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WILL THE CCCTB BE STILLBORN?

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Ask a tax manager to name his or her chief concern and most will point to transfer pricing. But to the untrained eye, the issue appears innocuous at first look. Put simply, transfer pricing refers to the arrangements for the valuation of transactions within a group of companies. Suppose that a group's subsidiary in Switzerland provides loans to its headquarters in Germany. The transfer pricing refers to the interest paid. If a group is expected to be responsible for what goes on in its own backyard, why should its internal transactions merit closer scrutiny than, say, its external purchases?

The matter becomes sticky when the group includes entities located in lower-tax countries. In these cases, transfer pricing can be used to divvy up costs and, therefore, profits between different fiscal regimes. Such a group can diminish its aggregate tax obligations by paying an inflated price for the goods, services or assets provided by the foreign subsidiary. In the example above, setting a high interest rate would reduce the group's taxable income in Germany by synthetically shifting them to Switzerland.

The transfer pricing regulations attempt to inhibit tax-motivated profit-shifting practices by ensuring that internal transactions are properly priced. Sometimes the regulations are straight-forward. For some transactions, the market price provides the perfect yardstick. So, something must be fishy if headquarters is caught paying hundreds of euro for a simple pencil. However, one may not find an easy market equivalent for all internal transactions, particularly when intangible assets are involved. In these cases, there is little guidance on what a 'proper' charge should be. The result is a complex set of procedures that are costly to comply with – and hard to enforce.

A 2004 Commission survey confirms that the documentation requirements represent a major difficulty for over 80% of businesses around Europe.[1] To make things worse, the authorities appear to be in no mood to allow any breaches. A recent Ernst & Young report finds that over three-quarters of the tax professionals interviewed expect to undergo a

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[1] European Commission (2004), *European Tax Survey*, Taxation Papers Working Paper No. 3/2004.

transfer pricing examination within the next two years.[2] Complex rules often give rise to unexpected outcomes. So, a lot of companies seek professional help. The Ernst & Young survey also finds that an overwhelming majority of the interviewed experts plan to hire external advisors to help mitigate their legal risks. Indeed, the increasing reliance on auditors is apparent from their swelling earnings. Just in the UK, the top four auditing firms' earnings from tax services alone grew 19% between 2004 and 2006, reaching over £1.6 billion and representing nearly a quarter of revenues.

Are we destined to live with these costly rules? The European Commission's project on a common consolidated corporate tax base (CCCTB) offers a way out. Expected to mature into a proposal by September 2008, the regime allows corporations to pool their EU-wide profits for tax purposes. In order to avoid adding apples to oranges, a common profit definition is to be applied. This means that EU countries will need to harmonise their use of depreciation allowances and other aspects of calculating corporate income. Once properly consolidated, the profits are allocated among member states according to a pre-determined mechanism, which are then subject to taxation.

By pooling EU-wide profits, the regime removes the fiscal impact of intra-group profit allocation. In addition to resolving transfer pricing problems, this also allows instant loss-offsetting. To top it off, the regime will be optional, so an unwilling corporation can opt-out. To sum up, the regime promises to make pan-EU business more attractive. Indeed, a recent KPMG survey found that a clear majority of businesses support the regime.3 But, not everyone is sympathetic.

Some fear that the CCCTB may undermine tax revenues, especially in small, 'business-friendly' supply economies. True, the use of sales-by-destination in the sharing formula may reduce revenues as export-generated profits are taxed elsewhere. However, the supply economies also happen to have favourable corporate taxes. So, most corporations will probably not divert their profits to higher tax regimes by opting-in. And even if they did, their cost reductions must be considerable. Is it not hypocritical to claim to be business-friendly while blocking the development of a regime that proves to be so beneficial for businesses?

There is also the suspicion – trumpeted in the most unlikely quarters – that consolidation will eventually become mandatory. Community-wide coordination on this issue, however, appears highly unlikely, at least for the time being. Certain member states will benefit from offering the optional regime perceived to be less taxing. Moreover, having a mandatory regime in some of the member states within the consolidated area will create authority problems. According to the current details of the project, a group's consolidation decision rests with its headquarters. The legality of imposed consolidation in one state may then be challenged by a dissenting corporation based in an optional state. In short, the current details of the optional regime offer no legal basis to set up a mandatory regime.

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[2] Ernst & Young (2007), *2007–2008 Global Transfer Pricing Survey: Global transfer pricing trends, practices, and analyses*, Ernst & Young International Tax Services.

[3] KPMG (2007), *Harmonised Corporate Tax Base – Are European businesses for or against it?* KPMG Europe.

Others see the project as a crusade to harmonise taxes altogether. But base harmonisation can never achieve such an ambitious goal. Just look at evidence from the VAT base harmonisation. Although the laws have been around for over three decades, the basic rates are nowhere near converging, ranging between 16 to 25%. There is no reason to believe that the CCCTB will be any different. To give an analogy from sports, applying the same rules to all teams does not make all games end in a tie.

Will CCCTB be an ultimate success? The answer depends on how well the proposal is tailored in the coming months. Several details merit attention. First, the regime will not be available to all corporations. Certain entities, such as those in which the group does not have sufficient ownership, may be disqualified. But, this may mean that the regime will be available to only a few companies. If the eligibility criterion is too restrictive, the potential benefits will also be limited.

Second, the common base should materialise. Although some exceptions may be temporarily permitted, the harmonisation of the tax base is essential for the ultimate value of the project. If, for whatever reason, a common base is not used, profit-shifting may still have a fiscal impact. In addition, a non-harmonised base will be a clear blow to the delivery of the promised reductions in compliance costs and legal certainties; as corporations will still need to consider the different calculation methods available in each member state.

Third, the sharing mechanism needs to be thoroughly debated. This is necessary not only for political reasons but also for efficiency's sake. The new regime will reveal novel tax planning strategies – some innocent, others less so. More deliberation is needed to avoid substituting old troubles with new ones.

Lastly, since tax measures require unanimity in Council, the project may be implemented under the 'enhanced cooperation' rules with less than full cooperation. Certain member states, including the Benelux countries, France, Germany, Italy and Spain, appear to be supportive. Others, such as Estonia, Ireland, Slovakia and possibly the UK oppose the project. But, it should not be forgotten that the regime's ultimate value hinges on its Community-wide availability. Moreover, it is not clear if enhanced cooperation can achieve the uniform implementation of the regime, putting, among other things, base harmonisation into question. In short, the effort will not be worthwhile if only a few countries join in. The Commission and all the interested parties should do all they can to convince governments to seriously consider joining the regime.

The CCCTB has the potential to be very positive for Europe. The academic literature supports the regime as a seamless way of taxing profits. Surveys have uncovered a sizeable interest. The project should not fall prey to lethargy, narrow national interests or the paranoid fear that any step forward is a step closer to full tax harmonisation. It is time to stop bickering about the size of slices and start making the entire pie bigger.