Member States. As an example, this could be within a range of more than 50% and not more than 90%. However, the method used to determine the necessary majority (voting rights or capital ownership) should be the same in each Member State in order to limit the additional administrative burden.

Even without a formal opening clause, Member States will have a *de facto* choice of whether to implement the common ownership requirement on their own. If the directive provides for a high

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[167] ECJ dated 19/5/2000 *Italien/Kommission*, C-6/97, ECR 1999, I-2981, para 15; ECJ dated 6/9/2006 *Portuguese Republic* v *Commission of the European Communities*, C-88/03, ECR 2006, I- 7115, para 18.

[168] See *Dieter Endres et al.* (eds.), *supra* note 162, at 756-820.

threshold, this would not hinder Member States from granting a more generous consolidation regime.

Considering the possibility of different thresholds for consolidation raises quite a few practical issues, especially regarding the consequences for the formula apportionment of the consolidated profit. If the controlling corporation is located in a country with a lower threshold than is applicable in the subsidiary's country formula, apportionment and separate entity accounting would be applicable in coexistence and probably would overlap, provided the country where the subsidiary is located does not accept its profit share as being determined by application of the formula.

c. Optionality

Another issue which - by its nature - will be left up to the individual decisions of the Member States is whether application of the CCCTB should be optional or mandatory. The Commission's concept to date allows for optionality with two limitations: (1.) the taxpayer may choose only the 'full-package', hence, if it sees to make use of the CCCTB rules, automatically consolidation and formula apportionment apply. (2.) if the controlling company opts for the CCCTB, the CCCTB applies to all affiliates which meet a certain threshold ("all in/all out"-approach)[169].

Where the directive provides for optionality, Member States could make the CCCTB mandatory on their own if they erode the choice by making the CCCTB rules applicable to companies with purely domestic activities as well.

If, in contrast, the directive would leave the decision of optional versus mandatory application up to the participating States, a Member State making CCCTB mandatory *only* for multinationals could be challenged on the basis of the fundamental freedoms in that at this point, CCCTB provisions are disadvantageous compared with the equivalent domestic provisions. First, application of the CCCTB would not put multinationals in a wholly different position, excluding these from comparison to companies with only domestic branches or subsidiaries. Second, the

[169] See Implementing the Community Lisbon Program: Progress to date and next steps towards a Common Consolidated Corporate Tax Base (CCCTB) dated 5/4/2006, COM(2006) 157 (final), p. 8 et seq.

argument that, as a whole, the CCCTB results in an advantage would not be able to offset a higher tax burden stemming from the application of individual provisions. According to this general practice, the ECJ would presumably take only the single disadvantageous provision into consideration, and would not adopt a comprehensive evaluation balancing the advantages and disadvantages of the CCCTB regime as a whole[170]. The taxpayer's possible advantage through cross-border loss offsetting under CCCTB is likely to be disregarded. Other offsetting tax advantages under the CCCTB would not be relevant to the determination of a discriminatory effect[171].

However, if some Member States mandated the CCCTB while others grant the option of applying it, it would have to be decided how, for example, cases will be treated where the controlling company is located in an optional country, while the subsidiaries are located in countries with mandatory CCCTB application. Again, formula apportionment and separate entity accounting would clash within one group.

d. Sharing mechanism

(1) A possible way to overcome the opposition against formula apportionment?

The question with the greatest potential severity for fiscal autonomy is whether and to which extent a CCCTB directive could allow Member States to deviate from the common profit-sharing mechanism in either altering the applicable formula or in permitting the continuation of separate entity accounting.

Flexibility in the delineation of the factors and their respective weight would allow Member States to use a formula geared to their own interest. This could therefore help in overcoming the problem that some Member States might not find their economic contribution to the accrual of profit adequately reflected in a specific formula. Another possible way to meet these concerns would be to allow on the continuation – either in general or in specific situations – of separate

[170] See ECJ dated 28/1/1986 *Avoir fiscal*, C-270/83, [1986] ECR 285, para 2; ECJ dated 27/6/1996 *Asscher*, C-107/94, [1996] ECR, I-3113, 3127, paras 51 *et seq*.; ECJ dated 21/9/1999 *Saint Gobain*, C-307/97, [1999] ECR, I-6181, para 54; ECJ dated 26/10/1999 *Eurowings*, C-294/97, [1999] ECR, I-7463, para 44.

[171] E.g. ECJ dated 21 September 1999, *supra* note 170, I-6161, para 54.

entity accounting if a Member State views this method as more appropriate. This situation will take place anyway if the CCCTB is made optional. Under the Commission's CCCTB model, optionality would divide the EU into groups of companies in which separate entity accounting takes place and groups in which profits are divided by formula apportionment. In this scenario, the decision is made by the taxpayer, not by the Member States. Instead, such a decision could be reserved to the Member States. This is also more or less the situation we would face under enhanced cooperation. Member States that do not immediately join the CCCTB could cherry pick to apply the harmonised tax base, but could choose not to adopt consolidation and/or formula apportionment.

A CCCTB system with different apportionment formulae – such as exists in the US - raises several questions: First of all, would such a system be desirable over today's transfer pricing regime in terms of simplicity, restraining tax competition[172] and restricting tax planning? How would double taxation or non-taxation resulting from the application of different formula have to be approached under European law? How would such a system fit into the existing network of double tax treaties?

(2) Effects of non-uniform application of formula apportionment

(a) Effects of alterations in the delineation and weight of the factors

As already mentioned in the context of the description of the US system[173], deviations from the standard formula cause non-taxation or double taxation. US states tackle aggregate minimisation of taxation mainly by way of throw-back rules. US taxpayers, on the other hand, try to avoid the unfavourable results of overlapping formula by factor planning, which contributes to the (poor) reputation of the state tax system as being cumbersome and cost-intensive. This is not compatible with the goal of simplification which the CCCTB project is aimed at.

Additionally, in Europe, double taxation would achieve a totally different dimension because of the higher level of nominal tax rates and the resulting effective tax burden. While the statutory

[172] See Working Paper CCCTB\WP\060\doc\en, No. 67.
[173] See *supra* III. 2. a.

corporate income tax rate in the US does not exceed 12%, and – given the deductibility from the federal tax base – effectively only amounts to 7.8% at a maximum, the level of corporation income tax in the European Union is much higher, lying within a range of between 10% and 35% for the nominal corporate income and an EU average of around 25%. Therefore double taxation due to different formula could hardly be tolerated without a relief mechanism[174]. Given the status quo of the comprehensive net of double tax treaties among the Member States, which avoids international double taxation with only rare gaps, a system of diverging formulae without systematic double tax relief would result in a huge step back.

Flexibility in formula design also fosters factor competition to attract investment by reducing the weight of property or/and payroll[175]. This is true in the US, and would apply to an even greater degree in the EU. In the US – in spite of the low impact of state corporate income tax on the overall expenses of a corporation[176] – taxpayers seem to be highly sensitive to opportunities to avoid taxation resulting from of the lack of uniformity between the formulae. US states, on the other hand, respond to the expectations of the business community and compete in their formula design for in-state investments.

(b) Effects of a coexistence of separate entity accounting and formula apportionment

Instead of leaving a scope for altering the apportionment formula, the CCCTB directive could be adopted with an opening clause for the Member States to continue to apply separate entity accounting instead of formula apportionment. This approach would pay heed to the commonly-advanced argument that transfer pricing (despite its complexity) is at least a known method, while formula apportionment (as a new method for all Member States) has the disadvantage of ignorance as to the effects of the change. Member States with this insecurity could decide to retain separate entity accounting, possibly over time, until convinced of the merits of formula apportionment by the experience of those Member States that adopted it right away. Furthermore, it is not unlikely that – as *Kimberley A. Clausing* and *Reuven Avi-Yonah*[177] assume

174 Less concerned *K. A. Clausing & R. Avi-Yonah*, *supra* note 3, at 22 discussing the unilateral or unharmonized adoption of formula apportionment at the international level and pointing out the chance to avoid double taxation by factor-shifting.

175 *J. M. Weiner*, *supra* note 8, at 36.

176 State corporate income taxes are said to amount on average only to 0.2% of a corporation's overall expenses, see *Michael Mazerov*, *supra* note 88, at 340.

177 *K. A. Clausing & R. Avi-Yonah*, *supra* note 3, at 21.

– taxpayers would be prone to account for their profits in formula apportionment countries, instead of in separate entity countries, since there, they are not taxed on the whole book profit. Instead, these are taxed only on that share apportioned by the factors in the country where they maintain a permanent establishment.

The decision between both of these methods could generally be left to the Member States' legislators. Or, as it is provided under the UDITPA, Member States' tax authorities could obtain the right to choose between formula apportionment and separate entity accounting if the latter is more equitable in determining net income from sources in the state[178]. Such a scope of discretion, however, would cause uncertainty as to the method applied for the taxpayer.

That brings up the question of whether countries which decide to turn to formula apportionment would be limited in being able to only apply it to the income earned in other formula apportionment countries or if they also would include the income of corporations located in EU Member States which continue to adhere to separate entity accounting (even worldwide)[179]. Here, the question of the borders of formula apportionment is raised. In the US, this is commonly referred to as the water's edge limitation in which no corporations outside the US are included into the combined reporting of the group. However, this problem also arises within the US in

[178] But only conditional upon the authorities showing that formulary apportionment would produce a "manifestly unfair result", see La. Rev. Stat. Ann. § 47:287.94 (C) (2001).

[179] Worldwide consolidation and formula apportionment would tackle tax evasion beyond the borders of the Community. That tax competition is an internal problem of the European Union does not mean that the traditional problem of the tax oasis would not exist anymore. It is therefore unclear whether European law limits Member States' sovereignty to apply anti-avoidance rules which are directed only against tax havens in third countries. Art. 43 and 48 of the EC Treaty guarantee the freedom of establishment only within the Community. In contrast, the wording of Art. 56 of the EC Treaty does not contain such a limitation for the free movement of capital. It is therefore highly controversial whether cross-border capital transactions to third countries may be entitled to claim equal tax treatment in reliance upon Art 56 of the EC Treaty. Some commentators deny the third-country ('external') application of Art. 56 EC Treaty to tax matters *a priori*. More persuasive, however, is the opinion that Art. 56 of the EC Treaty does apply to tax legislation in respect to capital transactions to third countries, but that restrictions are more easily justifiable than in intercommunity cases, especially because third countries do not fall into the scope of the Directive on Mutual Assistance concerning direct taxation see Council Directive 2004/56/EC dated 21/4/2004 amending Directive 77/799/EEC of 29/04/2004, OJ 2004, No. L 127, p. 70 – 72 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, certain excise duties and taxation of insurance premiums. To date, the ECJ has refused to give a clear answer to the question of the scope of the free movement of capital provisions, but seeks to avoid the crucial issue by arguing that the freedom of establishment takes supremacy over the freedom of capital (see ECJ dated 3/10/2006 *Fidium Finanz*, C-452/04, ECR 2006, I-9521). This has the consequence that the latter freedom is legally excluded and is no longer applicable as soon as the freedom of establishment has been successfully invoked. This approach is not convincing. It leads to the illogical consequence that Member States could discriminate against substantial investments in third countries, but are prohibited from doing so in the event of portfolio investments, because here, only the free movement of capital would apply.

cases where a group is partly resident in a state with mandatory combined reporting and partly resident in a state which applies separate entity accounting, where no consolidation is chosen.

Parallel application of formula apportionment and separate entity accounting to a group's profits almost inevitably causes double taxation: It is unlikely that both will lead to the same result[180]. Art. 7 para 4 of the OECD model convention (providing for that the results of the apportionment of profits do not diverge from the results of separate entity accounting) would not be applicable because it only functions as a grand fathering rule if the apportionment method has been customary in the contracting state before. This would not be the case if Member States initially adopt apportionment on the grounds of the CCCTB directive.

It is also a problem which arises where the application of formula apportionment is discussed at the international level[181], and which in the US, has been widely discussed in relation to the worldwide combined reporting which the State of California required in the past[182].Over the years, the idea of overcoming the problems of separate entity accounting by applying formula apportionment on a worldwide basis attracted not only academics[183] but also prominent practitioners[184] who are fed up with the practical problems of transfer pricing. At the same time, it has been criticised and rejected as an unworkable idea[185]. That every-day dealing with transfer prices is so cumbersome is firmly explained theoretically by the fact that in cases of truly and

[180] *J. M. Weiner*, *supra* note 8, at 40 *et seq*.

[181] See U.S. Departmnent of Treasury, The Final Report of the Worldwide Unitary Taxation Working Group, Washington D.C. 1984; furthermore in detail *J. M. Weiner*, Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level, U.S. Treasury Department OTA Paper 83, April 1999; also published in 23 Tax Notes International 2113 (December 23, 1996); and very recently *K. A. Clausing & R. Avi-Yonah*, *supra* note 3.

[182] See in particular *Charles E. McLure* (ed.), *supra* note 3.

[183] *R. Avi-Yonah*, The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Tax System, 15 Va. Tax Rev. 89, 156 *et seq*. (1995): combined approach of APAs for multinationals and formula solution based on the profit split method for the smaller taxpayers; *Jerome R. Hellerstein*, Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment, 60 Tax Notes 1131 (August 23, 1993).

[184] *Louis M. Kauder*, Intercompany Pricing and Section 482: A Proposal to Shift from Uncontrolled Comparables to Formulary Apportionment, 60 Tax Notes 485 (January 25, 1993); and recently *Michael C. Durst*, A Statutory Proposal for U.S. Transfer Pricing Reform, 46 Tax Notes International 1041 (June 4, 2007), who however only promotes the adoption of a "more formulary" approach to the allocation of the income of multinationals, but not of formula apportionment as it is known at state level.

[185] *Eric J. Cofill & Prentiss Willson*, Federal Formulary Apportionment as an Alternative to Arm's Length Pricing: From the Frying Pan to the Fire?, 60 Tax Notes 1103 (May, 24, 1993); *James W. Wetzler*, Should the U.S. adopt Formula Apportionment?, 48 National Tax Journal, 357 (1995); *William J. Wikins & Kenneth W. Gideon*, Memorandum to the U.S. Congress: You Wouldn't like Worldwide Formula Apportionment, 9 Tax Notes International 1915 (December 19, 1994).

successfully integrated multinationals, comparative transactions do not exist against which the arm's length standard may be applied[186]. On the other side: Insurmountable problems would arise in the enforcement of the unilateral adoption of formula apportionment. One of these problems is found in the absence of a common tax accounting standard for the determination of the income of multinationals. To apply formula apportionment would cause immense extra documentation burden. This is said to be one of the major drawbacks to the US proposals to apply formula apportionment at the international level. Within Europe, those problems would be solved by the implementation of the CCCTB. However, even more severe than the administrative burdens is the inevitable result of over- or under-taxation. As the other countries maintain their separate entity accounting, single handed actions would result in severe double taxation, the violation of all to date concluded double tax treaties and heavy distortions[187]. To this extent, the advocates of formula apportionment have not seriously attempted to allay these legitimate fears[188].

(3) Legal restrictions to alterations of the sharing mechanism

However, within the EU legal constraints might exist, which keep the Member States from making extensive use of available discretionary scope in the field of the sharing mechanism. And that could minimize the risks of allowing deviation from the sharing mechanism. Restrictions could arise on the basis of the fundamental freedoms, as well as from Art. 33 of the Sixth VAT Directive[189].

To start with the latter: Member States could be restrained from allocating a heavier weight of the sales factor to the formula because of the ban on imposing "any taxes, duties or charges which can be characterised as turnover taxes", provided for in Art. 33 (1) of the Sixth VAT

[186] See e.g. *R. Avi-Yonah*, *supra* note 183, 149 *et seq*.
[187] *James W. Wetzler*, *supra* note 185, at 361.
[188] Even *J. M. Weiner*, one of the strongest advocates of formula apportionment, has admitted that implementation of global formula apportionment at this moment is not a viable alternative to the present system: see at length *supra* note 181, Using the Experience in the US States to Evaluate Issues in Implementing Formula Apportionment at the International Level; *R. Avi-Yonah*, *supra* note 183, at 158 *et seq*. put forward the idea that – in spite of the distortions and double taxation – the U.S. should act as a first mover in convincing other countries to join.
[189] Council Directive 77/388/EEC.

Directive. It is argued that under formula apportionment, the corporate income tax in effect becomes a tax on the apportionment factors in the formula. US authors describe the step from an equally-weighed three-factor formula to sales-only apportionment as turning the corporation income tax from a tax on property, payroll and sales into a pure sales tax[190].

The Commission also concedes that all elements of the formula can cause double tax effects, when other taxes on the same factors are also considered[191]. This is true not only for the sales factor, but also for the property factor if a country imposes a property tax based on business assets, or for the payroll factor in regard to wage taxes. However, I share the Commission's view that this leads neither to juridical nor to economic double taxation. The inclusion of a factor in the formula does not imply a new taxation of this factor, but triggers only the allocation of taxing rights. The tax base on which the tax is applied remains profits. Hence, an increase of the sales component of the sharing formula does not turn the corporation income tax into a tax *on* the supply of goods, the provision of services or imports. The application of the different factors has effect only upon the applicable tax rates and the jurisdiction to which the tax has to be paid, but not on the tax base. Art. 33 (1) of the Sixth Directive therefore would not restrict Member States that intend to allocate more weight to the sales factor.

This result is assured by the recent ECJ finding in *Banca Populare di Cremona*[192]. The Court found that it was crucial whether the tax has "the effect of jeopardising the functioning of the common system of VAT by being levied on the movement of goods and services and commercial transactions in a way comparable to VAT". The levy therefore has to display the "essential characteristics" of VAT. The Court established four criteria to prove the VAT character of a tax: (1.) it applies generally to transactions relating to goods or services; (2.) it is proportional to the price charged by the taxable person in return for the goods and services which that person has supplied; (3.) it is charged at each stage of the production and distribution process, including that of retail sale, irrespective of the number of transactions which have previously taken place; and (4.) the amounts paid during the preceding stages of the process are deducted from the tax payable by a taxable person, with the result that the tax applies, at any given stage, only to the value added at that stage and the final burden of the tax rests ultimately

[190] *Carles E. McLure*, *supra* note 74, at 851.
[191] Working Paper CCCTB\WP\056\doc\en, No. 33.
[192] ECJ dated 3/10/2006 *Banca popolare di Cremona Soc. coop. arl*, C-475/03, ECR 2006, I-9373.

on the consumer[193]. Apportionment on the basis of sales by destination undoubtedly influences the location where the sales take place if a business is seeking tax advantages by factor-shifting. Nonetheless, even subject to a sales-only factor, the corporation income tax is not levied at a rate proportionate to the charged price of the goods or services, but instead, at a rate proportionate to the net profit. Furthermore, in spite of uncertainties about the incidence of the corporation income tax[194], it is at least unclear that it will be borne exclusively by the consumers rather than by the capital holders. This results in it falling outside the scope of Art. 33 of the Sixth Directive[195].

On the contrary, it is less clear whether Member States could defend formula alterations or the parallel application of separate entity accounting in view of the fundamental freedoms. Though no established Court practice exists with respect to this double-taxation in cases of overlapping formulae, the coexistence with separate entity accounting would probably be perceived as an infringement of the freedom of settlement and the free movement of capital.

The EC Treaty – being silent on direct tax matters – does not contain an explicit ban on international double taxation. The obligation to negotiate tax treaties to abolish double taxation (Art. 293 of the EC Treaty) only has procedural character, but does not provide for protection of the individual taxpayer[196]. Nor has the ECJ thus far arrived at an ultimate statement on this issue. In the recently decided *Kerckhaert & Morres* case[197], the question of international double taxation was so deeply intermingled with the issue of economic double taxation of dividends that the decision – stating that there was no obligation of the state of residence to avoid double taxation caused by a withholding tax levied by the source country – cannot be the last word on this subject[198]. It is obvious that heavier taxation of cross-border activities distorts the location of investments in the internal market. Even though challenging international double taxation by applying EC law will not provide a platform according to which of the involved Member States

[193] ECJ dated 3/10/2006, *supra* note 192, para 28.

[194] For discussion of this highly controversial issue see recently: *Alan J. Auerbach*, Who bears the Corporate Tax?, in James M. Poterba (ed.), Tax Policy and the Economy, Cambridge 2006, p. 1-40 with many references.

[195] ECJ dated 3/10/2006, *supra* note 192, para 31.

[196] ECJ dated 12/5/1998, *supra* note 30, para 15.

[197] ECJ dated 14/11/2006 *Kerckhaert and Morres*, C-513/04, ECR 2006, I-10967.

[198] So as well *Georg W. Kofler & Ruth Mason*, supra note 112, at 5.

are required to grant relief, most scholars assert a holistic view and consider international double taxation to constitute a violation of the market freedoms[199].

To substantiate the opposite view, in *Kerckhaert & Morres*, the ECJ's main argument was that double taxation is the inevitable consequence of non-harmonised tax systems. It remains within the bounds of the sovereignty of each Member State to tax both based upon residence as well as upon source, as is provided for under generally-accepted international standards[200]. Applying this rationale, double taxation stemming from the use of divergent formulae seems to be defensible if the CCCTB would not require full uniformity. Under the present system of double tax relief according to double tax treaties, the Court might argue that – since there is no right or wrong formula – it cannot decide which Member State must adjust its formula to avoid double taxation[201].

Given the uncertainty of the application of EC law to double taxation arising from divergent apportionment formulae, it might be interesting to analyse how these double taxation cases are viewed by the US Supreme Court on the grounds of the due process clause. This clause serves functions similar to those of the fundamental freedoms[202]. *Georg Kofler* and *Ruth Mason* very recently compared the practice of the ECJ with the practice of the US Supreme Court regarding the issue of juridical double taxation. Even though they prove on the grounds of the internal consistency test that *Kerckhaert & Morres* might have been decided differently if it would have been argued among US states[203], the court practice on formula apportionment by the Supreme Court gives no evidence that double taxation stemming from the application of different formulae is considered to be prohibited by the US Constitution[204].

However, neither this argument nor the *Kerckhaert Morres* decision is convincing to me. These are not consistent with the ECJ's general court practice. First, the Court consistently argues that -

[199] *Anno Rainer*, ECJ Decides on Withholding Taxes on Cross-Border Income, 35 Intertax 63 (2007); *Servaas van Thiel*, Removal of Income Tax Barriers to Market Integration in the European Union: Litigation by the Community Citizen Instead of Harmonization by Community Legislature?, 12 EC Tax Review 4, 10 (2003); further references see *Georg W. Kofler & Ruth Mason*, *supra* note 112, at 21 *et seq*. with note 59.

[200] ECJ dated 14 Nov. 2006, *supra* note 197, para 22.

[201] See explicitly *Moorman MFG Co.* v. *Bair, supra* note 108, at 280.

[202] *Georg W. Kofler & Ruth Mason*, supra note 112, at 25; *Tracy Kaye*, Tax Discrimination: A Comparative Analysis of U.S. and EU Approaches, 7 Fl. Tax Rev. 47 (2005).

[203] *Georg W. Kofler & Ruth Mason*, *supra* note 112, at 35-38.

[204] See especially the decisions *Moorman MFG Co.* v. *Bair, supra* note 108; and *Container Corporation of America* v. *Franchise Tax Board*, *supra* note 79.

despite the sovereignty remaining in direct tax matters - Member States must ensure that their domestic tax laws do not infringe with the fundamental freedoms. Second, although the effect of international double taxation is caused only by the interaction of different systems, it is also obvious that double taxation distorts cross-border investments. Third, especially in more recent decisions like *Marks & Spencer*[205] and *Amurta*[206], the Court has applied a holistic approach, reviewing both of the Member States involved, and not failing to address responsibilities[207]. Under a system of divergent and - to some extent - overlapping apportionment formulae, it might be more difficult to determine which state shall be compelled to abandon its taxing rights, since double taxation would no longer follow the well-known pattern of coexistence of source and residence taxation[208]. But this problem could be solved by leaving the final decision as to which measures will be undertaken to the Member States on the condition that double taxation will be avoided. This approach simultaneously addresses the critics that in the past, the Court has overstepped the line of judicial self-restraint. However, the solution should not be left to case-by-case decisions. An 'equitable adjustment provision' as is contained in Sec. 18 of the UDITPA would lack any legal certainty.

Since a non-uniform sharing mechanism not only results in over-taxation, but can also cause under-taxation, it must finally be examined whether throw-back rules employed to avoid under-taxation stemming from divergent formulae could be adopted in the EU without being subject to claims of discrimination. Throw-back rules as provided for under Sec. 16 (b) of the UDITPA for the purposes of US state corporate income taxation assign sales back to the state entitled to tax these where the taxpayer company has a sufficient nexus to that state, provided there is no nexus in the state of the destination of the sales. These are then added to the sales factor in the other state. Throw-backs would be even more important if the entitlement to tax was to continue to be based on a permanent establishment. Throw-back rules have some similarities with subject-to-tax rules as these were recently challenged in the *Columbus Container Case* before the ECJ[209]. However, the Court upheld the German switch-over clause, already rejecting differentiation since the only effect of the switch-over from the exemption to the credit method was that the

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205 ECJ dated 13/12/2005, supra note 28.

206 ECJ dated 8/11/2007 Amurta SGPS, C-379/05, (http://curia.europa.eu), para 39 *et seq*.

207 In this context see the criticism of *Michael J. Graetz & Alvin C. Warren*, Dividend Taxation in Europe: When the ECJ Makes Tax Policy, 44 Common Market Law Review 1577, 1617 *et seq*. (2007).

208 *W. Kofler & R. Mason*, *supra* note 112, at 28.

209 ECJ dated 6/12/2007 *Columbus Container Services*, C-298/05, para 49.

cross-border investment was taxed at the same level as the domestic investment. On these grounds, throw-back rules attributing otherwise non-taxed parts of the tax base to the seat country seem to be defensible.

V. Conclusions

In discussing a less ambitious approach for a reform of the European corporation income taxation, I sought to reveal ways out of an assumed political blockade. Possibly this assumed blockade will prove chimerical – in such case, all the better. Discussing some of the problems Member States would have to cope with in a non-uniform setting might convince these that there is no real alternative to collaborating. However, taking into consideration that over almost an entire century, the US states have not been able to agree on a uniform corporate state tax system, even though the economic differences among the states are probably less significant than in those the EU, it is very unlikely that the EU Member States will be able to achieve compromise on a uniform system.

On the other hand, one might find that the problems of a less uniform CCCTB introduction are not insurmountable. Hence, all the efforts already invested into the CCCTB project would not be rendered in vain, even if Member States are unable to initially agree on every point. Studying US state taxation provides some clues toward a pathway to a system leaving as much sovereignty to the Member States as possible, but which - in aiming toward a certain degree of uniformity – would avoid the most severe of distortions.

It also turned out that where adoption by all Member States fails, the spin-off of a sub-group under enhanced cooperation – if at all desirable – would have to face many similar problems as these arise under the not-uniform approach discussed. In particular, the question of whether formula apportionment should then be limited to corporations located in the CCCTB sub-group, or should apply without water's edge limitations to all EU groups, involves a substantial strategic decision. This is especially the case if adoption by the subset is considered to be only the first step and the exertion of maximum pressure on the other countries to join is intended.

In the long run, it might turn out that giving up some national legislative power to the EU level - not only by harmonising the national tax systems, but even by adopting a basic EU corporate income tax to which Member States are allowed to levy individual surcharges - is the only way to sustain the fiscal power *and* sovereignty of the Member States. Earlier in this paper, I questioned the likelihood of such far-reaching developments. However, to face the truth might be better than adhering to and defending parochial habits incompatible with the thus-far achieved degree of economic integration within the Common Market.