Harmonizing Corporate Income Taxes in the US and the EU: Legislative, Judicial, Soft Law and Cooperative Approaches

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The existence of 27 national corporate tax systems based on separate accounting and the arm's length standard (SA/ALS) poses serious obstacles to the creation of a single market within the European Union (EU). These include complexity, manifested especially – but not only – in the need to document and monitor transfer prices, the possibility of double taxation, and the general inability to offset losses incurred in one Member State against income earned in another. Moreover, income can be shifted from Member States where it would be taxed relatively heavily to others, where it would be taxed more lightly (see Commission of the European Communities 2002 and McLure 2008b). In addition, the European Court of Justice (ECJ) has found that, *as implemented by some Member States*, certain common features of Member State tax systems, including some often associated with SA/ALS (e.g., thin capitalization rules, imputation systems and exit taxes) are inconsistent with a single market.

To overcome these obstacles, the European Commission (2001b) has suggested that EU Member States consider adopting a Common Consolidated Corporate Tax Base (CCCTB). Under the CCCTB, a group of related companies could opt to use a formula to divide the group's consolidated income among the Member States where the group operates, in proportion to the fraction of the group's economic activity occurring there. Taxable income, the consolidated group, and the apportionment formula would be defined uniformly throughout the EU. Tax harmonization is not intended to encompass harmonization of statutory tax rates. (On the basic features the CCCTB might exhibit, see Agúndez-García 2006; McLure 2008b, and documents of the CCCT Working Group available on the website of the Taxation and Customs Directorate-General of the European Commission.) Jurisdiction to tax is generally not addressed in discussions of the CCCTB, it apparently being assumed, usually implicitly, that it would continue to be based on the existence of a permanent establishment.

It is widely assumed that it would be impossible to achieve the unanimous vote of all Member State representatives to the Council of the European Union ("the Council") required to adopt the CCCTB. Thus the Commission (2001a) has suggested that a subset of Member States might adopt the CCCTB through "enhanced cooperation," which allows as few as eight Member States – nine, if and when the Lisbon Treaty becomes effective – to agree formally to "go faster." Some may wonder whether "soft law" approaches, which underlie some recent Commission tax initiatives, might be employed to achieve harmonization. The first part of this article examines the possibility of employing legislative, judicial, and soft-law approaches or enhanced cooperation to harmonize corporate income taxes in the EU.

In the United States, as in Canada, taxation of most corporate income has long been based on formula apportionment. The EU has thus looked to US experience for lessons regarding how to structure the CCCTB. Hellerstein and McLure (2004a and 2004b) and Weiner (2006) describe some such lessons, many of them negative. The feature of US state corporate income taxes that perhaps most surprises European observers – one not to be emulated – is the extent to which these taxes are not harmonized. The second part of this article describes whether and how legislative, judicial, and cooperative approaches have – or have not – been employed to harmonize state corporate income taxes.

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Corporate tax harmonization in the EU[1]

Potential means of harmonization

Legislation: Under Article 94 of the EC Treaty, the Council could, in theory, adopt directives that would harmonize the corporate income taxes of Member States. But, because that article requires unanimous agreement on tax provisions to be applied throughout the EU and a number of Member States (notably Ireland and the United Kingdom, but also Cyprus, Latvia, Lithuania, Malta and Slovakia) have expressed opposition to the CCCTB, there is little hope that the Council would enact a directive mandating CCCTB.

Judicial decisions: While the ECJ has achieved a degree of proscriptive harmonization, by outlawing certain tax practices, proscription can never create a truly harmonized system, as that would require the Court to legislate on the myriad details that comprise a tax code. Moreover, the ECJ reacts passively to cases brought before it; does not take the initiative in harmonization. Thus the Commission has suggested resort to enhanced cooperation.

Soft law: Before turning to enhanced cooperation, it will be convenient to dispose of soft law, usefully defined as "rules of conduct that are laid down in instruments which have not been attributed legally binding force as such, but nevertheless may have certain (indirect) legal effects, and that are aimed at and may produce practical effects" (Senden 2004, 112). The best-known example of soft law in the tax field, the Code of Conduct on Business Taxation, involves proscriptive harmonization: agreement of Member States not to engage in tax practices identified as harmful. Soft law could not produce the detail and legal certainty required for the CCCTB, and Member States that oppose the CCCTB are unlikely to participate in a soft law initiative to introduce it. Enhanced cooperation thus seems to offer the best – and perhaps the only – hope for introducing the CCCTB.

Enhanced cooperation: The Commission has promised to produce a proposal for the CCCTB by the end of 2008, but presumably does not expect the proposal to gain unanimous support. Thus, once the Council has rejected the proposal, the Commission will presumably propose that enhanced cooperation be used to start the CCCTB ball rolling – provided it is asked by at least eight Member States to do so and believes that it can muster the qualified majority required to approve the exercise of enhanced cooperation. The Commission has created the CCCTB Working Group, composed of tax experts from Member States, to assist it in ironing out the many details of the CCCTB, including the crucial administrative details that economists seldom consider, and perhaps to build support for the CCCTB among Member States. The Commission envisages use of the comitology procedure to deal with many details, especially of procedure (see McLure 2008a).

The role of the Commission in tax policy: Under the EC Treaty, the Commission has sole responsibility for forwarding legislative proposals, including those for enhanced cooperation, to the Council (or, regarding most non-tax issues, to the Council and the European Parliament). As "guardian of the Treaties, it initiates infringement cases before the ECJ and may support the position of other (Member State or private) litigants. (It may argue that certain tax provisions violate the EC Treaty or that they constitute state aids.) The Commission has sometimes used this power to gain Member State support for initiatives or to induce harmonized solutions.

Prospects for enhanced cooperation

It is unclear whether eight or more Member States will favor adopting the CCCTB via enhanced cooperation and whether the required qualified majority of Member States will vote to allow it. After all, enhanced cooperation does not produce soft law that lacks binding legal effect; for Member States choosing to participate, laws enacted under enhanced cooperation are binding, in the same way as directives, and they will cast a long shadow. Support may depend, inter alia, on the strength of business support for CCCTB and the effects on revenues, output, and welfare the various Member States expect to experience. These are likely to depend, in turn, on details such as the apportionment formula chosen and especially on whether corporate participation in the CCCTB is mandatory or voluntary, as mandatory participation would limit opportunities for tax planning.

Business support: A recent survey of tax officials of 403 large corporations doing business in more than one EU Member State suggests substantial business support for the CCCTB. Although details of the

[1] This discussion is based on McLure (2008a). See also Martín (1999).

scheme have not been made public, 78 percent of respondents favored its adoption. Even in Ireland, whose government is adamantly opposed to CCCTB, half or respondents favored adoption. Only 15 percent of interviewees thought harmonization would never occur, 66 percent thought CCCTB would be in place by 2015, and 85 expected to see it by 2020 (see KPMG 2007). Of course, it is one thing to view positively a pig in a poke and another actually to buy it. Once the Commission has introduced its proposal, business support may either increase or decrease.

Revenue and other effects: Several attempts have been made to estimate the revenue effects of replacing the present system with the CCCTB. Unfortunately, while results of these studies show some qualitative similarity, quantitative estimates of revenue losses vary widely, because of differences in methodologies, assumptions, and data. Moreover, for the most part, they attempt to estimate the revenue effects for each Member State and in the aggregate, assuming that all 27 Member States participate in CCCTB. It would be more useful to know the revenue effects for a limited number of Member States if only they were to adopt CCCTB via enhanced cooperation.

Using data on outbound FDI for German firms, employing an apportionment formula that accords equal weight to payroll, profits, and sales, and assuming mandatory corporate participation, Fuest, Hemmelgarn and Ramb (2007) estimate, for the 15 pre-2004 EU Member States, a 20 percent aggregate loss of corporate tax base of the multinational companies in their sample. Belgium, Ireland and the Netherlands are big losers, presumably because CCCTB would limit income shifting. Other Member States are estimated to lose substantial amounts of revenue primarily because of the ability under the CCCTB to offset cross-border losses.

Devereux and Loretz (2008), based on analysis of data from a sample of more than 400,000 EU companies, reach quite different conclusions. They find that aggregate revenues in 22 of the 25 pre-2007 Member States would fall by 2.5 percent if corporate participation is voluntary and would increase by about 1 percent if participation is mandatory. (If, as proposed, corporate participation is optional, Member States will almost certainly experience revenue losses.) Using a similar methodology, Oestreicher and Koch (2007) estimate a fall in aggregate revenues of 4.45 percent in 23 of the pre-2007 Member States if participation is compulsory and 4.57 percent if it is optional.

Estimates of effects on aggregate revenue are relatively insensitive to the choice of apportionment factors, but the estimated distribution of revenue changes among Member States is not, the inclusion of the number of employees in the apportionment formula being particularly important. Moreover, the estimated effects on the revenues of particular Member States, most notably Ireland and the Netherlands, depend crucially on whether corporate participation is voluntary or mandatory.

Under mandatory corporate participation, profits shifted to those Member States under SA/ALS would be apportioned among all Member States. Corporations that currently shift large amounts of profits to avoid taxes presumably would not participate in CCCTB if it were voluntary. But making corporate participation optional, while perhaps being necessary for political reasons, would substantially reduce its benefits, especially the reduction of income shifting.

Brøchner, Jensen, Svensson and Sørensen (2007) employ a sophisticated computable general equilibrium model to estimate for the 25 pre-2007 Member States the effects on GDP, welfare, and revenues of tax base coordination, with and without harmonization of tax rates, at either the weighted or unweighted average. They find that, in the aggregate, harmonization increases GDP and welfare, but, depending on the alternative examined, it has a relatively small negative or insignificant effect on revenues. Of more relevance for present purposes, effects on GDP and welfare and on revenues of individual Member States move in opposite directions, suggesting that it may be difficult for "winners" (however defined) to compensate "losers." Unfortunately, these estimates are based on separate accounting and do not include the effects of consolidation, including cross-border loss offset, or of formula apportionment. They thus may not be comparable to the other estimates reported here and may not accurately and fully indicate effects to be expected from adoption of CCCTB. While cross-border loss-offset may cause revenues to be affected more negatively than estimated, the prevention of profit-shifting inherent in consolidation may reduce (or reverse) revenue losses, except in Member States that benefit from profit-shifting. Loss offsetting may also contribute to eco-

nomic efficiency and thus to GDP and welfare. As the authors note, coordination would reduce costs of compliance and administration, adding further to GDP and welfare; these costs savings, which they (like the other authors) do not attempt to estimate, would be greater under consolidation.

Since CCCTB is unlikely to be adopted unanimously, especially in a compulsory form, the relevant question is whether eight or more Member States are likely to want to participate in enhanced cooperation. (A subsidiary issue that could be crucial, because of its precedental importance, is whether those pioneering Member States would make corporate participation mandatory.) That probably depends in part on the revenue effects those Member States could expect to experience, if only they were participating. It is difficult to infer much about this from the results mentioned above. It also seems senseless to analyze the revenue effects of all possible combinations of eight or more Member States. The most promising approach might be to analyze the revenue effects for eight Member States with relatively similar economies (especially corporate profitability, compared to payroll, profits, and sales) and tax systems (in terms of tax rates, existing provisions for cross-border loss offset, and absence of preferential regimes), taking due account of public announcements regarding CCCTB – especially opposition to it – by political leaders.

Devereux and Loretz (2008) examine the revenue effects in the six original members of the EC, plus Denmark and Austria, "two countries that already allow for international loss consolidation", if only those eight Member States were to engage in enhanced cooperation. With voluntary participation there is a 1.5 percent reduction in aggregate revenues. By comparison, there is a slight aggregate gain in revenue if participation is mandatory. But in that case the Netherlands would experience a substantial loss in revenue. It seems unlikely, of course, that the Netherlands would engage in enhanced cooperation with mandatory corporate participation.

Brøchner, Jensen, Svensson and Sørensen (2007) estimate the effects of tax harmonization on GDP, welfare and revenues under enhanced cooperation among the euro group (and for the 15 pre-2004 Member States of "old Europe"). The dispersion of effects across Member States for the euro zone is somewhat smaller than for EU25.

The dynamics of enhanced cooperation: The possibility of using enhanced cooperation to initiate harmonization creates an interesting dynamic. Bordignon and Brusco (2006) present a theoretical analysis of the dynamics of enhanced cooperation. Member States that oppose harmonization may not be able to prevent its being initiated via enhanced cooperation. But corporate tax harmonization begun in this way would almost certainly form the basis for future harmonization. Thus even Member States that oppose the CCCTB have an incentive to participate in the CCCTB Working Group, if only to prevent inclusion of provisions (especially compulsory corporate participation) that they would find objectionable, either now or if they decide later to participate in CCCTB. Consistent with this conjecture, representatives of all 27 Member States have been participating in deliberations of the Working Group.

Corporate tax harmonization in the United States

State corporate income taxes in the United States resemble in broad outline the type of system that would make sense for the EU, but differ from it in important respects (see McLure 2007 and 2008a). Moreover, reliance on legislative, judicial, and cooperative approaches in the two unions differs substantially, sometimes only in theory but sometimes also in practice.

Substantive issues[2]

Definition of income: The existence of the federal income tax and the federal Internal Revenue Service (IRS) is an important force for tax harmonization in the United States. Conformity of state corporate income taxes to the federal tax code contributes to uniformity, thereby reducing compliance costs and the possibility that there will be gaps and overlaps in the tax bases of the various states. State reliance on the IRS to take the "first cut" at tax administration contributes further to uniformity and cost reduction.

State adoption of the federal definition as their starting point in defining taxable income was the result of pressure from the business community, which decried the complexity of dealing with diverse definitions. Continued conformity is threatened by the tendency of the federal government to modify its

[2] See Hellerstein and Hellerstein (1998) for more detail on these issues.

definition of taxable income significantly from time to time, without consulting the states, which may "decouple" for revenue reasons.

Consolidation: Although some states require groups of corporations involved in a unitary business to file a combined report – the state equivalent of consolidation – many do not. (Some states provide for elective "consolidation", which generally follows the federal consolidation rules, which define a group wholly by reference to ownership. On the distinction between mandatory combination based on the unitary business principle and elective consolidation (see Hellerstein and Hellerstein 1998). Moreover, the US Supreme Court has ruled that there is no single definition of what constitutes a unitary business. There is thus little uniformity – and a substantial amount of litigation – regarding this aspect of state taxation.

Apportionment: The formulas employed by the states to apportion business income are not uniform. Whereas in 1978 all but one state employed a three-factor formula that placed equal weight on payroll, property, and sales, almost 80 percent of states that tax corporate income now assign at least one half the weight to sales, nine states use only sales to apportion income, and an additional six states will phase in sales-only apportionment. Moreover, states do not treat sales other than those of tangible products consistently.

Jurisdiction to tax: A federal law, Public Law (P.L.) 86–272, prohibits states from taxing the income of potential taxpayers whose only activity in the state is solicitation for sales of tangible products to be delivered from outside the state. Of course, much of modern commerce does not involve tangible products. Since there are no federal or judicial guidelines for jurisdiction to tax in this crucial area, state practice exhibits substantial diversity. (The US Supreme Court refused to hear a case where a decision would have provided guidance.)

Means of coordination

Legislation: The Commerce Clause of the US Constitution gives the US Congress plenary power to regulate interstate commerce (see Hellerstein 2007). Although states have no power to veto (or even have a direct say in) federal legislation affecting state taxation, they can attempt by political means to prevent or modify such legislation. In fact, Congress has only once enacted legislation (P.L. 86–272) that seriously restricts state corporate taxation.

Judicial decisions: Although the US Constitution does not contain provisions equivalent to the "freedoms" (of movement of people, goods, and capital and of establishment) found in the EC Treaty, the US Supreme Court's interpretation of the Commerce Clause creates essentially the same effect. While the Court has outlawed many specific details of state taxation, it has generally given the states considerable latitude regarding "big picture" issues such as the definition of income, consolidation, and formula apportionment. In particular, it has not required uniformity, which would be tantamount to legislating.

Soft law: Soft law, as that concept is understood in the EU, does not exist in the United States; law that is not "hard" (that is, legally binding, being enshrined in legislation or court decisions) is not law. Even so, interstate cooperation sometimes takes on attributes of soft law, as defined above.

Interstate cooperation: The US Constitution does not provide for anything resembling enhanced cooperation. The Compact Clause authorizes states to enter into compacts of any kind with the consent of Congress, and states can join compacts, even without Congressional consent, as long as doing so does not expand their powers at the expense of federal powers. The states have rarely engaged voluntarily or successfully in cooperative efforts to harmonize their corporate income taxes. They have generally acted only when faced with the prospect of federal legislation that would restrict their taxing powers. The state initially showed little interest in the most important such effort, the Uniform Division of Income for Tax Purposes Act (UDITPA), a model law drafted in 1957. When federal legislation was introduced in the mid-1960s that would have regulated state taxation of corporate income, the states quickly created the Multistate Tax Compact, which incorporates UDITPA, and the Multistate Tax Commission. Among the stated purposes of the Compact is to "promote uniformity or compatibility in significant components of tax systems" (see Hellerstein and Hellerstein 1998; McLure 2008c and references cited there).

UDITPA is not hard law; it is a model law that states can adopt or not – or repeal – as they wish. Although most income-tax states have adopted

statutes that incorporate UDITPA or are patterned after it, many deviate from that model law in significant ways. A key element of UDITPA, the equally-weighted three-factor apportionment formula, has been seriously eroded by the increased (or exclusive) weight many states, including members of the Multistate Tax Compact, now place on sales. Moreover, as its name indicates, UDITPA deals only with the division of income. It does not address the definition of the income to be divided or the issues of jurisdiction to tax or combination. An effort to revise and modernize UDITPA has recently been launched. It seems likely, however, that, because of business opposition and the states' apparent lack of interest in uniformity, not much progress will be made on the big picture harmonization issues of jurisdiction to tax, combination, and the apportionment formula.

No "guardian of the Constitution": In the United States no organization is the "guardian of the Constitution" as the European Commission is the "guardian of the Treaty" in the EU. That is, no US governmental institution is charged with formulating and advocating legislation that is consistent with an internal market.

Summary comparison and commentary

Whereas the Commission has urged EU Member States to replace their diverse corporate tax systems, which are based on SA/ALS, with a uniform system based on consolidation and formula apportionment, the US states have long had apportionment-based systems, albeit systems that are defective and far from uniform in many important respects. The US Congress has the constitutional power to legislate uniformity, but has not, in part because of the political opposition of both the states and business. While the EC Treaty confers similar legislative powers on the Council, any Member State can veto the exercise of those powers. Enhanced cooperation, by as few as eight Member States, is the most likely mechanism for initiating the CCCTB.

The US Supreme Court has accorded the states wide latitude in the exercise of fiscal sovereignty over big issues in corporate taxation, while proscribing many specific practices that discriminate against interstate commerce. By comparison, the ECJ has issued decisions that render certain tax practices off limits; of course, it has had no occasion to rule on the CCCTB. Enactment of the CCCTB by directive would make the Court's job relatively straightforward. (Its role would change dramatically, from a quasi-Constitutional Court interpreting the freedoms to a Supreme Court making sure that Directives are interpreted in a uniform manner throughout the EU.) By comparison, initiation of CCCTB via enhanced cooperation could raise thorny questions of compatibility with the EC Treaty, for example, because activities in participating and non-participating Member States would not be treated in the same way.

While interstate cooperation can and does occur in the United States, there is no concept in US law similar to enhanced cooperation, which creates hard law that is binding on EU Member States that participate in it. Moreover, in the United States no institution plays a role analogous to that of the European Commission as "guardian of the Treaty". Of potentially great importance, the Commission champions CCCTB. These two differences – plus the increasing cost reliance on SA/ALS will impose on the economies of the EU as economic integration proceeds – seem conducive to, but do not guarantee, enactment of the CCCTB, if only by a subset of Member States. It seems likely that, if once created via enhanced cooperation, the "CCCTB club" would gradually expand to produce a system that exhibits more uniformity than state corporate income taxes in the United States.

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