



**EUROPEAN COMMISSION**  
DIRECTORATE-GENERAL TAXATION AND CUSTOMS UNION  
Analyses and tax policies  
**Analysis and Coordination of tax policies**

Brussels, 17 February 2006  
Taxud E1, MH

**CCCTB\WP\026\doc\en**  
Orig. EN

## **COMMON CONSOLIDATED CORPORATE TAX BASE WORKING GROUP (CCCTB WG)**

### ***The territorial scope of the CCCTB***

**Meeting to be held on 9 March 2006**

Centre de Conférences Albert Borschette  
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**WORKING DOCUMENT**

## **I Introduction and purpose of the paper**

1. The discussion of international aspects in the CCCTB was opened at the CCCTB WG meeting on 8 December 2005. The Commission working document 'International aspects in the CCCTB' (CCCTB\WP\019 – hereafter International Aspects WD) gave a general overview of principles and issues and the subject was referred to a new subgroup (hereafter SG4) for closer analysis. It was mentioned in the original WD that the territorial scope of the CCCTB will have to be analysed closely and the Commission Services committed themselves to prepare an additional working document on this particular issue.
2. The International aspects WD concentrated on how the CCCTB impacted on transactions with third countries, under the assumption that all twenty five MS participate in the CCCTB. Partial CCCTB implementation by a limited number of MS or by a limited scope of companies, for example if it were optional, was placed to one side for future discussion. The International Aspects WD introduced the discussion on the topic and principally covered the role of tax treaties in the CCCTB jurisdiction, the elimination of double taxation, the need for common definitions of terms relevant for the CCCTB and the question whether anti avoidance rules should be covered or not. SG4 met on 13 February in Madrid and had a first discussion on these issues. More details will be given in a Report prepared by the Chair of the SG4 and a working document "An overview of the main issues that emerged at the first meeting of the subgroup on International aspects" (provisional reference - CCCTB/WP/029) prepared by the Commission Services.
3. This working document, in common with the International Aspects WD, assumes that the base is consolidated. The Commission prefers that the base should be consolidated from the beginning, and because consolidation introduces a number of additional issues it is necessary to address the International and Territoriality issues from this perspective to gain a full understanding. However, the precise consolidation method, and the precise definition of a 'group' can be discussed separately and it is the Commission Services' intention to introduce this later this year. This WD has the objective of further examining the source and residence rules and how these are suitable and could be applied in a number of situations within the CCCTB. The principal purpose is to outline what income according to where it has its source and which companies (and permanent establishments) according to where they are tax resident should be covered by the CCCTB<sup>1</sup>. It focuses on the geographical connection between the taxable income and the respective territory. Under the above assumption that the CCCTB will be consolidated, there is a need to discuss what (if any) income is to be excluded

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<sup>1</sup>The limitation of the territorial scope of the CCCTB is sometimes also referred to as the 'CCCTB or EU water's edge', see e.g. Weiner, J.M. (2005): 'Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada', Taxation Papers, Working Paper n° 8, DG Taxation and Customs Union, European Commission; Agúndez-García, A. (2006): 'The Delineation and Apportionment of an EU Consolidated Tax Base for multi-jurisdictional Group Taxation', Taxation Papers, DG Taxation and Customs Union, European Commission (forthcoming).

from the tax base subject to apportionment. Any income not covered by the CCCTB could remain taxable income at the national level of the CCCTB jurisdictions although it is clearly desirable that the number of categories of such income, if any, should be kept to a minimum. The Group should also consider to what extent common rules should be applied to any such income categories.

4. Hereafter this working document examines various aspects of the territorial scope of the taxpayers and taxable income to be potentially covered by the CCCTB by looking at three categories,
  - **Income earned by tax residents of the CCCTB jurisdictions** (hereafter residents) **from CCCTB jurisdictions' sources**,
  - **Income earned by tax residents from sources outside of the CCCTB jurisdictions** (hereafter the 'foreign income'<sup>2</sup>), and
  - **Income earned by companies tax resident outside of the CCCTB jurisdictions** (hereafter non-residents) **from the CCCTB jurisdictions' sources**
5. **Foreign income of non-residents** is not very likely to be covered by the CCCTB as taxing rights lie outside of the EU. On transactions between related parties from the CCCTB jurisdictions and third countries the arm's length principle will remain to be applied. A common approach to its application and connected problems, e.g. dispute resolution, would therefore be highly advisable as potential adjustments of transfer prices made by competent authorities of MS would influence the common tax base to be shared among participating MS.
6. This working document uses the terminology established in the International Aspects WD and has to be read in close conjunction with it. Further background information is also available in the Company Tax Study<sup>3</sup>. The terms consolidation, consolidated group, apportionment mechanism, apportioned base, formula etc. are used without prejudice to any future debates. They have not been defined yet and they are used in this working document in their general meaning. Similarly as in the International Aspects WD possible consequences of adopting of the CCCTB by less than 25 MS are not analysed at this stage.
7. In order to establish a good starting point for a proper allocation of taxing rights when there is consolidation and the consequent apportionment the limitation of the territorial scope of the CCCTB has to be considered. The precise details of consolidation and the apportionment mechanism will be dealt with separately.

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<sup>2</sup>Any income from exports or sales abroad earned by tax resident companies not attributable to a permanent establishment abroad is not included in foreign income and therefore not excluded from the CCCTB (this type of income would be covered by the first group of situations – income earned by tax resident companies from the CCCTB jurisdictions sources). It is mentioned because it would be of fundamental importance if exports to third countries (or sales related to items consumed by foreign customers) were excluded from the CCCTB for the apportionment of the CCCTB.

<sup>3</sup> Company Taxation in the internal market. SEC1681 23.10.2001, For example Part IV, Section 15.9 'Potential 'new' issues and related technical issues: foreign income and double taxation agreements'

8. Another reason why the territorial scope of the CCCTB has to be analysed closely is the proper and fair application of double taxation relief, particularly if the credit method were to be applied (for more details see the section III).
9. It may be very difficult to reflect all the nuances through the apportioning mechanism, for example to work out the formula in such a way that it would apportion (after the consolidation) the consolidated foreign income only to MS to which it 'belonged' according to the respective tax treaties with third countries. The results of allocation according to a new method (e.g. a formula) may not be necessarily the same as if the arm's length principle were used.
10. The application of a new apportioning mechanism, which will replace the arm's length principle within the CCCTB jurisdictions, would mean a different method of distributing taxable income among MS in comparison to the current situation. If for example income classified as business profits according to the respective tax treaty, earned by the CCCTB jurisdictions' tax residents from sources outside of the CCCTB jurisdictions (foreign income), is included in the consolidated tax base and redistributed amongst MS, and there are more members from different CCCTB jurisdictions in the consolidated group than the one who earned the foreign income, than they all would be able to share the tax base, which would include the respective foreign income.
11. In the case of foreign income the distribution of taxing rights is currently being done by the double taxation conventions, which represent obligations of MS participating in the CCCTB towards third countries and the changing of them would require further steps. Theoretically CCCTB jurisdictions would be able to give up taxing rights allocated to them, but they cannot unilaterally change the scope of an obligation which reduces the rights of their treaty partners outside of the CCCTB, without changing the treaties. On the other hand changing/amending/partially suspending parts of the treaties amongst MS within the CCCTB can be done by the CCCTB (EC) legislation. Indeed this is a consequence of the EC legislation.
12. Although the apparent redistribution of foreign income by way of an allocation system – for example the income of a PE in a third country being allocated to a number of MS instead of remaining in the MS whose company has the PE – might appear radical this is in line with the philosophy of a consolidated tax base. Within the group, income from the CCCTB jurisdictions' sources would be treated in a similar way. Income of tax residents of one CCCTB jurisdiction would be consolidated with income of tax residents in other CCCTB jurisdictions and shared by all MS for taxation. The method of allocation currently adopted is to separately account on a single entity basis and apply arm's length pricing.

## **II Income earned by residents from sources in the CCCTB jurisdictions**

13. As already discussed in SG1 and SG3 any income earned by residents from the sources in the CCCTB jurisdictions should be in principle covered by the CCCTB. No income has been identified so far as being not taxable, although

some discussion is still to be held on exempt income. This should be without prejudice to possible ring-fencing of some specific types of profits and losses within the CCCTB that are being discussed in SG1 and SG3.

14. Similarly the scope of resident companies to which the CCCTB would apply should be as wide as possible. Whether some corporate taxpayers of specific nature should be excluded from the scope of the CCCTB will be discussed at a later stage.

### **III Foreign income earned by residents**

15. If the worldwide taxation of tax residents is applied the foreign income earned by residents would be taxable in the CCCTB jurisdictions. To decide whether such income should be included in the CCCTB or taxed separately at a national level of the MS concerned, various aspects and consequences have to be examined. As mentioned in paragraph 3 it may also be interesting to see whether some coordination should be done in respect of income left outside of consolidation, for example whether there should be some common rules for it, although it is not consolidated. A common approach will be necessary at the least for defining which income is consolidated and which is left outside.
16. Relieving double taxation before the CCCTB is apportioned to participating MS could represent a less complicated solution, i.e. the application of the exemption method to income included in the CCCTB would be simpler than using the credit method. The exemption method relieves the double taxation at the level of the tax base whereas the credit method applies to the tax liability, so that the tax rate is reflected in the latter (assuming that the ordinary credit method<sup>4</sup> would be used).
17. So far both methods for the elimination of double taxation work on a bilateral basis and the taxation of the income in question is distributed between not more than two states. Double taxation relief is granted by one of them. Although some of the implications for the CCCTB may appear complicated at first sight it is worth recalling that 'traditional' double taxation agreements are also difficult to apply in situations where more than two states are involved, so-called 'triangular cases'. The CCCTB will be shared by more than two states in most cases and it would not lead to a 'fair' result if just one of them were to provide the credit for the whole amount of the tax paid abroad. It could be possible to allocate the tax paid abroad to be credited by each participating MS according to the same method/ formula as the one used for sharing a tax base, however not necessarily with the same results, because the tax rate is reflected in the amount of credit, if the ordinary credit method is used. The future CCCTB intends to provide for rules on how the tax base is calculated and shared among MS, but there is no ambition

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<sup>4</sup> 'Ordinary credit method' – credit for the foreign tax is restricted to the amount of 'domestic' tax on the corresponding foreign income so if the 'domestic rate' is lower than the foreign rate the credit relief is restricted. This may be extended so that excess credits may be carried forward for credit against future 'domestic' tax on future foreign profits or may be expensed as tax deductible expenses. In contrast the 'Full credit relief method' provides a full credit by for example permitting the foreign tax to be credited against 'domestic' tax on other income.

to say how the tax liability should be calculated. Therefore the application of a method reflecting actual tax rates as, for example, the credit method would be difficult.

18. According to the ordinary credit method, which is currently used in most cases, the deduction shall not exceed that part of the tax, as computed before the deduction is given in the state of the tax residence, which is attributable to the income to which the tax paid abroad relates. How to calculate the amount of income and especially the tax that would relate to it in the state of tax residence is another open question to be analysed in more detail.
19. Most MS provide an additional deduction to relieve a partial double taxation following from disallowing a part of tax paid abroad when full credit is not available. The residual part of a credit can be carried forward or allowed as a tax deductible item in the following tax year. However if this residual part of the tax paid abroad, that exceeded the above mentioned limit, was brought back in the common tax base the subsequent redistribution would be difficult because the residual part of the credit and subsequently the tax base would be affected by different tax rates. Bringing this item back into the CCCTB would mean an advantage for MS with lower tax rates.
20. Theoretically the full credit method would be slightly easier to apply, but Member States have little practical experience with this method at present. Besides that problems with the sharing of the credit among participating MS would remain.
21. One possible solution would be leaving all foreign income earned by residents outside of the CCCTB. If the worldwide taxation of income of residents were to be applied at the same time it would mean that the foreign income of tax residents would be taxed at national level separately from the CCCTB and similarly the double taxation relief would be provided at national level outside of the CCCTB. Although this possibility is theoretically relatively simple, in practice it would mean that companies would be taxed separately on their profits from domestic activities and from activities abroad. This may not be very appropriate, particularly in the case of business profits allocated to permanent establishments which are currently included in one single tax base in most MS. Making any distinction in tax treatment of different types of income (foreign/domestic) may open the door for tax planning and the risk of profit shifting between the income covered by the CCCTB and income not covered by the CCCTB would increase.
22. Another way to deal with the issue would be to include foreign income earned by residents in the CCCTB and apply the exemption method (before apportionment) to it. However simple and uncomplicated this solution seems to be, prudent anti-avoidance rules would have to be introduced at the same time since it is slightly sensitive to some planning techniques, particularly those benefiting from lower tax rates in some third states. It also has to be considered whether in respect of third countries it is wise to allow the deduction of foreign losses if the exemption method is applied. Traditionally the effect of the exemption method is that the state of residence disregards both foreign profit and losses, but this is not always

- the case<sup>5</sup>. The treatment of any such losses – should they be 'shared' between participating CCCTB states, or remain outside the CCCTB allocation system and therefore 'funded' by one state needs to be discussed (see paragraph 28).
23. If the exemption method were to be applied to foreign income covered by the CCCTB as a general rule, it needs to be discussed how to proceed in cases where the credit method is stipulated in the respective treaty and whether this problem could be overcome without treaty renegotiation. It should be taken into account that in cases when existing bilateral tax treaties provide for it, companies might still be able to claim the credit in the state of their tax residence, unless the CCCTB legislation somehow prohibited this as a condition of participation.
  24. How appropriate it is to include foreign income in the CCCTB could also be studied for different types of income separately. Making a distinction between active and passive income may be particularly useful in this respect. As the criterion for distinction between active and passive income the Article 7 of the OECD Model and practices developed within OECD could be used as a starting point, although it would need to be refined to ensure a completely common definition. Business profits as defined there would represent active income; any other income would be passive. For further differentiation of passive income, if necessary, some additional guidance can also be found in the OECD Model. If some categories of foreign income should be left out of the CCCTB and others included the definitions of the respective categories would have to be done prudently and preferably in line with the OECD Model. For example business profits could be included in the CCCTB and remaining income left out and taxed at the national level. It would be important to give clear definitions of the types of income and also to specify how related expenses should be identified as covered by the CCCTB, and not covered by the CCCTB. It is an open question whether or not including such income in the CCCTB would mean only that the income would not be consolidated (but still taxable under common rules) or whether its taxation would be left completely to national legislation.
  25. The distinction between income covered by the CCCTB and not covered could also be done according to another criterion, e. g. whether income is subject to a withholding tax abroad or taxed on a net basis abroad. A disadvantage of this solution would be that the decision of what income is covered by the CCCTB would be in the hands of third states and MS would have to renegotiate tax treaties if they wanted to cover income subject to a withholding tax. If withholding tax were imposed in the state of source and the income were to be included in the CCCTB, it would have to be included in gross amount (before the tax was withheld).

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<sup>5</sup> At present, five MS provide for a deduction of losses from permanent establishments situated in another MS, although they exempt their profits from the tax base of the head office. Although this working document primarily covers relations between EU MS and third states within the context of the CCCTB it has to be noted, that if MS find that their existing systems create unjustified obstacles to the fundamental EC treaty freedoms, steps to remove those obstacles will have to be taken. The CCCTB itself will obviously also have to respect the freedoms.

26. Any income covered by the CCCTB should not be subject to a withholding tax within the CCCTB jurisdictions<sup>6</sup>. The CCCTB legislation could explicitly state that. Otherwise distribution of the shared tax base may be unfair. The MS imposing a withholding tax would take their 'share' before an apportionment according to the agreed method and it would probably be rather difficult to make corresponding corrections afterwards (a withholding tax is applied on gross income, the CCCTB would be calculated on net basis, etc.).
27. Members of the Group may wish to consider whether foreign income of residents (or respective resident companies themselves) should be covered if the resident does not perform any business activity on the territory of the CCCTB jurisdictions and the business is done solely or mainly in third countries (for example a CCCTB jurisdiction resident holding company with branches/permanent establishments in third states outside of EU).
28. If some MS were to keep the taxation of the worldwide income of their tax residents and use the credit method for the elimination of double taxation in respect of income included in the CCCTB while other participating MS were to apply the territoriality principle or use an exemption method for the elimination of double taxation in respect of the same type of income, the income would have to be kept outside of the CCCTB and only 'pooled' with the tax base after apportionment in MS with credit method. For example, if
- business profits earned from sources outside of the CCCTB jurisdictions were included in the CCCTB (if taxable), and
  - MS1 wished to include them in taxable income of tax residents and apply a credit method for elimination of double taxation, and
  - MS2 wished not to include them in taxable income of tax residents (or would include them in the taxable income and apply an exemption method for the elimination of double taxation),

it would be difficult to include business profits earned through a permanent establishment in a third country in the CCCTB. MS1 would have to separate the profits and losses earned through a PE in a third state from other income and expenses earned by resident companies (which would be included in the CCCTB) and pool them with the remaining profits and losses of the company after apportionment of the CCCTB. MS2 would not have to do any additional adjustments of the apportioned CCCTB. If the MS2 wished to apply the exemption method but permit the deduction of foreign losses the deduction of these losses would probably also have to be done after the apportionment (see paragraph 22 above). Such a solution would include in the CCCTB the income and losses of the same type in all participating MS although they applied a different basic rule on the definition of taxable income (worldwide versus

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<sup>6</sup> Similarly it would be difficult to include in the CCCTB income on which a withholding tax is applied at national level within one MS.

territoriality). The main difference in comparison to the current situation would be that in the credit MS the income earned through a PE abroad would not be treated in exactly the same way as the remaining income of the company.

#### **IV Income earned by non-residents from sources in the CCCTB jurisdictions**

29. Whether the CCCTB should be potentially available to all non-residents or only to those who are members of the EU group will need to be considered. For example should two permanent establishments of a non-resident company, with no related companies resident in CCCTB states, be treated as part of the CCCTB and therefore be able to consolidate their tax bases. However, as the following analysis illustrates, there are a number of factors to examine before a conclusion can be reached.
30. Non-residents are generating income taxable in the EU MS, for example business profits earned through permanent establishments situated in the EU MS. One of the most common situations is a parent company situated outside of the CCCTB jurisdictions with one or more permanent establishment(s) in one or more CCCTB jurisdiction(s). Another example could be a parent tax resident in a CCCTB jurisdiction with a subsidiary tax resident outside of the CCCTB jurisdiction and the subsidiary would have one or more permanent establishment(s) in one or more CCCTB jurisdiction(s).
31. Although the simplest solution would be to exclude non residents' income taxable within the CCCTB jurisdictions from the CCCTB, it may not be the most suitable one. Activities carried out through a permanent establishment often represent an integral part of business conducted in the EU. Such a solution would also be very sensitive to the shifting of profit outside of the CCCTB and would require a system of prudent anti-avoidance rules.
32. As for the calculation of the CCCTB, the inclusion of non-residents' income earned through permanent establishments situated in the CCCTB jurisdictions should not create a major difficulty, because the tax base of permanent establishments could be calculated according to the same rules as the tax base of residents.
33. The difficulty would arise when allocating business profits to permanent establishments. In most existing tax treaties negotiated between EU Member States and third countries the arm's length method is used as an allocation rule. In the CCCTB a different mechanism would be used for the allocation of the tax base to participating MS. Some third countries may find such a practice contrary to the applicable tax treaty and may require recalculation of a permanent establishment's profits according to the arm's length principle. For example if a parent company resident in MS1 has a subsidiary in a third country and this subsidiary has a permanent establishment in MS2 and the parent consolidated with the permanent establishment, the profits would be allocated to the MS1 and the MS2 according to a different method than the arm's length principle. If the only permitted method for the allocation of profits to the permanent establishment

according to the tax treaty between the MS2 and the third country state of residence of the subsidiary is the arm's length principle there is a potential conflict which needs to be addressed. For CCCTB purposes the MS2 has a tax base calculated in accordance with the CCCTB allocation method; but according to the Treaty with the third country the tax base must be calculated on the arm's length basis.

34. Individual tax treaties have to be analysed closely because some of them may offer a solution<sup>7</sup>. The OECD Model accepts alternative allocation methods to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, insofar as it has been customary in a contracting state<sup>8</sup>. Amending of all respective existing tax treaties may be a final answer to the problem in the longer term.
35. Short term solutions, so the CCCTB can function before any re-negotiation of tax treaties with third countries, will be necessary. It will be important to establish the approach major third countries would take to this issue. It would be particularly valuable to see for which third countries the allocation of profits to permanent establishments according to a method different from the arm's length principle would be interpreted as customary and allowable, and which of them would interpret that as a breach of the treaty provision. Permanent establishments of companies tax resident in the latter countries would not seem to be able to benefit from the CCCTB before the respective tax treaties were amended.
36. On the other hand the exclusion of permanent establishments of third states' residents from the CCCTB scheme may also create a problem in relation to tax treaties, particularly to non-discrimination clauses incorporated in most of them. For example the OECD Model states: 'The taxation on a permanent establishment which an enterprise of one state has in the other state shall not be less favourably levied in that other state than the taxation levied on enterprises of that other state carrying on the same activities'<sup>9</sup>.
37. The process of amending existing tax treaties could be done by either bi-lateral or multilateral negotiation for the CCCTB jurisdictions. Advantages and disadvantages of both possibilities should be further examined, taking into account, for example, the prospects of faster results, and the benefits of applying a common policy in states that are more closely linked than OECD states are in general.

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<sup>7</sup> For example Art. 7 Para 4 of the tax treaty concluded between Germany and Norway, Art. 7 Para 4 of the tax treaty concluded between Germany and China

<sup>8</sup> Art 7 Para 4 of the OECD Model

<sup>9</sup> Art 24 Para 3 of the OECD Model