The European Commission's Proposals for Corporate Tax Harmonization

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Introduction

When a group of affiliated corporations operates in multiple jurisdictions that impose income taxes, it must divide its taxable income among the jurisdictions. The Member States of the European Union (EU) currently employ separate accounting to determine the income of each member of corporate groups and "source rules" to attribute that income to the Member States where the income is deemed to originate. Separate accounting relies on arm's length prices – prices that would prevail in transactions with unrelated parties – to value transactions between members of the group. But using separate accounting and the arm's length standard (hereinafter SA/ALS) is complex and impedes the creation of a single market. The European Commission ("the Commission") recently proposed that EU Member States consider shifting to formula apportionment (FA) to divide the consolidated group income of EU corporations. (Commission of the European Communities, 2001, 2002; Diemer and Neale, 2004). While shifting from SA/ALS to FA is desirable, it faces formidable political obstacles, because the adoption of income tax measures requires *unanimity.*[1]

This article describes and appraises the Commission's proposals. It first describes salient features and problems of the current system and the four alternatives tabled by the Commission. It then discusses the two proposals thought to be politically viable, under the simplifying assumption that all Member States and all eligible corporate groups opt to participate. Some strengths and weaknesses of the US and Canadian FA systems are noted, primarily in footnotes.[2] The fifth section considers the implications of making participation optional, and the sixth deals with taxation of international income flows. The concluding section summarizes benefits and costs of shifting to FA and reemphasizes the political obstacles to harmonization.

Separate Accounting and the Commission's Proposals

The current system

EU Member States generally apply the system outlined in the OECD Model Tax Treaty to income flows within the EU, as well as to flows to and from non-EU countries. They generally tax the net business income (income after deduction of expenses) of permanent establishments deemed to originate within their jurisdiction. Gross payments of interest, dividends, and royalties are subject to withholding taxes, which are often reduced by treaty, sometimes to zero. It is thus necessary to distinguish between types of income and apply "sourcing" rules to determine where each is deemed to originate. Member States use SA/ALS to determine the amount of business income to tax. Some exempt foreign-source business income. Others tax the worldwide income of resident corporations, but allow a credit for taxes paid to source countries.

Problems of SA/ALS

The economic integration of the EU and the growing number of cross-border transactions between affiliated corporations will make the continued use of SA/ALS increasingly problematic:[3]

- Compliance with 25 national tax systems is complex and costly;
- Distinguishing between types of income and determining the geographic source of each is complicated;
- Arm's length transfer prices may not exist for the most important transactions, those involving intangible assets; there may be no transactions with third parties and information on similar transactions by competitors is generally unavailable;
- There are both incentives and opportunities to manipulate transfer prices, including terms of financial transactions, to shift income to low-tax jurisdictions;
- Because operations in various Member States are economically interdependent, a

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[1] Also, under the principle of *subsidiarity*, the Community acts outside its areas of exclusive power only if an objective cannot be sufficiently achieved by actions of the individual Member States and is thus better achieved by the Community. Setting income tax rates is the exclusive prerogative of Member States.

[2] For more complete discussions of US experience and its relevance for the EU, see Weiner (1996) and (2001); McLure and Weiner (2000); and Hellerstein and McLure (2004a) and (2004b).

[3] See Commission of the European Communities (2002, p. 739); UNICE (2000); and Klemm (2001).

- scientifically defensible division of income may not exist;
- When Member States do not agree on a corporation's transfer prices, double taxation may result;
- The European Court of Justice (ECJ) may find that some rules (e.g., thin capitalization rules) contravene the EU Treaty;
- The inability to offset losses in one Member State against profits in another discourages cross-border expansion;
- SA/ALS can distort choices of organizational form (e.g., operation via a subsidiary or a branch) or impede cross-border reorganizations;

A simple example illustrates some of these problems. Suppose that a corporate group headquartered in Luxembourg uses legally separate affiliates chartered in the Member States indicated to engage in the following closely integrated activities: research in Germany, financing in the UK, production in Ireland, and sales in France and Belgium. Under current practice each Member State would employ SA/ALS, based on relevant domestic law, to determine the income of the entity subject to its jurisdiction. It would be necessary to determine the nature of various income flows and the proper transfer prices for headquarters activities, financing, research, and final products. Transfer prices may be manipulated to shift income to Ireland, which has the lowest tax rate; arm's length prices may not exist for the fruits of research; and Member States may not agree on particular transfer prices. Also, losses in one Member State may not offset income in another.

FA recognizes the inherent difficulty of using SA/ALS in an integrated market to determine the "true" source of income (the entity or the geographic area) and uses a formula to divide income among the jurisdictions where the corporate group operates. An FA system must address four issues – the definition of apportionable income, the definition of the consolidated group, the apportionment formula, and tax administration.

The Commission's four alternatives

These two proposals involve loss of sovereignty over tax policy that would probably be unacceptable to some Member States[4] and are generally not considered further:

- *European Union Company Income Tax* (EUCIT). Revenues would accrue to the EU, not to Member States.
- *Harmonized European Tax System* (HETS). Except for rates, corporate income taxes of all Member States would be totally harmonized; all would use the same definition of apportionable income, the same definition of the consolidated group, and the same apportionment formula.

The two proposals that may be politically viable share these characteristics: voluntary participation by both Member States and corporate groups (to get around the unanimity rule);[5] a single apportionment formula; tax administration by the Member State where the group parent is headquartered (the "Home State," generally the place of effective management under existing rules); and application of domestic tax systems in Member States that do not participate, for corporate groups that do not participate, and for purely domestic corporations (those operating in only one Member State).

- *Common Consolidated Base Taxation* (CCBT). Participating Member States would agree on the definition of apportionable income, the definition of groups, and cross-border offsetting of losses.
- *Home State Taxation* (HST). A participating group would calculate apportionable income under the rules of the Home State (provided it participates), including those for consolidation and cross-border offsetting of losses. Under the principle of "mutual recognition," participating Member States would only recognize the legitimacy of tax rules of other Member States that do not deviate too much from accepted norms.

For convenience, the last three schemes are called "harmonization". Business groups see Member State control of tax rates, plus the elective nature of CCBT or HST as crucial to healthy tax competition. (Commission of the European Communities, 2002, pp. 464, 467; UNICE, 2000, 2002.) The Commission

[4] The Commission's proposals represent a remarkable turn of events. During the 1980s some EU members (especially the Netherlands and the UK) opposed US state application of FA to the worldwide activities of unitary corporate groups. Moreover, less than 10 years ago the Ruding Committee rejected a shift to FA. (Commission of the European Communities, 1992).

[5] Under the Treaty of Nice, as few as eight Member States can engage in "enhanced cooperation." The Commission believes that this vehicle could be used to implement either CCBT or HST. The principles of subsidiarity, unanimity in tax matters, and enhanced cooperation would be maintained (although modified slightly) under the new constitution.
An evolutionary approach in which individual Member States replace SA/ALS with their version of consolidation and FA, with a common methodology developing over time, seems doomed to failure. It would create chaos during the transition, which might never end. Also, the ECJ is unlikely to tolerate the inherent distortions of competition. Finally, any Member State shifting unilaterally to FA would need to renegotiate its bilateral tax treaties with other Member States, a process of mind-boggling time, effort, and complexity.

has recently come down squarely in favor of CCBT over HST as a "systematic long-term 'tax solution' for the Internal Market." (Commission of the European Communities, 2004b) Adoption of HST or CCBT need not be the final step in harmonization. HST might lead to CCBT. If CCBT were to become compulsory for all taxpayers and all Member States, the result would be HETS, which most impartial observers agree is preferable to either HST or CCBT.

HETS would greatly alleviate the problems with SA/ALS identified above, if not eliminate them, for transactions within the EU:

- Transfer pricing problems would be vastly reduced;[6]
- Cross-border loss-offsets would occur automatically for groups;
- There would be no need to distinguish between types of income, transactions between members of a consolidated group would have no tax consequences;
- Organizational form would have no effect on tax liabilities of consolidated groups; and
- Both over-taxation and under-taxation would be reduced, the latter because of reduced opportunities to shift income to low-tax Member states.[7]

CCBT would resolve most of these problems, as would HST to a lesser degree, but only to the extent that Member States and corporations participate. Although there could still be as many as 26 tax systems under CCBT (25 under HST),[8] any participating corporate group would confront only one of these, plus those of nonparticipating Member States. Tax administrations would need to enforce only one tax system under HST or two under CCBT (the common and domestic systems), but under HST they might need to be familiar with others. Application of parallel systems to cross-border and purely domestic firms under CCBT and differences in definitions of income and consolidated groups under HST could interfere with cross-border investment.

Consider the implications of CCBT and HST for the "Luxembourg" group described earlier, assuming that the group and all six Member States participate. The group's income would be consolidated and apportioned among the Member States where the group operates using a common formula; SA/ALS would be used only to divide income between EU and non-EU countries and between participating and non-participating Member States.[9] Under CCBT the tax base and consolidation rules would also be uniform. Under HST, these would be determined by Luxembourg.

Key Issues for Common Consolidated Base Taxation (CCBT)

CCBT would require common definitions of taxable and apportionable income, consolidated groups, and apportionment formulas, plus cooperation in tax administration.[10] The discussions of apportionment formulas and tax administration are equally applicable to HST, but the tax base and rules for consolidation would be governed by the domestic law of Home States. Subsequent sections consider the effects of non-participation by Member States and corporations – assumed away for present purposes – and the taxation of international flows of income and related treaty issues.

The definition of income

Current differences in the definition of taxable income (involving, *inter alia,* depreciation allowances, capital gains and losses, intangibles, overhead costs, and entertainment) make agreement on a common definition of apportionable income difficult and helps explain support for HST, which requires only enough similarity for mutual recognition. Contrary to the situation with free trade or the value added tax (VAT), there is no objectively supportable definition of income for tax purposes; rather this is largely a matter of political philosophy and consensus. No higher-level EU government provides a definition of income, as in the US and Canada. Further, until recently, each Member State set its own accounting

[6] As explained below, if value added were used to apportion income, transfer pricing could still be a problem.
[7] Income could be shifted to affiliates in low-tax countries outside the EU or (in the case of CCBT or HST) non-participating Member States. Simplification would free tax administrators to concentrate on remaining problem areas.
[8] These are counts of very different things. Under CCBT a single system would be applied to all participating corporate groups operating in participating Member States. Under HST participating Member States would apply their domestic tax systems to participating corporate groups subject to their jurisdiction.

[9] Whether income from unrelated activities should be subject to consolidation and apportionment cannot be considered here. The American states distinguish between business income, which is apportionable, and non-business income, which is attributed to a particular state or states. See Hellerstein and McLure (2004a) and (2004b). The EU is unlikely to draw such a distinction, which the Commission does not mention.
[10] US experience provides little guidance in most of these areas. "Don't do what we do" is its pervasive message of Hellerstein and McLure (2004a). Canada provides a better model, except for its failure to consolidate groups.

standards, and the degree of conformity of taxable income to income reported on financial statements differs between Member States.

Two recent developments may spur harmonization. First is the creation of European Companies (or *Societas Europaea,* hereinafter SEs), for without harmonization becoming an SE may hold little attraction.[11] Second, beginning in 2005, companies listed on EU stock exchanges must utilize International Accounting Standards for financial accounting. This requirement should facilitate a common definition of income for tax purposes. Yet financial accounting and tax accounting serve different purposes, and participating Member States still need to agree on a common pattern of conformity. See Commission of the European Communities (2002, pp. 494–95), (2003a), (2003b), and (2003c), European Federation of Accountants (2002), Diemer and Neale (2004), and Selbach (2003).

The definition of the consolidated group

It is assumed that FA would be applied to the *consolidated* income of participating corporate groups, using apportionment factors of the entire group. Without consolidation, harmonization would not solve problems of non-neutrality toward organizational structure, cross-border loss offsets, transfer pricing, and income shifting.[12]

Consolidation of US federal tax returns of domestic corporate affiliates depends solely on common ownership. By comparison, under US constitutional jurisprudence states can require "combination" of activities of commonly owned corporations only if they constitute a "unitary business," the existence of which may be indicated by (as described by court cases) mutual "contribution and dependency" among group members, "functional integration, centralized management, and economies of scale," or a "flow of value" between affiliates that SA/ALS may not capture.

Both legal (ownership) and economic (unitary) definitions of the consolidated group have advantages and disadvantages. The economic approach is conceptually appealing, but relies on subjective judgments based on complex factual analysis. The ownership approach is simpler, but can be manipulated and can give anomalous results, as when a single formula is employed to apportion income of commonly owned but quite different businesses. Hellerstein and McLure (2004a, pp. 203–206), lean toward an ownership-based EU test.

The apportionment formula

The choice, definition, and weighting of factors in the apportionment formula poses conceptual and theoretical problems and could have important revenue implications for Member states.[13] Apportionment formulas in the US employ weighted averages of the ratios of in-state to total payroll, property and sales. These "factors" were traditionally weighted equally, but a decided shift toward assigning greater weight to sales has occurred, and some states now use only sales to apportion income, to improve their investment climate. All Canadian provinces consider only payroll and sales, weighted equally. Following Lodin and Gammie (2001, pp. 47–50), the Commission raised the possibility of basing apportionment on value added at origin.[14] (See Commission of the European Communities, 2002b, p. 414).

Conceptual/theoretical issues. If formula apportionment is intended to attribute corporate income to jurisdictions where it arises, capital is the most logical apportionment factor. In this view, including either sales or payroll in an apportionment formula has little economic rationale; including sales may reflect a political compromise that allocates more income to "market" jurisdictions. This reasoning suggests that basing apportionment on value added is not a good idea, since labor payments account for the majority of value added. Apportionment based on value added at origin, minus labor costs, has theoretical appeal, as this adjustment would isolate capital's contribution to value added.

Apportionment based on value added. Because all EU Member States impose VATs, those participating in CCBT (or HST) could relatively easily base

[11] See Lannoo and Levin (2002). Without harmonized taxation, an SE will be governed by the tax law and treaties of the Member State where it is chartered.

[12] Some activities might be excepted from this treatment, either because the standard apportionment formula does not produce satisfactory results (e.g., transportation, professional athletics, and finance and insurance) or because the activities are accorded special treatment under the national laws of Member States (e.g., insurance, shipping, airlines, and oil and gas).

[13] On conceptual and theoretical problems, see Klemm (2001) and McLure (2002). On practical problems with the way factors are defined in the United States, see Hellerstein and McLure (2004a) and (2004b).

[14] Apportionment is commonly based on "micro" factors that reflect the taxpayer's circumstances. An alternative floated by the Commission, using "macro" factors could have anomalous effects and should not be considered seriously. If, for example, apportionment were based on industry averages, there could be both a "toll charge" for expansion into high-tax Member States and opportunities for abuse by taxpayers. A formula based on macro factors might reasonably be used to apportion revenues, as under the EUCIT. See McLure (2004b).

apportionment on value added.[15] Whereas VATs in the EU are destination-based, keying apportionment to an origin-based measure of value added would be more appropriate, as the Commission indicated. The inclusion of exports and exclusion of imports from the measure of value added would make apportionment vulnerable to manipulation of transfer prices, though less so than the measurement of income under SA/ALS. Hellerstein and McLure (2004a) suggest that this may be the Achilles' heel of this idea. Subtracting labor costs would magnify the problem.

Administration of CCBT

No central EU tax administration exists, and none is envisaged. Rather, tax authorities of the Home State would administer CCBT on behalf of all participating Member States, calculating the apportionment factors for each participating Member State, as well as apportionable income.

Corporations with non-EU parents pose intriguing problems. Activities of first-tier sister subsidiaries of non-EU parents (and their lower-level subsidiaries) should be consolidated, to achieve the benefits of harmonization. There are several ways to deal with a corporate group not headquartered in the EU. The multinational could interpose an additional EU corporate layer between the non-EU parent and the EU subsidiaries. But the foreign multinational might simply be allowed to elect the Member State where the group is deemed to be headquartered. Such an election could offer tax planning opportunities, especially under the HST.

Some Home States would use lax tax administration to attract headquarters operations, undermining revenues of other Member States. Moreover, Home States with relatively small fractions of the economic activities used to apportion income of particular corporations may not want to devote administrative resources to audits benefiting primarily other Member States.

Other participating Member States might thus reserve the right to challenge the Home State's determination and division of the tax base.[16] This would entail expense for taxpayers and tax authorities and the risk that different participating Member States might treat a given group differently. Mutual Agreement Procedures in bilateral tax treaties and the EU Arbitration Convention should significantly restrain these tendencies, since, unlike the situation under SA/ALS, the CCBT would provide a single legal benchmark. Even so, effective administration would require unparalleled trust and exchange of information among tax administrations. This is a tall order for, as Schön (2002, p. 284) notes, "There is not ... a long-standing and broadly based cooperation between the tax administrations of the Member States involved, including regular international tax audits."

One also wonders whether Member States would be willing to trust their fiscal destiny to the courts of the Home State. A super-national system of tax courts would help assure uniform application of CCBT.

Home State Taxation (HST)

The HST system would have a uniform apportionment formula, but would rely on the definitions of income and consolidated groups and the tax administration of the Home State. Its main attraction is the ease and speed of implementation.[17] HST would be problematical, in part because HST is intended to implement taxation at *source,* but is based on the *residence* of the corporate parent. The following discussion ignores issues created by the optional nature of HST.

A Hybrid of Capital Importing and Exporting Neutrality

Capital export neutrality (CEN) occurs when taxation is the same for all taxpayers resident in a given jurisdiction. By comparison, under capital import neutrality (CIN) taxation is the same for all income derived from a particular source jurisdiction. HST is a strange hybrid of CEN and CIN. Apportioned income is taxed at the tax rate of the source jurisdiction, as under CIN. But income to be apportioned is defined by the Home State, as under CEN. It is thus inevitable that neither CEN nor CIN can generally be fully achieved. Particularly worrisome, taxpayers operating in a given Member State, but headquartered in different Home States, would pay tax based

[15] It would be necessary for entities that are exempt under the VAT to calculate value added; in some cases (e.g., financial institutions and insurance) this would be difficult. See also Hellerstein and McLure (2004a).

[16] Member States cannot rely on the tax administration of a higher-level government, as in the US and Canada.

[17] Also, HST is sometimes advocated to ease the compliance burden on small and medium-sized enterprises, without jeopardizing large amounts of revenues. See Commission of the European Communities (2003c) and references provided there and (2004a) and (2004b).

on different definitions of apportionable income (albeit at the same rate). Mutual recognition is the sole guarantor of a relatively level playing field in any source jurisdiction.

Inherent in HST is the risk that Member States may use generous tax laws, as well as lax tax administration, to lure headquarters activities. Schön (2002, p. 285) raises the possibility that tax subsidies offered by Home States would be "exported" to other participating Member States where subsidiaries operate, creating revenue losses there. Moreover, groups headquartered in Home States not offering similar tax subsidies, including purely domestic corporations of the source jurisdiction, would experience a competitive disadvantage. Again, mutual recognition is the sole guarantor of a relatively level playing field.

The authors of the HST proposal argue, "The HST technique ... is not aimed at obtaining more tax neutrality in the sense of export or import neutrality. Instead its aim is to achieve more tax neutrality for enterprises with cross-border activities ... and to remove the extra costs caused by the company tax obstacles to cross-border activities..." (Lodin and Gammie, 2001, p. 20) But perhaps capital import neutrality cannot be dismissed so easily. The ECJ may not condone the differential taxation of groups headquartered in different Member States inherent in HST, given recent rulings against discrimination in the treatment of resident and non-resident companies.

Cross-border loss offsets and consolidation

Existing provisions for cross-border loss-offset are far from uniform and, on the whole, not very generous. Unless deductions are allowed for virtually all losses incurred in other participating Member States, a primary objective of harmonization would not be met.[18]

Administration of HST

A corporate group opting for HST would need to know only the tax rules of its Home State. This could produce substantial simplification. It would, however, need to know enough about the tax rules of all participating Member States to decide whether to opt for HST and where to establish headquarters operations (or whether to change Home States).

It is much more difficult to assure that tax administration does not depart from the norm required for mutual recognition than to assure that statutes and regulations meet a similar standard. This problem seems substantially greater than its counterpart under CCBT. Mutual Agreement Procedures and the EU Arbitration Convention would provide less comfort, since there would be no external legal benchmark for performance of the Home State tax authorities.

The courts of the Home State would presumably pass judgment on decisions made by the tax authorities of their jurisdiction, even when the bulk of economic activity occurred elsewhere. This is not likely to go down easily with the tax authorities of other participating Member States. Yet the institution of a supra-national tax court seems unlikely, as such a court would need to rule on application of 25 Home State tax systems.

The mechanics of mutual recognition

The mechanics of mutual recognition need to be spelled out more clearly, as mutual recognition is the only safeguard against the export of tax subsidies and the use of generous definitions of the tax base and lax administration to compete for the headquarters of corporate groups. Is mutual recognition a one-time thing? Could it be revoked, once granted? Could lax administration of seemingly satisfactory statutes precipitate revocation? Would groups headquartered in a Member State losing mutual recognition no longer be eligible to participate, at least until reorganized with a parent in another participating Member State? Would the "nuclear option" – kicking a Member State out of the HST club, ever be exercised? If not, what protection against unfair competition would remain?

Summary assessment of HST

HST is an innovative but an unusual solution to a vexing problem. It has no counterpart in the US and Canada. Its principal advantage is speed of introduction. There seems to be a presumption that, over time, the tax bases of participating Member States would converge, tempered by recognition that adop-

[18] The Commission offers the example of a parent located in a participating Member State that does not allow consolidation and two subsidiaries located in another participating Member State that does. If the group participated in HST it would lose the ability to net the profits and losses of the subsidiaries, and transfer pricing problems would not be eliminated. Commission of the European Communities (2002, p. 477).
The voluntary nature of HST complicates matters further. Suppose a parent in participating Home State A sells a subsidiary in participating Member State B. If the purchaser is headquartered in Member State A, the subsidiary's tax rules would not change. If the purchaser were part of a group headquartered in Member State B or in another participating Member State, the tax rules of the Member State of residence of the new parent would apply. If the purchaser were part of a group headquartered in a non-participating Member State or outside the EU, the tax rules of Member State B would be relevant.

tion of HST might impede further harmonization.[19] HST is thus seen as a "pragmatic response," a "workable solution," and a "'halfway' house, balancing the needs and concerns of business and governments and permitting those Member States which already have reasonably similar tax systems to provide a joint solution for business." (Commission of the European Communities, 2002, p. 467) Schön (2002, p. 285) warns, however, "Although the simplicity and elegance of HST cannot be denied, the influence it will have on the competitive situation of domestic and international business and the Member States should make us think twice about its advisability."

Economic and Revenue Effects of Optional Features

Though perhaps crucial for political reasons, optional participation has undesirable economic ramifications, as well as reducing tax revenues unless tax rates are increased, on average.

Economic effects

The table below shows the effects of Member State and corporate decisions on participation in CCBT or HST. The table examines a corporate group consisting of three corporations, each of which operates in only one of three Member States. The situation is identical under CCBT and HST, except for obvious differences (shown by indicating in parentheses where "HST" would be substituted for "CCBT"). The top line shows current tax treatment for all corporations operating in the EU; SA/ALS is used to determine the income of the legal entities operating in each Member State, based on relevant domestic tax law. Under HETS, all groups would be subject to the same definition of income, consolidation rules, and apportionment formula, as in the bottom left-hand corner of the table below.

The bottom line shows the situation for a corporate group that participates in CCBT (HST), when Member States A and B participate, but (C) does not. First, Member States A and B use SA/ALS and the CCBT definition of income (Home State definition) to isolate income earned within their joint boundaries (hereafter AB income), and Member State C employs the same methodology, but its definition of income, to determine the income of the corporation located there. Second, the participating Member States apportion consolidated AB income, using a common formula. The domestic definition of income (which in A and B might match the CCBT definition) is used for purely domestic firms in each Member State.

Three decisions determine how income of a particular corporation is defined and divided among Member States: whether the corporate group participates in CCBT (HST); whether the Member State where the corporation operates participates; and, if either the Member State or the corporate group does not participate in CCBT, the domestic definition of income (the choice of Home State). Thus:

– If both the Member State and the group participate, FA is used to apportion consolidated AB income, as defined under CCBT (Home State) rules;
– If either a Member State or the group does not participate, SA/ALS and the domestic definition of income determines taxable income, as for purely domestic corporations;

[19] See Commission of the European Communities (2002, p. 471), (2003c). Schön (2002, p. 284) notes, "In Europe, however, we are used to the fact that transitional regimes have an inclination to linger around for decades."

Effects of Member State and group participation in CCBT (HST) on methods of determining source of income (Three affiliates operating in three Member States)

	Participation in CCBT (HST) by Member States		
Group participation	Member State A: Yes	Member State B: Yes	Member State C: No
No	Income of entity in A is determined by SA/ALS, based on definition of income in A	Income of entity in B is determined by SA/ALS, based on definition of income in B	Income of entity in C is determined by SA/ALS, based on definition of income in C
Yes	Total income of group earned in Member States A and B, determined under CCBT (HST) definition of income (and isolated from income of entity in C by SA/ALS), is apportioned by common formula		Income of entity in C is determined by SA/ALS, based on definition of income in C

– Under HST, one of 25 Home State tax regimes would determine how much income each participating Member State would tax.

These decisions create differences in tax treatment of corporate groups operating in various Member States that could violate non-discrimination clauses of both the EU Treaty and bilateral treaties between participating and non-participating Member States. Westberg (2002, p. 328) contends that the ECJ may take a dim view of the discrimination that HST could create, for example, when parents in non-participating Member States have subsidiaries in a participating Member State. This criticism would apply equally to CCBT, if domestic law differed from CCBT. Domestic law could be aligned with CCBT, but not HST. On this important topic, see also Schön (2002, pp. 280–81). Also, Schön (2002, p. 286) raises the possibility that discrimination may be challenged under domestic constitutions of Member States.

Revenue effects

The parallel operation of two tax systems in a given country (25 under HST) is also problematic because, on average and all things equal, it would reduce revenues. Taxpayers can be expected to choose the tax law (domestic or other) that produces the lowest liability, and opportunities for tax arbitrage may exist.

International/Treaty Considerations

Harmonization of corporate taxes also raises knotty issues of relations with third (non-EU) countries.[20] Some would occur because some Member States currently exempt foreign source income, while others tax worldwide income, but allow foreign tax credits (FTCs) for source country taxes. A simple example based on the HST, taken from Lodin and Gammie (2001, p. 55), illustrates the problem.

Suppose that a second-tier subsidiary T in a non-EU country pays a dividend subject to a 10 percent withholding tax to its parent S, a Swedish subsidiary of a British parent B. Under current Swedish law and a bilateral treaty between Sweden and the non-EU country, the dividend might be exempt in Sweden. There would be no credit for the withholding tax; no British tax consequences, and no international double taxation.

Under HST, British law would prevail; thus the dividend, grossed up for both the withholding tax and underlying income tax on T, would be included in consolidated income of the S/B group and FTC would be allowed for both non-EU taxes. But no British FTC would be allowed for tax on the portion of the dividend attributed to Sweden; Sweden would not allow a credit, since it employs an exemption system. Thus international double taxation would occur.

If the dividend were paid instead to a British subsidiary of a Swedish parent, international double taxation would be avoided under current law via the British system of worldwide taxation and FTCs. Under the HST, Swedish law would prevail and the dividend would be exempt from both Swedish and British tax. The British treaty with the non-EU country might arguably obligate the UK to allow the FTC, producing international undertaxation.

Treaty provisions for exemption and for worldwide taxation with FTCs probably also cannot comfortably coexist under CCBT (or HETS). (Taxing foreign-source dividends would create problems similar to those in the example with the British parent; exemption would create problems like those with the Swedish parent.) Hellerstein and McLure (2004a) argue for the conceptually correct solution, omitting foreign-source dividends and income of foreign PEs from the apportionable tax base, at least until existing treaties can be renegotiated or replaced by a consistent EU treaty with non-EU countries.

Concluding remarks

The case for harmonization is overwhelming. The benefits of simplification, for both taxpayers and tax administrators. are not easily overstated. Both overtaxation and under-taxation would be reduced. These benefits would be greater, the more Member States participate.

Harmonization also involves costs. Transition would be costly for both corporations and governments. The timing of the choice to participate would allow

[20] This discussion relies heavily on Lodin and Gammie (2001, pp. 53–58 and especially pp. 77–104, which was prepared by the Research Department of the International Bureau for Fiscal Documentation). See also Westberg (2002) and Weiner (2003).

corporations to moderate these. The taxation of international income flows would probably become less clear, at least for a while. Finally, harmonization could change the distribution of the tax base among participating Member States. It is difficult to generalize on the effects on tax revenues and tax liabilities of participating corporations.

The political obstacles to harmonization are daunting, especially because of the unanimity requirement. The confluence of three developments may, however, eventually break the political logjam. First, Member States' tax bases and treatment of groups may converge over time, facilitating adoption of common policies. Second, economic integration will accentuate problems inherent in SA/ALS. Third, and perhaps most important, ECJ decisions may make the present system increasingly untenable. One cannot predict whether and when the logjam will break, or what the result will be.

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