CONCLUSIONS AND RECOMMENDATIONS OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION

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Preface

The present publication reflects the summary of the report of the Committee of Independent Experts on Company Taxation which met between January 1991 and February 1992. The Committee was chaired by Onno Ruding and its members were Donal de Buitléir, Jean-Louis Descours, Lorenzo Gascon, Carlo Gatto, Ken Messere, Albert Rädler and Frans Vanistendael.

The report has been prepared at the request of the Commission of the European Communities in accordance with the Committee's mandate (p. 7) and consists of 10 chapters. The complete report will be published at a later stage.

CHRISTIANE SCRIVENER

Member of the Commission
of the
European Communities

Brussels, 25 October 1990

Mandate given to Mr. Onno Ruding for the Committee established to examine company taxation in the European Community

The Committee will evaluate first and foremost the importance of taxation for business decisions with respect to the location of investment and the international allocation of profits between enterprises. An assessment of the impact of taxation relative to other factors on such decisions is necessary in order to determine whether existing differences in corporate taxation and the burden of business taxes among member countries lead to major distortions affecting the functioning of the internal market.

If such distortions do arise, it is essential to examine all possible remedial measures, taking into account the influence that other policies (e.g. economic and monetary union) might have on the extent of the tax-induced distortions. In order to determine the most appropriate action at the Community level, it is necessary to distinguish clearly between the main elements of the corporate tax system, namely the type of tax system, the tax base, and the statutory tax rate. Moreover, since some businesses are not subject to corporation taxes as a consequence of their legal status, the question also arises as to what action is required concerning non-corporate income taxes.

In this regard, it is essential to define the priorities among the different measures that the Committee envisages, preferably with proposed dates for their implementation. The Committee will also have to give its opinion on the legal nature of any envisaged measure in order to determine whether the objective is to harmonize certain aspects or to limit it to the establishment of a framework for national tax legislation.

Finally, the Committee should consider the demands placed on the tax system by other political objectives, such as those pertaining to the environment, health and social affairs, to address the question of how and to what extent it will still be possible to take into account non-tax considerations.

Other questions could also be addressed, if need be.

Ch. Scrivener

Executive summary

This report is the work of the Committee, chaired by Onno Ruding, which was set up by the Commission of the European Communities in December 1990, on the initiative of Mrs Scrivener, Member of the Commission, following the communication of the Commission 'Guidelines on company taxation' of 20 April 1990. The Committee met 11 times between January 1991 and February 1992. The Committee's mandate was to evaluate the need for greater harmonization of business taxation within the European Community. In carrying out its work, and on the basis of its mandate, the Committee considered the following questions:

1. Do differences in taxation among Member States cause major distortions in the internal market, particularly with respect to investment decisions and competition? Special attention is focused on those distortions considered to be discriminatory.
2. In so far as such distortions arise, are they likely to be eliminated simply through the interplay of market forces and tax competition between Member States, or is action at the Community level required?
3. What specific measures are required at the Community level to remove or mitigate these distortions?

The Committee's main findings are briefly summarized below.

1(a) Principal tax differences (Chapter 3)

There are major differences in the corporate tax systems operated by each Member State, as well as considerable variations in the statutory corporation tax rates and corporation tax bases (which determine the level of taxable income).

In addition to these basic differences, there are, more specifically, differences in the tax treatment of cross-border income flows (dividend, interest and royalty payments). These not only concern the imposition of withholding taxes at the point of payment, but also the methods and extent of relief for double taxation in the hands of the recipient. And on the other side of the coin, there are differences in the methods of allowing losses incurred by a branch or subsidiary in one Member State to be offset against the profits of the parent in another Member State.

(b) Distortions

The Committee reviewed the evidence which included a simulation study and an empirical survey to establish how far the differences identified caused major distortions or were discriminatory.

The simulation study (Chapter 4) examined how far each Member State's tax system provided incentives to both domestic and foreign direct investment, and modelled the corporate tax component of the cost of capital in each country from domestic and foreign sources. It suggested that withholding taxes levied by source countries on cross-border dividend payments between related companies are the main reason for bias against inward and outward direct investment.

Other significant sources of bias are:

(i) differences among Member States in the methods of providing relief for double taxation on cross-border income flows;

(ii) differences in corporation tax rates between countries; and

(iii) the discriminatory effect of unrelieved imputation taxes ('précompte', advance corporation tax, etc.) related to distributions by parent companies from profits earned abroad.

The empirical survey (Chapters 5 and 6) examined how far location decisions are influenced by tax considerations. The evidence suggested that tax differences among Member States distort foreign location decisions of multinational firms, and cause distortions in competition, especially in the financial sector. The strength of the evidence suggested that the distortions could be large, but it was not possible to quantify the consequent misallocation of resources in a satisfactory way.

(c) Other considerations (Chapter 2)

In examining the differences and distortions arising, the Committee was aware of the need for any recommendations to take into account considerations of fairness, administrative feasibility, compliance costs and transparency. This latter point was considered particularly important to avoid distortions of competition within the Community through the use of hidden tax incentives.

Experience in non-EC federal countries was also taken into account (Chapter 9).

2. Convergence and competition (Chapters 7 and 8)

The Committee found that there has been some convergence of different countries' tax regimes despite the absence of concerted action. However, many of the changes seem to have arisen from a general desire by the countries concerned to establish tax regimes which are more neutral from a domestic viewpoint. This has involved cutting both corporate and personal statutory tax rates and reducing tax concessions.

Overall, the corporate tax component of the average cost of capital across Member States converged over the past decade. However, much of this convergence was attributable to downward convergence of interest and inflation rates rather than deliberate action on the part of tax authorities. (The exceptions were Germany and the UK where tax reform also made a significant contribution.)

There is no evidence to suggest that independent action by national governments is likely to provoke unbridled general tax competition leading to erosion of the corporate tax revenues of Member States. However, the Committee was concerned about the tendency of Member States to introduce special tax schemes designed to attract internationally mobile business, particularly in the financial sector.

There was also specific concern about tax competition in the area of withholding taxes on cross-border flows of interest from portfolio investment.

3. Conclusions and recommendations (Chapter 10)

Despite the observed convergence over the past decade wide differences in tax regimes remain. Some of these differences distort the functioning of the internal market both for goods and for capital. And it is unlikely they will be reduced significantly through independent action by Member States. Accordingly, action is needed at Community level.

However, other considerations, such as the need to allow Member States as much flexibility as possible to collect revenue through direct taxes, and the principle of subsidiarity, argue in favour of focusing Community harmonization on the minimum necessary to remove discrimination and major distortions.

So at this stage in the Community's development action should concentrate on the following priorities:

(a) removing those discriminatory and distortionary features of countries' tax arrangements that impede cross-border business investment and shareholding;

(b) setting a minimum level for statutory corporation tax rates and also common rules for a minimum tax base, so as to limit excessive tax competition between Member States intended to attract mobile investment or taxable profits of multinational firms, either of which tend to erode the tax base in the Community as as whole; and

(c) encouraging maximum transparency of any tax incentives granted by Member States to promote investment, with a preference for incentives, if any, of a non-fiscal character.

A programme of total harmonization is not justified at this stage. None the less the Committee believes that the adoption by all Member States of a common system of corporation tax is a desirable long-term objective.

Detailed recommendations

These fall into three categories. Each proposal in each category is classified as falling in one of three phases according to the urgency of implementing it. Phase I should be implemented by the end of 1994. Work on Phase II should commence immediately with a view to implementation during the second phase of economic and monetary union. Implementation of Phase III is envisaged as being concurrent with full economic and monetary union. The recommendations are to be found in Chapter 10 of the report, which sets out the Committee's conclusions and recommendations in more detail.

A — Elimination of the double taxation of cross-border income flows

To ensure the elimination of withholding taxes levied by source countries on dividends paid by subsidiaries to parent companies, the Committee recommends:

- that the scope of the 'parent-subsidiary' directive be extended to cover all enterprises subject to corporate income tax irrespective of their legal form (Phase I). The directive should subsequently be extended to all other enterprises subject to income tax (Phase II);
- a substantial reduction in the participation threshold as prescribed in the 'parent-subsidiary' directive (Phase II).

To combat evasion a sufficient level of taxation at source should be ensured, so the Committee recommends:

- that the Commission propose by way of directive a uniform withholding tax of 30% on dividend distributions by EC resident companies subject to waiver where appropriate tax identification is provided (Phase II).

To eliminate other withholding taxes levied by source countries between enterprises in different Member States, the Committee recommends:

- that the proposed 'interest and royalties' directive be adopted and that the scope of the directive be extended to encompass all such payments between enterprises together with accompanying measures to ensure that the corresponding income is effectively taxed within the Community in the hands of the beneficiary (Phase I).

To eliminate double taxation arising from transfer pricing disputes the Committee recommends:

- that the Commission urge all Member States to ratify the Arbitration Convention as soon as possible (Phase I); and
- that the Commission take action together with the Member States to establish appropriate rules or procedures concerning transfer pricing adjustments by Member States (Phase I).

To reduce impediments to cross-border investments likely to generate losses in early years the Committee recommends:

- that Member States adopt the draft directive dealing with losses of permanent establishments and subsidiaries in other Member States (Phase I);
- that all Member States introduce full vertical and horizontal offsetting of losses within groups of enterprises at the national level (Phase II); and
- extension of the draft directive to allow full Community-wide loss offsetting within groups of enterprises (Phase III).

To ensure that bilateral agreements for minimizing double taxation are on a proper footing the Committee urges:

- Member States not only to conclude bilateral income tax treaties where none exist between them, but also to complete those where coverage is limited (Phase I); and recommends

- action by the Commission in concert with Member States aimed at defining a common policy on double taxation agreements with respect to each other and also with respect to third countries (Phase I).

B — Corporation taxes

To reduce discrimination between the tax treatment of domestic and foreign-source income the Committee recommends that existing discrimination in the taxation of dividends from profits earned in another Member State be removed. To this end:

- Member States which apply imputation taxes on the distribution of profits earned in another Member State should be obliged, on a reciprocal basis, to allow such tax to be reduced by corporate income tax paid in another Member State in respect of dividends remitted by a subsidiary, or profits earned by a permanent establishment (Phase I);
- Member States with various forms of tax relief for dividends received by domestic shareholders from domestic companies should be obliged, on a reciprocal basis, to provide equivalent relief for dividends received by domestic shareholders from companies in other Member States (Phase I).

To achieve a more fully harmonized corporation tax system within the Community, the Committee recommends:

- that the Commission and the Member States examine in the course of Phase I alternative approaches to determine the most appropriate common corporation tax system for the Community (Phase III).

To reduce the risks of serious erosion of corporate tax revenues the Committee recommends:

- that a draft directive be prepared by the Commission prescribing a minimum statutory corporation tax rate of 30% in Member States for all companies, regardless of whether profits are retained or distributed as dividends (Phase II);
- adoption by all Member States of a maximum statutory corporation tax rate of 40% (Phase II); and related to this,
- that there should be only one kind of tax on corporate income in Member States. If this cannot be achieved, local income taxes should be taken into account when fixing the statutory corporation tax rate so that the combined rate of tax falls within the range of 30 to 40% prescribed by the Committee (Phase II);
- in addition there should be a set of minimum standards for the tax base to cover:

  depreciation practices (to include intangibles such as goodwill),

  leasing,

  stock valuation,

  provisions,

  business expenses,

  headquarters costs of enterprises,

pension contributions by or for expatriate workers,

carry-over of tax losses,

capital gains,

(Phases I and II).

Since the time at which corporation taxes are payable varies from one Member State to another the Committee recommends:

- that the Commission should seek to establish common rules by way of directive to harmonize the dates at which taxes of common application are payable (Phase II).

To improve neutrality between different forms of business organization:

- the Commission should seek to establish common rules which would permit unincorporated enterprises the option of being taxed as if they were a company, with the proviso that such a regime should apply for a minimum period of time (Phase II).

C — Other issues

To remove different burdens arising from additional mixed-base taxes the Committee recommends:

- that Member States having such multibase local business taxes replace them by a tax on profits levied on the same base as the central government corporation tax (Phase II).

Chapter 10

Conclusions and recommendations

I — Introduction

In accordance with the Committee's mandate set out in Chapter 1, the purpose of this report has been to address three key questions. First, do differences in taxation among Member States cause major distortions in the functioning of the internal market, particularly with respect to investment decisions and competition? Special attention was focused on those distortions that involve discrimination between residents and non-residents. Second, in so far as such distortions do arise, are they likely to be eliminated simply through the interplay of market forces and tax competition between Member States, or is action at the Community level required? Third, if Community action is necessary, what specific measures are required to remove or mitigate these distortions? In considering all these issues, the Committee has also:

(i) taken account of the impact of corporate taxes on both the level of investment and the propensity to save; and

(ii) been sensitive to the world economic situation in which there is the risk of a shortage of funds.

The first question was addressed in Chapters 2, 3, 4, 5 and 6 of the report. Chapter 2 focused attention on the main tax problems posed by the removal of barriers to the free movement of goods, persons, services and capital in the Community's endeavour to establish a single internal market. These problems relate to the economic efficiency, fairness, administrative feasibility, simplicity, compliance costs, certainty and transparency of taxation in Member States, as well as the possible constraints imposed by such a situation on countries' capacity to levy taxes and their freedom to pursue their own economic and social objectives. Chapter 3 highlighted the principal differences in the rules for the taxation of business income that exist between Member States, paying special attention to those aspects of countries' tax laws that could be considered discriminatory with respect to other EC members. Chapter 4 assessed the overall distortionary impact of such differences by reference to the tax component of firms' cost of capital, the latter being regarded as a potentially important determinant of firms' investment decisions and competitiveness. Empirical evidence regarding the distortionary effects of taxation on firms' investment and tax planning decisions was examined in Chapters 5 and 6.

The answer to the second question was discussed in Chapters 7 and 8, which assessed the extent to which tax differences between Member States have narrowed during the past decade, as well as the seriousness of the threat posed by tax competition to their revenue-raising capacity. By way of comparison, Chapter 9 summarizes the main aspects of business income taxation in three quite different non-EC federal countries (Canada, Switzerland and the United States). Attention is focused on the extent to which these countries' sub-national corporate income taxes are harmonized, and the manner in which such harmonization has been accomplished. The Committee believes that current tax practices in these three countries could be indicative of what might be necessary for the Community in the not too distant future.

The objective of this final chapter is to address the third question; that is, to specify in the light of the previous nine chapters the measures required at the Community level in order to remove major tax distortions and discrimination pertaining to investment and competition. Before doing so, however, it is useful to summarize in Part II of this chapter the main findings of those chapters, starting with the existing principal tax differences between Member States. Part III contains the Committee's recommendations.

II — Main findings

Principal tax differences between EC Member States

As described in Chapter 3, the principal differences in the taxation of business income between Member States relate to the nature of the corporation tax system, statutory tax rates, the definition of the tax base together with various types of tax relief, withholding taxes on income flows abroad, and the manner in which relief is provided for double taxation with respect to income derived from cross-border activities. There are also major differences between countries in the taxation of unincorporated businesses and net wealth.

More specifically, two Member States (Luxembourg and the Netherlands) operate classical corporation tax systems, under which profits distributed in the form of dividends are fully taxed twice, once at the corporate level, and again at the shareholder level. The other 10 Member States provide varying degrees of relief for such double taxation, at either the corporate level, the shareholder level, or both levels. Relief at the corporate level is achieved by levying a lower tax rate on dividend distributions, as in Germany, or by allowing partial or full deduction for dividend payments, as in Greece. Relief at the individual shareholder level is accomplished either by granting imputation credits, as in Germany, France, Italy, Ireland and the United Kingdom, with France, Germany and Italy providing a full credit for corporation taxes actually paid, or by levying reduced personal tax rates on dividend receipts, as in Belgium, Denmark, and Portugal.

There are also considerable differences in statutory corporation tax rates among Member States. They range from 10% in Ireland, for manufacturing and certain internationally traded services, to a rate of 50% in Germany on retained earnings.[1] Tax-free zones exist in certain countries as well, including the special enterprise zones in France, the free zones in the Portuguese islands of Madeira and Santa Maria, as well as the Canary Islands of Spain. In addition, special regional tax concessions exist in some Member States, which provide reduced corporate tax rates for enterprises, as in the Mezzogiorno area of Italy. Some Member States also levy reduced rates of corporation tax on small and medium-sized businesses.

Furthermore, the definition of the corporation tax base varies from one Member State to another. Taxable income is, as a rule, computed on the basis of 'sound commercial accounting principles' and thus related to the profits reported in company accounts.

[1] The overall corporation tax rate on retained earnings in Germany is 57.5%, if local taxes are included.

However, whereas in some countries (Belgium, France, Germany, Greece, Italy, Luxembourg and Spain) there is a close linkage between the accounts required for tax purposes and those prepared for reporting purposes, in others (Denmark, Ireland, the Netherlands and the United Kingdom) the linkage between the two sets of accounts is not as close. Moreover, depreciation rules and rates for tax purposes, the tax treatment of losses, stocks and other expenses, and provisions (especially those for bad debts and occupational pension plans), taxation of capital gains, as well as adjustments allowed to compensate for the impact of inflation, differ significantly across countries. Various forms of tax relief, including investment tax credits and allowances, are also available in some Member States.

The tax treatment of cross-border flows of corporate income differs from the treatment of flows arising within a Member State in a number of respects. First, apart from the corporate income tax, a withholding tax is normally imposed on cross-border payments of dividends, interest, and royalties. The rates of such withholding taxes vary according to bilateral tax treaties, the provisions of which differ depending on the two countries involved, both within and outside the Community.

Second, apart from a few limited cases in Denmark and France, Member States do not generally allow losses incurred by foreign subsidiaries to be offset against the taxable profits of their parents. By contrast, such offsetting is generally permitted by most Member States in the case of foreign branch losses, albeit in different ways.

Third, with regard to methods of providing relief for double taxation of intra-company income flows within the Community, seven countries (Belgium, Denmark, France, Germany, Italy, Luxembourg, and the Netherlands) for the most part exempt dividends paid to parent companies residing in their jurisdictions by what are considered to be subsidiaries located in other Member States.[1] The other five countries allow some form of credit for corporation and withholding taxes paid abroad in respect of such foreign-source dividends. On the other hand, apart from the possibility of a few cases where bilateral tax treaties have not yet been concluded between them, Member States generally allow a credit for withholding taxes levied by other EC countries on interest and royalty payments made by a subsidiary to its parent, though this does not result in the elimination of double taxation in all cases.

Finally, the majority of Member States do not give any relief to individual tax-residents in their jurisdictions, who are shareholders in companies established in other Member States, in respect of corporate income tax already paid in those Member States on the dividends they receive. In the case of purely classical corporation tax systems, this involves no discrimination against cross-border dividend flows, provided that the same personal income tax rate applies to dividend receipts, whatever their source (domestic or foreign). In the case of imputation systems, however, apart from limited exceptions, no country operating an imputation system recognizes taxes paid abroad for imputation purposes. As a result, when foreign-source income is redistributed to individual resident shareholders, it is taxed, as if under a classical system, because a full credit against imputation tax (advance corporation tax, 'précompte', etc.) is not given for foreign tax paid. Hence, these imputation systems do not treat foreign-source income in the same way as domestic-source income. A second, but quite separate issue is the fact that Member States with imputation systems do not usually extend the imputation credit to

1 The definition of a subsidiary varies between Member States according to their tax legislation.

non-resident individual shareholders elsewhere in the Community (the United Kingdom, Ireland and, to a lesser extent, France and Italy being exceptions owing to bilateral tax treaties with certain countries).[1]

Impact of tax differences between EC Member States

The main problems arising as a result of the foregoing tax differences between Member States involve economic efficiency arising as a consequence of distortions in competition, intra-Community fairness, administrative feasibility, particularly in the face of international tax planning, simplicity, taxpayer compliance costs, certainty and transparency.

Tax distortions to investment

The pattern of overall incentives to domestic and foreign direct investment provided by Community countries' tax regimes was described in Chapter 4. It was shown that for a typical investment by a company in the manufacturing sector, either at home or abroad, the corporate tax component of the 'cost of capital' varies considerably from one country to another.[2] In the case of purely domestic investment, the corporate tax component of the cost of capital ranges from 0.1% in Greece and Ireland to 1.2% in Luxembourg under the assumptions of the model. Therefore, taxation in Luxembourg constitutes a greater potential impediment for domestic companies to undertake new investment at home than do the tax laws of Greece and Ireland, at least as far as the typical project is concerned. Other things being equal (which is seldom the case), a relatively high cost of capital for domestic investment in a country increases the overall cost of doing business, and thereby reduces the competitiveness of its firms compared to those located in other countries where the cost of capital is lower. However, the Committee considers that the magnitude of the cost of capital applicable to businesses undertaking purely domestic investment is, in the first instance, a matter for each Member State to decide for itself, without interference by the Community, unless it can be demonstrated that differences in the cost of capital applicable to purely domestic investments causes serious distortions in the functioning of the internal market.

Not only does the corporate tax component of the cost of capital for domestic investment vary across Member States as a consequence of tax differences between them, but, more importantly, for outward and inward investment it is, on average, generally higher than for domestic investment. For example, the corporate tax component of the cost of capital related to a typical investment undertaken by a company in another EC country through a wholly-owned subsidiary is 2.1%. The latter can be compared with a figure of 0.7% if the company undertook the same investment at home. The discrepancy between the cost of capital for domestic and for foreign investment is even greater in the case of investments undertaken by newly-established subsidiaries that depend more heavily on their parent companies for equity finance.

1 Germany further reduces its withholding tax below the internationally accepted level of 15% but ensures that the benefit of this reduction goes only to the shareholder rather than the foreign treasury.

2 Recall that the cost of capital is also commonly known as the 'hurdle' or 'break-even' rate of return. It is defined as the minimum inflation-adjusted pre-tax rate of return that is required in order for the project to be profitable.