

Common Consolidated Corporate Tax Base: sharing the tax base under formulary apportionment

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Abstract

The present situation in the area of corporate income taxation in the European Union, when companies are facing 27 different corporate taxation systems, which decreases the competitiveness of the corporations, for it does not enable to use fully the advantages connected with the internal market, has resulted into a effort of the European Commission to introduce harmonized system of corporate taxation in the form of common consolidated corporate tax base (CCCTB). The need of decrease in compliance costs of taxation has even increased in connection with the economic crisis. The paper discusses the possible attitudes and methods of consolidated tax base allocation between the individual member states. Based on the discussion, the paper tries to identify advantages and disadvantages of formulary apportionment with three equally weighted factors - sharing mechanism, which has been selected for CCCTB system.

Keywords: CCCTB, formulary apportionment, tax base, sharing, European Union

JEL codes: H25, K22

1. Introduction

European Commission has worked for more than 10 years on the possible model of common system of corporate taxation in the European Union. Its effort resulted into a publication of CCCTB directive proposal on 16th March 2011. The CCCTB proposal represents a unique system. The introduction of CCCTB system of should bring number of advantages to the corporations.

Under proposed CCCTB system the fair tax competition should be established, for the nominal corporate tax should become more transparent for the enterprises for they will reflect real tax burden (they are comparable in case that the rules for corporate tax base construction are harmonized). The introduction of CCCTB system will also help to remove the obstacles to international mergers and acquisitions, resulting from the lack of coordination of capital profit taxation. The problem with transfer pricing should be eliminated, which results in to the compliance costs decrease, not only on the side of the taxpayers abut also on the side of the tax authorities. The compliance costs of taxation will be also decreased by the fact, that the companies will no longer face 27 different systems of taxation on the internal market. Last advantage of CCCTB system is the fact that it enables the cross-border loss compensation.

It is also necessary to mention, that the introduction of CCCTB system will probably be connected also with some disadvantages. As the disadvantage can be considered the fact, that the existence of two systems (national tax system and CCCTB), leaves the space for speculations, tax arbitrations, tax evasion and fraud. Therefore the proposal introduces quite strict rules for getting in and getting out of the CCCTB system in order to avoid possible speculations and tax arbitrations.

Another area which has been the subject of great discussion represents the tax base sharing mechanism. The aim of the paper is to discuss the possible consequences of the formulary apportionment system, which has been finally proposed in the CCCTB directive proposal.

There are used standard scientific research methods in the paper. Firstly, the comparative analysis of possible models of sharing mechanism is done. In that part, the method of description is also used. Then, the method of modulation is used in order to show, how the selected system of the tax base sharing under CCCTB will work within the EU. The conclusion represents the synthesis of the results reached in the paper.

2. Theoretical background

There are two basic theoretical approaches towards the problem of the determination of the income of MNE in each country, where it is active – formulary apportionment and separate entity accounting. Under separate accounting approach each enterprise within the group is treated as separate entity. Those entities are completing financial accounts and exterminating the profit according the rules in comprised in the taxation systems in each location. The parent company has to calculate its financial account as each of its enterprise would be independent entity – i.e. all the transactions between the members of the group have to be at arm’s length.

As mentions (Bakker, 2009) under arm’s length principle, affiliated businesses should set transfer prices at levels that would have prevailed had the transaction occurred between unrelated parties. As mentions (OECD, 2001) , the arm’s length principle eliminates tax consequences that could arise solely from the organizational form of the enterprise.

Under formulary apportionment, the member of the group can calculate its share on the profit based on the activities, which are conducted in its location. When applying the formula, there is no need for MNE to calculate the profit earned by each member of the group. As mentions (Sorensen, 2004) and (Deveraux, 2004) formulary apportionment can be regarded as a system of source taxation.

First scientific work, which has been focused sharing mechanism, concretely on formulary apportionment, was done by (Musgrave, 1972), who pointed out that formulary apportionment could eliminate the problem with transfer pricing within multinational corporations. Later (Gordon and Wilson, 1986) examined how corporate taxation of multinational firms using formula apportionment affects the incentives faced by individual firms and individual states. (McLure, 1980) has proved that when a formula consists of the factors as property of the company, payroll and sales, corporate income tax transforms into a tax on property, payroll and sales. This has also been proved by (Goolsbee, and Maydew, 2000). Also (Wellish, 2000) shows, that when a labour is used as the factor, then the costs of labour are exceeding the local wage rate, which reduces the demand for labour in each state.

The possible methods of sharing the tax base, mainly the formulary apportionment in the conditions of the EU has been discussed by (Hellerstein, 2004; McLure, 2004), who emphasize that EU should learn from the US and Canadian experience with formulary apportionment. Also (Weiner, 2005) and (Mintz, 2004) stipulate several problems of US and Canadian experience that could be useful for EU corporate taxation. The problem of the sharing mechanism within the EU and possible proposals has been discussed by (Sorensen, 2004), (Deveraux, 2004) or (Agúndez-García, 2006).

Another authors as (Lodin, 2001; Gammie, 2001) were focusing on value added based apportionment. Also (Hellerstein, 2004; McLure, 2004) were analysing in their study value added approach.

There are several mechanisms which have been developed to share a tax base between the states. Some of them are already applied for sharing the tax base in the countries as United States, Canada or Switzerland. Some of those mechanisms have been discussed and selected by the CCCTB working group as the potential candidates for the tax base apportionment under CCCTB system. Allocation formulas can be divided according the factors which are used for allocation on macro - based formula and micro-based formula. While applying micro-based formula, two approaches can be used – value added approach (VA) and formulary apportionment (FA) approach. Selected formula can influence the portion on the tax base in dependence on the factors which are used. The basic criteria which should be met by the method of apportionment are fairness, enforceability, simplicity and cost-efficiency.

3. Results

3.1 Macro-based formula

Under macro-based formula the tax base is apportioned according to the factors which are aggregated at national level – for example GDP or “national value added tax base”. Application of that tax base sharing mechanism under CCCTB system would enable two ways of apportioning. Firstly, the tax base could be distributed only among the states, in which the CCCTB group would be active. Secondly, the CCCTB could be apportioned among all member states.

The application of macro-based formula in CCCTB system would result in the practical sharing described following. The group is acting in the member states A and B. Member state A accounts for 8,2% of EU GDP, member state B for 4,3% of GDP, member state C for 6,9% of GDP and member state D for 1,1% of GDP. In that situation, when the apportioning factor is GDP and CCCTB is distributed among all member states each state will receive the part which is equal to its account on EU GDP. I.e. Member state A will receive 8,2% from CCCTB group tax base, member state B 4,3%, member state C 6,9% and member state D 1,1%.

While in second situation, when the tax base is shared only by the states in which the CCCTB is acting would look as follows. The group is acting in the member states A, B, C and D and the distribution of the aggregated GDP of these countries is 35%, 15%, 5% and 45%. Then, the tax base will be distributed according to these above mentioned percentages between the member states A, B, C and D.

It is necessary also to mention that the system under which the tax base would be distributed only among the states, where CCCTB group is active, would enable tax planning – the company could be located in low tax jurisdiction in order to avoid taxation or at least to decrease the tax burden. Therefore the implementation would require also the implementation of anti-avoidance rules.

3.2 Value added approach

Under value added approach, there are two ways of calculating value added by a business – a subtraction-based value added and an addition-based value added. Under the subtraction-based method, the value of the inputs is subtracted from the value of the outputs (inputs do not include capital purchases or depreciation) in a given time period. Value added can be then calculated as follows:

$$\text{Value added} = \text{total value of the output} - \text{total value of the input} \quad (1)$$

Under the addition-based value added, the total remuneration of the employed production factors is employed. Therefore the value added is calculated as follows:

$$\text{Value added} = \text{labour compensation} + \text{interests} + \text{profits} \quad (2)$$

Under the value added approach is also needed to consider the territorial scope – i.e. where should value be considered to have been added. If there is a multinational corporation operating in two states – in state A is the production and in state B the sale – where have been the value added - in state A or B? The above described example implies two possible approaches to the value added approach.

First of them is origin based value added. Under that approach the value is considered to be added in the place, where the production takes place. While under destination based value added the value is considered to be added in the place, where the consumption takes place.

In case that value added sharing mechanisms would be implemented into the CCCTB, following formula would be applied in order to show the distribution of the CCCTB according to the value added:

$$TB_i^{VA} = CTB \left(\frac{VA_i}{\sum_i^n VA_i} \right) \times 100 \quad (3)$$

where TB_i^{VA} ($i=1, \dots, n$ represents all the jurisdictions where the group operates) stands for the tax base of the group that would be allocated under the value added (VA) approach. Based on the above stated formula the CCCTB would be distributed among the jurisdiction according the share of the value added of the company operating in one member state on the total value added of the group (Agúndez-García, 2006).

The group of the companies is operating in member states A, B and C. The microeconomic indicators of the group in each member state are shown in table 1.

Table 1: Subtraction-based value added and addition-based value added approach

Indicator	Member state A	Member state B	Member state C	Total
Sales (output)	2100	300	2200	4600
Labor compensation	550	30	450	1030
Interests	0	20	100	120
Other external costs (input)	750	100	650	1500
Profit	800	150	1000	1950
Profit in %	41,02%	7,69%	51,29%	100.0%
Subtraction-based value added	1350	200	1550	3100
Addition-based value added	1350	200	1550	3100

Source: own calculations

As can be clearly seen above, subtraction-based value added and addition-based value added are producing the same results, for the difference between the total production (output) and total consumption (input) of the company should be equal to the remuneration of the labour and capital plus profit.

The apportionment of the CCCTB based on value added approach is shown on the table 2 (while applying formula No. 3):

Table 2: The apportionment of the CCCTB based on the value added approach

	Member state A	Member state B	Member state C	Total
Share of the CCCTB	$\frac{1350}{3100} = 43.55\%$	$\frac{200}{3100} = 6.45\%$	$\frac{1550}{3100} = 50.0\%$	100.0%

Source: own calculations

3.3 Formulary apportionment in U.S.A. and Canada

Formulary apportionment represents the traditional tool for the distribution of the tax base of the group, which has been applied in the U.S.A. and Canada. The application of formula allocation in the U.S.A. dates back into the 1870s, when it was applied not in the field of corporate taxation, but property taxation of transcontinental railroad system. As mentions (Wiener, 2005) instead of measuring the property value in each state, companies generally measured their total property value as a single unit and distributed that total across the states according to the value of the railway lines located in each state relative to the total value in all of the states. Formulary apportionment in corporate taxation was firstly used in Wisconsin. It was three factors formula including factors as property, costs of manufacture and sales. It can be said that by the end of 1930s, nearly all the states of the federation have adopted formulary apportionment. This three factor formula with equally weighted factors is called "Massachusetts" formula. This formula can be expressed following:

$$P_i = P_t \left(\frac{1}{3} \frac{C_i}{C_t} + \frac{1}{3} \frac{L_i}{L_t} + \frac{1}{3} \frac{S_i}{S_t} \right) \quad (4)$$

where P_i represents profits allocated to the state i , P_t profits of the enterprise, C stands for property, L for labour and S for sales.

As mentions (Mayer, 2009), since 1980s states have moved from equally weighted factors to the formula, where sales factors has been increased, while factors of property and payroll have been decreased. This is clearly evident from the following table 3.

Table 3: State Corporate Income Tax Rates and State Apportionment of CIT in USA in 2011

State	SCIT in %	Apportionemnt	State	SCIT in %	Apportionment
Alabama	6.5	3 Factor	Nebraska	7.81	Sales
Alaska	9.4	3 Factor	Nevada	none	none
Arizona	6.968	Double wtd sales**	New Hampshire	8.5	Double wtd sales
Arkansas	6.5	Double wtd sales	New Jersey	9.0	Double wtd sales
California	8.84	Sales/ Double wtd sales	New Mexicko	7.6	3 Factor/Double wtd sales
Colorado	4.63	Sales	New York	7.1	Sales
Connecticut	7.5	Double wtd sales/Sales	North Carolina	6.9	Double wtd sales
Delaware	8.7	3 Factor	North Dakota	6.4	3 Factor
Florida	5.5	Double wtd sales	Ohio	*	Double wtd Sales
Georgia	6.0	Sales	Oklahoma	6.0	3 Factor
Hawai	6.4	3 Factor	Oregon	7.6	Sales
Idaho	7.6	Double wtd sales	Pennsylvania	9.99	90% Sales/5% Property/5% Payroll
Illinois	9.5	Sales	Rhode Island	9.0	3 Factor
Indiana	8.5	Sales	South Carolina	5.0	Double wtd sales
Iowa	12.0	Sales	South Dakota	none	none
Kansas	7.0	3 Factor/Sales	Tennessee	6.5	Double wtd sales
Kentucky	6.0	Double wtd sales	Texas	*	Sales
Lousiana	8.0	Sales	Utah	5.0	3 Factor/Double wtd sales
Maine	8.93	Sales	Vermont	8.5	Double wtd sales
Maryland	8.25	Sales/Double wtd Sales	Virginia	6.0	Double wtd sales
Massachusetts	8.25	Double wtd sales	Washington	*	none
Michigan	*	Sales	West Virginia	8.5	Double wtd sales
Minnesota	9.8	90% Sales/5%property/ 5% Payroll	Wisconsin	7.9	Sales
Mississippi	5.0	Sales	Wyoming	none	none
Missouri	6.25	3 Factor /Sales	Dist. Of Columbia	9.975	3 Factor
Montana	6.75	3 Factor			

* Those states do not apply corporate income tax but gross receipt tax

with rates not strictly comparable to corporate income tax

** double wtd sales means 80% sales/10% property/10% payroll

Source: Federation of Tax Administrators, 2011

As can be seen from the table above, at present the majority states are applying double weighted formula¹, 11 states still apply Massachusetts formula. New Mexico and Utah enables the application of both methods – double weighted formula as well as Massachusetts formula. Some of the states also apply a single-factor sales formula.

The development of formulary apportionment in Canada has been different from the United States. As mentions (Weiner, 2005), initially allocation rules assigned income according the location of the permanent establishment of the company. If the company had permanent establishments in more provinces, then the income was allocated according the separate accounts or according the ratio of gross income of the permanent establishment to the total income of the corporation. This formula was considered as giving too much weight on the province, where the headquarter was situated. The three factor formula as was applied within the U.S.A. was perceived that it attribute too much income to the exporting provinces as mentioned (Mintz, 2004). Therefore subsequently, the standard formula has been modified on the formula with equally weighted gross revenue and payroll. The applied formula can be expressed as follows:

$$P_i = P_t \left(\frac{1}{2} \frac{GI_i}{GI_t} + \frac{1}{2} \frac{L_i}{L_t} \right) \quad (5)$$

where P_i represents profits allocated to the province i , GI_t gross incomes of the enterprise, and L stands for labour. It is very interesting, that the factor payroll covers also fees paid for services that would be normally performed by employees of the corporation. And further, gross income does not include interests on bonds dividends on shares of capital stocks, royalties, etc. Not used in connection with the principal business operations of the company.

The main difference of Canadian formula from the one applied in the U.S.A. is the fact, that federal allocation rules comprise specific rules for specific industries – i.e. that specific formula is applied to certain type of business. Formula apportionment for truck and bus operators represents the combination of two factors – payroll and the ratio of the kilometres driven in the provinces in which the company has permanent establishment. Or formula apportionment for insurance companies is based on ratio of an aggregate of net premiums for insurance of the property located in the province and resident persons in that province to the total premiums. Other specific formulas are applied for railway industry, banks, airline industry, etc.

As mentions (Daly, 1992) the system of apportioning profits in Canada among the provinces deserves special attention, for it is part of provincial tax arrangements, but at the same time is highly harmonized.

3.4 Formulary apportionment under CCCTB

The most frequently used factors are represented by profits, payroll, property or sales. The above described factors of the formula are used in various combinations and are weighted differently in the states using FA for the apportionment (Petutshig, 2010). The proposed formulary apportionment under CCCTB comprises three factor formula equally weighted according the factors of sales, labour and assets:

$$ShareA = \left(\frac{1}{3} \frac{S^A}{S^{group}} + \frac{1}{3} \left(\frac{1}{2} \frac{P^A}{P^{Group}} + \frac{1}{2} \frac{E^A}{E^{Group}} \right) + \frac{1}{3} \frac{A^A}{A^{Group}} \right) * CCCTB \quad (6)$$

where S represents sales, which are based on the sales of goods and services. P represents payroll, which includes the costs of salaries, wages, bonuses and all other employee compensation, including related pension and social security costs borne by the employer. E represents the number of employees, which are considered part of the group that pays the remuneration, unless they are under the control of a different group member, in which case they are considered part of that group. Employees

¹ Some of the states put weight bigger than 50% on sales factor.

are included if they are employed for at least three uninterrupted months. And finally, A represents assets, which include all fixed tangible assets, including buildings, airplanes and machinery, owned, rented, or leased by a group member. The practical application is shown on table 4.

Table 4: The application of three-factor formula with equally weighted factors

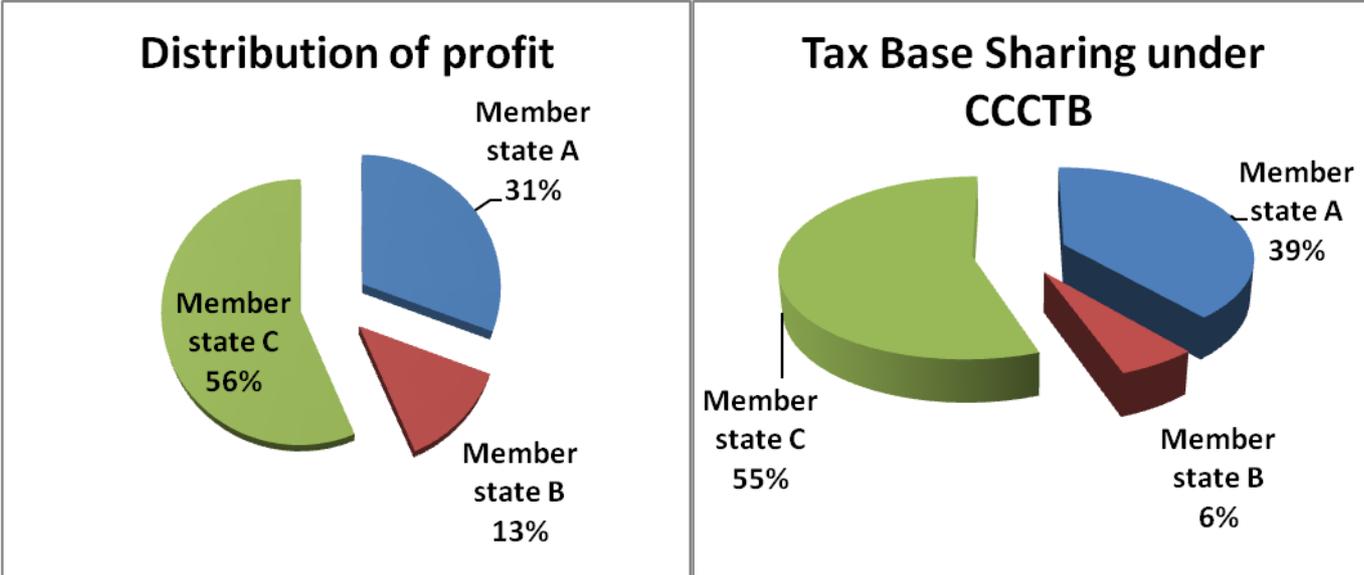
Factor	Member state A	Member state B	Member state C	Total
Profit	300 (30.8%)	125 (12.8%)	550 (56.4%)	975 (100.0%)
Payroll (P)	150	25	450	625
Number of employees (E)	100	50	300	450
Assets (A)	40	0	25	65
Sales (S)	800	250	1500	2550
$TB_i^n = \frac{1}{3} \frac{S_i}{\sum_i S_i} + \frac{1}{3} \left(\frac{1}{2} \frac{P_i}{\sum_i P_i} + \frac{1}{2} \frac{E_i}{\sum_i E_i} \right) + \frac{1}{3} \frac{A_i}{\sum_i A_i}$	(38.7%) 377,33	(5.8%) 56,55	(55.5%) 541,12	(100.0%) 975,00

Source: own calculations

As can be seen from the above presented Table 4, the distribution of the consolidated tax base between the Member States A, B and C due to the application of three-factor formula differs from the share of individual group members on the profit. The situation is shown on following Figure 1 and Figure 2.

Figure 1: Distribution of profit

Figure 2: Tax base sharing under CCCTB



Source: own calculations

Source: own calculations

The biggest change can be seen in Member State B, where the share on profit in the group represented 13%, but with the application of three-factor formula, the share on the consolidated tax base has dropped by 7% on 6%. This has been cause mainly by the fact, that group member in member state B does not possess any assets in that state. This represents the proof, that the outcome of the allocation of consolidated profit among the member state and the impact on the tax revenues of the member states is hardly predictable and should be the subject of further research.

The Commission was aware of the impacts on the tax base sharing and tax revenues that may result from the application of three factor formula, therefore the proposal of the directive comprises the specific rules for specific sectors of industry according to the pattern, which is already applied in Canada. Therefore there are stipulated specific provisions for specific industries as financial institutions, insurance undertakings, oil and gas and shipping, inland waterways transport and air transport with regard to the definition of individual factors comprised in the formula.

Moreover, the directive proposal comprises in Art. 87 safeguard clause according to which, if the taxpayer or the tax authority consider the outcome of the apportionment to a group member that it does not fairly represent the extent of the activity which is carried out in the member state, taxpayer or tax authority may request application of an alternative method.

4. Conclusion and discussion

At present the business acting on the Internal Market is facing 27 different corporate taxation systems. As a result of that the compliance costs of taxation are arising to the business. That fact decreases the competitiveness of the European companies on the global market. Therefore the Commission decided to introduce harmonization models in the area of corporate income taxation – home state taxation system and common consolidated corporate tax base. The introduction of pilot project under home state taxation system has not started yet; therefore the Commission has turned the attention to the CCCTB.

Before the publication of CCCTB proposal, the European commission considered three possible methods for apportioning of CCCTB. The basic difference is that the distribution can be done either on macro or micro level. In case of micro-level, there can be used two alternatives – formulary apportionment or the method based on the calculation of the value added.

The selected sharing mechanism should be built on the basic traditional tax principles as the principle of equity and principle of efficiency. Formulary apportionment should be as simple as possible not only to apply but also to audit by the tax authorities. It should also be difficult to manipulate and it should ensure fair and equitable distribution of tax base. Finally, it should not lead to the undesirable effects in terms of tax competition.

The aim of the CCCTB is to decrease the compliance costs of taxation; they cannot be raised again by the allocation mechanism. Therefore all the advantages and disadvantages of the models need to be judged carefully.

As regards the macro-based formula, the main disadvantage is considered to be the fact, that it can generate a decoupling between the creation of the value in the member state by a multinational group and its tax liability in that member state. It represents the disconnection between the real economic activity performed by a company and the share on the tax base which is in the conflict with the idea of the fair distribution of the tax base. Therefore the macro-based formula seems to be rather unacceptable option. Further, it is important to mention at that point that the even though the distribution between all member states seems to be just it can generate race-to-the-top of the tax rates, for member states will get a fixed share on any group (under that system they would not be forced to attract the tax base by the lower tax rate). Therefore, the distribution among all member states should be accompanied by the measurement on the EU level concerning the tax rates. In respect to the fact that member states are not willing to approve any measurement concerning the corporate tax rates, macro-based formula seems to be unrealistic solution. On the other hand, that method is very simple and efficient.

Under the value-added based formula the situation described above is avoided for it relies on micro-economic indicators (as profit). On the other hand, some disadvantages can also be found. Firstly, the system requires a lot of calculations from the side of the companies (therefore it does not contribute to the decrease in compliance costs of taxation). Secondly, for the value-added calculation all the intra-group transactions should be done at arms length price (i.e. transfer prices has be used). Therefore that method would not eliminate the problems with transfer pricing on the Internal Market, which was one of the aim of the CCCTB introduction.

Formulary apportionment seems to be more just, for under that system, the connection between the factor which creates the value in the jurisdiction and the share on the CCCTB is closer (relative to

the others). It is important to mention that formulary apportionment has been applied in the U.S.A. and Canada for quite a long time. As state (Hellerstein and McLure, 2004) EU should learn from the problems and experience in U.S.A. for they are facing serious problems connected with the lack of unified factors and weights used for the apportionment (at present different weight on each factor is used in individual states). The factors which could be used in formula have to be discussed carefully. As has proved (Welish, 2004) or (Goolsbee and Maydew, 2003) using labour as a factor of formulary apportionment transforms corporate income tax on labour tax. As a result of that, the states can use tax competition in the form of lower labour tax rate or certain types of incentives to attract the business.

Even though the fact that the CCCTB directive proposal comprise the suggestion of three factor formula, the example above have proved that there can arise serious budget consequences for the member states due to the allocation of the share on the tax base. Therefore there should be established discussion on the weighing of the factors of the formula. In theory, there can be found two basic approaches towards the weighting of the factors in formula. (Francis and McGavin, 1992) are in favor of equal weighting, while (Fox, 2005) argue for higher weight on sales. It is also necessary to mention, that the discussion could be also lead about the definition of the factors, for they also play very important role in the allocation. The definition of the factor of assets in the present CCCTB directive proposal does not comprise intangible assets. Moreover, self-generated assets are not defined as assets for factor purposes. This fact can very much influence the allocation of the tax base by negative way in the member states, where the companies with the major share of intangible assets on tangible assets are situated.

The formula for the allocation of the consolidated profit among the member states will definitely impact the revenues of members states, therefore the great deal of the attention should be paid to the decision on the weighing of the factors.

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