

SPEECH TO THE CONGRESS OF THE CONFEDERATION FISCALE
EUROPEENNE BY CHRISTOPHER TUGENDHAT, VICE-PRESIDENT
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THE STATE OF TAX HARMONIZATION IN THE EUROPEAN COMMUNITY

Introduction

May I first thank the Confederation for inviting me to address its members on the occasion of the 1982 Congress in Aachen. The Commission values these invitations as providing an opportunity to list our achievements, explain our policies and to elicit an informal response from eminent members of the European taxation profession.

The last two years since your Rome Congress have been difficult ones. Our economies are still struggling to break out of recession and there is no disguising that the outlook remains sombre. Many old problems in the Community are still causing difficulty and the admission of a tenth member, Greece, has also brought new ones of adjustment. These difficulties are inevitably reflected in the survey I am about to present on the current state of tax harmonization. While there has been some modest progress in the VAT field, there has been no movement on excise duties and direct taxes.

Let us look at VAT, excise duties and direct taxes in turn, starting with value added tax.

VALUE ADDED TAX

Two years ago, my predecessor as Commissioner responsible for taxation, Mr. Burke, gave you a general outline of the directives harmonizing the basis of assessment of value added tax in the European Community, of the directives designed to prevent double taxation of individuals and of the directives providing for mutual assistance between Member States.

Let me bring you up to date on developments in these areas and on the rulings given by the Court of Justice in cases relating to VAT. The Sixth Directive on VAT providing for a uniform basis of assessment - a necessary part of the own resources system for financing the Community budget - came into operation in 1980. VAT is now collected in all Member States (except for Greece, which will not introduce VAT until 1984) on a common basis of assessment. The Community can take up to 1% of the sums so collected as own resources. The amount taken in 1982 was 0.925%. This is expected to finance 55% of the Community budget for this year. The harmonization envisaged by the Council in the own resources decision of 21 April 1970 has thus become a reality.

Work on directives stemming from the Sixth Directive has continued during the past two years.

The Eighth Directive⁽¹⁾, which introduced harmonized arrangements for the refund of VAT to taxable persons not established in the territory of the country, has now entered into force in all nine Member States applying VAT, Italy having introduced the necessary provisions on 20 May this year.

(1) Eighth Council Directive of 6 Dec. 1979, OJ No L 331, 27.12.79.

The Eighth Directive, which covers only taxable persons established within the Community, is to be followed up by the Thirteenth Directive, which will harmonize the refund arrangements for taxable persons established outside the Community. The proposal lays down the principle that VAT charged on the goods and services purchased by taxable persons established outside the Community should be refunded, so as to eliminate the considerable disadvantages caused by current deflections of trade resulting from differences in Member States' attitudes to non-Community countries; however, the proposal does not impose uniform rules as to refund arrangements, given the wide variety of tax systems in non-Community countries.

The proposal has been adopted by the Commission and was presented to the Council on 19 July of this year.

The Commission proposal to the Council regarding exemption from VAT on the final importation of certain goods pursuant to Article 14(1)(d) of the Sixth Directive has made progress in Council.

Let me remind you briefly that the aim of the proposal is to harmonize the scope and detailed rules governing the exemptions provided for in that Article. The proposal covers a wide variety of goods, ranging from personal effects imported by individuals and students to goods imported for research or test purposes or upon transfer of an activity.

The proposal has been the subject of difficult discussions and, on the basis of a compromise put forward by the Presidency, it may be expected that the Council will adopt the proposal before the end of the year.

The proposal for a Directive harmonizing the VAT and excise duty procedures applicable to the stores of ships, aircraft and international trains seeks to lay down implementing arrangements and to define more precisely the scope of the procedures. As yet, the proposal has not been adopted by the Council.

The Seventh Directive relates as you know to the VAT system to be applied to second-hand goods, works of art, antiques and collectors' items. After a break of two years the Danish Presidency of the Council has recently reactivated discussion of this proposal and it is hoped that progress will be made on the basis of a compromise solution. The Commission has indicated that it is flexible in regard to some of the details of the proposal and, in particular on the limit of 4/5ths proposed for deduction of input tax for certain second-hand goods (notably cars).

So far I have covered recent developments related to the harmonization of the basis of assessment of VAT. Let me now turn to the programme for simplifying formalities and procedures in intra-Community trade.

In the first place the Commission has proposed measures designed to simplify formalities for firms, specifically a scheme for deferred payment of the tax payable on importation and measures to improve the application of VAT to small firms.

The proposal relating to deferred payment of the tax payable on importation by taxable persons is designed to remove obstacles to intra-Community trade. The Commission's proposal would allow VAT on imports to be entered on periodic tax returns, a system which already exists in four Member States thereby eliminating the need to make immediate payment at the frontiers and allowing for set-offs of reimbursements.

Formalities would be substantially simplified :

For example

- formalities at importation would be cut to a minimum: the taxable person would calculate the tax due, on his own responsibility, and declare it on his next overall tax return;
- customs-related formalities would consist solely of the lodging of the relevant import documents (e.g. Community transit procedure).

The cost of the formalities would undoubtedly be reduced, and tax treatment of imported goods would become more nearly comparable to that applied to domestic goods.

The arrangements would be obligatory for goods coming from other Member States, but would be optional for goods coming directly from a third country.

Next the Commission plans to propose measures designed to improve the application of VAT to small firms.

The most frequent criticism made by small firms is not of the VAT system itself, but rather of the complexity of the paperwork involved.

The VAT machinery entails a burden of accounting, invoicing, and tax return procedures which small firms were not in a position to bear when VAT was introduced in 1970. Initially, therefore, provision was made for exemptions, granted up to a given turnover ceiling, and for flat-rate taxation schemes. Article 24 of the Sixth Directive (special scheme for small undertakings) gave Member States a fairly free hand in deciding on the schemes applicable to its own small firms and on eligibility.

Because there is no strictly defined Community scheme for small firms, the schemes operated by the different Member States are fairly diverse. This has not eliminated the practical complexities of VAT administration, which are disproportionately demanding for small firms, as a result mainly of restrictions on the right to deduct VAT payable on certain purchases, the many different rates applied and of the myriad tax return requirements.

In view of this situation and the criticisms that have been made, the Commission is considering putting forward a proposal to harmonize the schemes for small undertakings, advocating a uniform exemption ceiling, probably of 10.000 ECU (which is roughly equivalent to DM 24.000, FF:60.000 or £6.500).

With a view to further simplifying VAT arrangements for small firms, the Commission is also planning to propose a simplified taxation scheme which could be adopted by all the Member States. Under this scheme, the formalities for small firms would be simplified as follows :

- 1) the chargeable event and VAT accounting would be simplified and based on payments and receipts, these being practical cash flow concepts that are immediately intelligible to small businesses and tradesmen (any reference to "supply" would be abandoned) ;
- 2) the VAT imputation mechanism would be simplified by standardizing most of the exceptions to the principle of deductibility and the operation of the rule of a time lag in deductions and possibly, in the case of certain homogeneous activities, by providing for a flat-rate deduction for determining input VAT;
- 3) simpler payment procedure with payments on account and settlement at the end of the year;
- 4) simpler VAT return, which would be annual and harmonized with the direct tax return to be made by small firms.

The Commission will formulate its approach on this matter in the near future.

Of course, the ultimate simplification would be the alignment and then standardization of the VAT rates applied in all the Member States. Quite apart from practical considerations of simpler accounting procedures, such a move would do away with tax frontiers and create a genuine common internal market.

However, we must be realistic: that eventuality, however dear to the Commission's heart must remain a hope for the distant future.

Let us now turn to the directives and proposals introduced the last two years with regard to exemptions for individuals.

The Council recently adopted the Fifth Directive relating to tax-free allowances for travellers, raising the ceiling from 180 to 210 ECU for goods transported in personal luggage in intra-Community travel. Unfortunately, this new ceiling does not fully allow for loss of purchasing power in real terms, particularly since it will not come into force until 1 January 1983, and in the case of Denmark, its implementation may be postponed until the end of 1983.

The Commission has resumed overall examination of tax free allowances for individuals. In due course it will prepare a report for the Parliament and the Council to be followed, we hope, with a proposal for a directive covering amongst other things a programme of adjustment of allowances expressed in money terms over a period of several years, development of the small parcels allowances and simplification of the clearance procedures applying to private individuals.

To conclude this section on VAT, I would like to turn to a very recent Court decision which stands out as breaking new ground: this is the judgment given by the Court of Justice on 5 May 1982 in Case 15/81 Gaston Schul.

In the first place it had been asked whether it was proper for the Sixth Directive to provide for the taxation of used goods acquired from a private person in one Member State and imported by another private person into another Member State, when the same transaction, if carried out within one and the same Member State, would be exempt.

Secondly, it was argued that there was inequality of treatment in that VAT was neutral where it applied to transactions carried out between taxable persons, but involved double taxation where such transactions were carried out between private persons resident in different Member States.

The Court based its answer on Article 95 of the Treaty, which is intended to ensure freedom of movement for goods within the Community by eliminating the protection afforded by discriminatory taxation.

Noting that, at the present stage of partial harmonization of Community law, Member States are free to charge the same amount of tax on imports as the value added tax which they charge on similar domestic products, the Court took the view that such tax was justified only in so far as the imported products had not borne value added tax in the exporting Member State. Otherwise imported products would be taxed more heavily than similar domestic products.

Accordingly, the Court concluded that the importing country should reduce the VAT payable on importation by the element of VAT borne in the exporting Member State.

This decision obviously has potentially very wide implications. It reaffirms that tax frontiers must not have the effect of contravening the principles of non-discrimination laid down in the Treaty.

While it is clearly right that the advantages of a single market should be made available not only to traders but also to private persons carrying out transactions within the Community, the method proposed by the Court for making this a reality appears to pose difficult problems.

The Commission is currently studying ways of overcoming these difficulties while at the same time complying with the principle laid down by the Court. It will be putting forward proposals in the near future.

EXCISE DUTIES

I know that the importance of the "bit 5" excise duties - i.e., on tobacco, hydrocarbons, alcohol, beer and wine - was stressed by my predecessor in both the speeches he delivered to you. I would remind you that expenditure on goods subject to excise duty accounts for up to one-fifth of total consumer expenditure and that most of these duties are levied at very high rates - often at 70% or more of retail price. Given these high rates of duty, even small differences in excise coverage or administration can radically affect the cost structure of a whole industry, or of industries which make use of the goods subject to excise duty. For example the energy cost to industry is considerably higher in Member States which subject heavy fuel oil to excise duty than in the Member States where it is exempt. It is therefore still the case that harmonization of excise duties offers the most substantial single opportunity in the fiscal area to promote market interpenetration and neutrality of competition.

Regrettably, notwithstanding the importance of excise duties and the widespread support for excise harmonization from the producers concerned, progress is very slow indeed.

In recent years we have also witnessed a certain retrograde movement, evidenced by the Commission being obliged to bring a variety of cases before the Court, most of them in the field of drinks taxation, for tax discrimination against products of other Member States. In 1980 the Court decided a number of such cases in the sense advocated by the Commission and it was then hoped the way was clear to a harmonized excise system at least for drinks. This has not in the event proved the case. Last October, the Council failed to reach agreement on a compromise package for harmonising excise duties on drinks, and the Commission has since been obliged to resume a number of Court actions.

Nor is the Council the only source of delay. In July 1980, the Commission presented a proposal for a third stage on the road towards a harmonised excise duty for cigarettes. This duty is of course a major revenue earner for all the Member States and because it accounts on average for almost three-quarters of retail price, it is of crucial importance for the whole cigarette industry. The third stage was due to begin on 1 January 1981. In fact, more than two years later, Parliament has yet to agree on its opinion on the proposal, and the second stage has already had to be prolonged to the end of this year.

TAX FREE SHOPS AND THE BUTTERSHIPS CASE

Let me round off this part of my survey by telling you where we stand on the vexed question of tax-free shops and butterships.

The Commission has had to consider the status of tax-free shops and travellers' allowances from time to time in the past but the current controversy arises out of the European Court's judgment of 7th July, 1981 in the butterships case (Case 158/80 REWE). The main thrust of the Court's judgment is simply that the practice of selling goods duty-free and tax-free on sham voyages to just outside territorial waters is incompatible with Community law. There is however a passage in the judgment to the effect that in intra-Community travel the sale of third country goods in tax-free shops is not permitted unless the Community customs duties and agricultural levies have been paid.

As a result of this judgment the Commission decided to seek enforcement both of the element calling for abandonment of butterships and of the element calling more generally for the levying of customs duties and agricultural levies in tax-free shops in relation to intra-Community trade. Indeed, as various members of the tax-free trade have admitted to us, the Commission could hardly have done anything less. At the same time however the Commission indicated that it had no intention of taking any further initiative in relation to tax-free shops. The Commission has made this point on numerous public and private occasions.

In April this year the Commission started infringement proceedings against the Member States under Article 169 of the Treaty to seek implementation of the butterships judgment. None of the cases has reached the stage of a reference to the European Court. The Commission is still studying the replies of the Member States to the Commission's first formal letter, but it looks as though the Member States will now implement both elements of the judgment by the turn of this year, thus avoiding the need to go on to the Court.

Those involved in the tax-free trade have nevertheless voiced concern that the Commission's action in seeking implementation of the butterships case in some way spells the end of tax-free shops. As I have indicated this is certainly not the Commission's objective. Indeed we fully recognise the economic importance of these sales. Our action only related to third-country goods sold in intra-Community trade; it leaves untouched duty-free sales in travel to third countries and it leaves untouched sales free of VAT and excise duty on goods sold in intra-Community trade. Our information suggests that third country goods sold in Community tax-free shops represent at the moment not more than 20% of total sales (principally optical goods, bourbon whisky and Cuban cigars), and less than that in sales in intra-Community trade. Of course a change in the mix of goods sold could help to compensate for any loss of income on third country goods. And the inclusion of customs duties and agricultural levies in prices charged will in any event have a fairly small effect by comparison with the VAT and excise duty exemptions which are much more significant. I hope therefore that the trade will now be satisfied that the Commission has no designs on tax-free shops.

DIRECT TAXATION

In the field of direct taxation there are some further developments to report. You will observe that they are all characterised by the Commission's concern to remove tax obstacles and distortions which fragment the common market.

Mergers

The obstacles should not, however, be underestimated. The case that springs most readily to mind is our mergers proposal for deferring the tax charge when companies from different Member States take part in a merger, division or contribution of assets and the consideration takes the form of shares in the acquiring company. This is obviously in keeping with our aim to promote capital movement and economic activity across frontiers. Two of the most prosperous members of the Community are blocking the mergers proposal. It seems that the Federal Republic may be afraid that the removal of tax obstacles to transnational mergers will tempt German companies to set up their management abroad so as to evade the provisions of worker-participation (Mitbestimmung). If this is correct I have great difficulty in understanding the objection, first because it has nothing to do with considerations of tax neutrality in the European Community, secondly because such transfers are permitted and have indeed occurred under existing German law.

On the other hand, the Netherlands, which has a classical system of corporation tax, is concerned at the potential competitive impact from Germany, where the full imputation system is available to residents. But at the same time the Netherlands Government seems to be unwilling to consider harmonization of corporation tax systems, which would meet this difficulty.

Mr. Chairman, in the light of these objections, which involve certain internal inconsistencies, members of the Confederation practising in the countries concerned may want to lobby their Ministers and Members of Parliament, to get them to reconsider their positions. It is regrettable that in thirteen years, the Council has not once discussed the mergers proposal nor, for that matter, the complementary proposal dealing with parent and subsidiary companies. Both proposals were presented by the Commission in 1969: both could have made, and could still make, a significant contribution in enabling firms to organise and compete on a European scale.

Corporation tax

So far as corporation tax is concerned, we have as you know been striving for many years to eliminate the distortions brought about by the diverse national systems of company taxation. My predecessor, Mr. Burke, dealt at length with our 1975 proposal for harmonizing corporation tax systems, when addressing you two years ago in Rome, so I do not propose to go over the same ground again.

Having laid down a common partial imputation system, we are now concentrating our efforts on designing a common tax base, to be as neutral as possible in its effects on competition and capital movements. We have largely completed our review of the depreciation provisions, but there is still a long way to go: capital gains, valuation of stocks, provisions and reserves, treatment of losses, etc. In this work of the utmost technical complexity, I am very pleased to acknowledge the valuable input being provided by members of your organisation.

Foreign losses

There is a somewhat separate aspect of the tax base which is engaging our attention and that is the treatment of foreign losses. As a general rule, an enterprise operating inside one Member State through several branches can aggregate the profits and losses of those branches for tax purposes. Where however, its operations extend over two or more Member States, via permanent establishments or subsidiary companies, this economic continuity is broken by the different methods of relieving double taxation - by exemption or by credit - and in the case of subsidiary companies by the legal barriers between a parent company and its subsidiary set up abroad.

To overcome this problem, my services are working on a scheme to set off the loss incurred by a permanent establishment or subsidiary against the profits of the parent company in another Member State, which would recover the relief as soon as the permanent establishment or subsidiary made a subsequent profit.

This concept, known as "deferred taxation" is essentially simple, but we shall need to introduce certain complications and restrictions, both as regards relief and recovery, in order to prevent abuse. Enterprises should not, for instance, be permitted to switch profits and losses between members of a long chain of companies so as to exaggerate the loss or to postpone the recovery. The safeguards we are building into the scheme should not, however, affect the small to medium sized enterprise, with only a few dependent entities. Because of the scheme's ramifications, it will be some time before it is ready for presentation. I have no doubt however that our activity in this area will be of the utmost interest to the business community you serve.

Transfer pricing: Arbitration procedure

I now come to an extremely sensitive issue, transfer pricing. Under the Council directive of 19 December 1977 on mutual assistance⁽¹⁾, the tax authorities of the Member States have a duty to exchange tax data, with particular reference to artificial transfers of profits (Article 4(1)(d)) and to transfer pricing (Article 10).

We have since had the OECD report on transfer pricing, which some States, like Italy and Germany, are incorporating into their national legislation. You are also probably aware that the British Government is being sued by one of the largest UK companies for authorising two of its competitors to adopt a certain level of transfer prices. The subject is clearly one of enormous political, commercial and budgetary importance.

What part is the Commission playing in all this? I have already alluded to our mutual assistance directive. Article 6 of that directive provides a legal basis for Member States to conduct joint audits, although the Commission has yet to learn of such audits taking place. There is no doubt however that over a period of time the effects of greater vigilance and improved intelligence will be felt in the increased numbers of instances requiring an upward adjustment to taxable profits.

(1) 77/799/EEC; OJ L 336, 27.12.1977

Now such a result is acceptable provided that it is accompanied by a corresponding reduction in the taxable profits of the other party to the transaction giving rise to the original increase. To ensure that double taxation of the same income is avoided, we need an arbitration procedure which will not only decide, when all else fails, on what consequential adjustments are necessary but will also, by its very existence in the background, exert pressure on the companies and Member States concerned to reach a settlement rather than resort to arbitration.

The system proposed by the Commission is reasonably flexible and pragmatic. A different approach is favoured by certain Member States who want to put the procedure on a much firmer legal basis. In the Commission's view, a more formal structure is likely to create too many constitutional as well as political problems.

I know that I can count on your support in this matter. You discussed it two years ago at your Congress in Rome and the subject is likely to play a central part in your podium discussion on transnational audits. It is mainly the small and medium-sized enterprises which will suffer from the double taxation resulting from non-adjusted corrections by different tax administrations. These enterprises are of particular concern in the context of transnational business activities and industrial politics in the EEC. They are also of course the mainstay of your professional clientèle. This makes us "natural allies" and prompts the thought that perhaps by our united efforts we may achieve some progress in this field.

Income Tax

Turning from corporation tax to income tax, I should like to devote a few words to the Commission's 1979 proposal for improving the tax treatment of non-resident workers and of persons making certain payments abroad. The salient features of the proposal, if I may refresh your memory, are:

1. to tax frontier workers in the Member State of residence, with credit being given for any tax withheld at source by the Member State of employment,
2. to tax other non-resident workers in the Member State of employment but on terms no less favourable than those applied to resident workers,
3. to prohibit Member States from refusing income tax relief for payments such as insurance premiums and pension contributions simply because they are made to an entity in another Member State.

The news I am able to bring you is that the proposal is now safely through the Economic and Social Committee and through Parliament, the two Community organs reflecting and representing European opinion. Both bodies have given very positive endorsement to our proposal, as regards its basic purposes and provisions. We are hopeful that the proposal will soon - perhaps under the present Danish presidency - be given due attention in the Council.

This brings me to the Commission's most recent initiative, designed to articulate the Community interest in the formulation of national tax policies. The Commission feels that, just as its proposals are closely scrutinised at national level, so taxation proposals of the Member States should be discussed at Community level, especially when those proposals denote major changes in structure or direction. In November 1981, the Commission accordingly submitted a proposal for a Council decision establishing a prior information and consultation procedure for tax matters. Under this procedure, a Member State would be required to notify the Commission and the other Member States whenever it puts forward major tax proposals likely to affect the common market or Community policy, the idea being to promote convergence and avoid divergence in national taxation policies. This proposal is now pending before Parliament but the latter has evinced little or no interest in it and has yet to designate a rapporteur.

In the Commission's view it is most regrettable that the Parliament has not been able to find time for this proposal, which concerns the most elementary term of cooperation and which moreover is an obvious precondition for further harmonization.

Conclusion

This concludes my review of the present state of tax harmonization in the EEC. It is, I know, somewhat disappointing, somewhat short in achievement over the past two years. I also know, as someone who has been a member of the Commission for six years, that we must combine vision with patience and firmness in the pursuit of our goals. I ask for your continued support in this most challenging task of creating the right tax conditions for Europe to function and prosper as a single, harmonious Community.