
**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 a 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
- II — Main findings
- III — Policy 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.

On the other hand, the discrepancy is somewhat smaller in the case of mature subsidiaries that are less dependent on their parent companies for equity finance. Furthermore, the corporate tax component of the cost of capital associated with direct investment by companies in or from other Member States varies widely depending on the source and residence countries involved.

It would appear from the simulation results reported in Chapter 4 that withholding taxes levied by source countries on cross-border dividend payments between related companies are the main reason for the bias against inward and outward direct investment. Therefore, the partial abolition of such withholding taxes, as required by the 'parent-subsidiary' directive, is an important first step towards the removal of discrimination in favour of domestic, as opposed to foreign, investment. Other significant, although relatively less important, sources of bias against transnational investment are differences among Member States in the method of providing relief for double taxation on cross-border income flows (adoption of the exemption method by all Member States would improve the degree of locational tax neutrality), and differences in corporation tax rates between countries. By contrast, the simulation results suggest that withholding taxes levied by source countries on cross-border inter-corporate interest payments and variations in the Member States' corporate tax bases (arising as a consequence of differences in depreciation allowances and stock valuation) constitute relatively minor sources of non-neutrality as far as companies' investment location decisions are concerned. (Obviously the assessment of the relative importance of potential distortions is limited to the elements included in the model.) Moreover, apart from the existence of unrelieved imputation taxes (advance corporation tax, 'précompte', etc.) related to dividends distributed by parent companies from profits earned abroad, which also results in discrimination against direct transnational investment, differences between Member States' corporation tax systems do not appear to be a significant source of such discrimination, at least as far as investment in the corporate industrial sector is concerned.

It would be surprising if tax-induced differences among countries in the cost of capital pertaining to domestic and cross-border investments did not have some effect on business investment, especially in the case of marginal projects. The review of empirical evidence contained in Chapter 5 indicates that multinational firms' decisions concerning the location of investment are indeed influenced by tax considerations. This conclusion is confirmed by a survey by this Committee of companies based in 17 European countries, including all 12 EC Member States. For example, 48% of respondents claimed that taxation is always or usually a major factor in the decision as to where to locate a production plant. The corresponding figures for other activities were 38% for a sales outlet, 41% for an R&D centre, 57% for a coordination centre, and 78% in the case of a financial centre. Such evidence suggests that tax differences among Member States do have a major impact on foreign location decisions of multinational firms and thus cause distortions in competition, especially in the area of financial activities. The outcome is likely to be a misallocation of resources within the Community, resulting in reduced productivity, which in turn reduces the Community's overall competitiveness relative to non-EC countries. However, the Committee has found no satisfactory way of quantifying the size of this misallocation, either in absolute terms or in relation to other market distortions that may exist. Nor is taxation the only important determinant of investment location decisions. Nevertheless, the fact that empirical evidence gathered by the Committee indicates that taxation does have a strong influence on the location

of investment and on financing decisions is *prima facie* evidence that the distortions in competition and resulting efficiency losses caused by taxation could be large.

Intra-Community fairness

As pointed out in Chapter 2, inter-country fairness has traditionally involved the principles of source-country entitlement, non-discrimination, and reciprocity. According to the first principle, the source country has the prior right to tax business income from direct investment earned within its jurisdiction. This principle can be justified on the grounds that the source country has to finance the infrastructure and public services from which the business benefits. The second principle reflects the view that countries' tax laws should not discriminate against foreign firms and shareholders, or against domestic firms and individuals investing abroad. Reciprocity has usually entailed equality of rates of withholding tax between parties to bilateral treaties, although such equality may be abandoned in return for some other concessions, or lack thereof (for example, the non-granting of imputation credits to non-residents). The Committee adheres to these three principles and the recommendations made later in this chapter reflect such adherence. Unfortunately, as pointed out in Chapter 3 and elsewhere in this report, there are a number of features of Member States' existing tax legislation that, in the Committee's view, violate the principle of non-discrimination.

International tax planning

Not only do differences in taxation affect firms' direct investment decisions, but they appear to have an even greater impact on the companies' financial and legal structures. According to the survey undertaken on behalf of the Committee, roughly two-thirds of respondents claimed that taxation is always or usually a major factor in financial decisions of multinational firms, including whether to finance new investment locally or through the parent, the type of finance used in either case, whether to set up a new operation in the form of a branch or a subsidiary, and whether to channel income from foreign operations through holding companies or other intermediaries in countries other than those where the parent or its foreign operations are located.

Moreover, it would appear that taxation is an important determinant of the form in which profits are repatriated to the parent company (dividends, interest payable or transfer pricing). Nevertheless, companies seem to feel that constraints do exist on their ability to shift profits to relatively low tax jurisdictions. This finding is consistent with the evidence that taxation also affects the location of real investment.

Administrative and compliance problems

The existing tax differences between Member States also have administrative implications in a single market. Of particular relevance are problems involving enforcement, taxpayer compliance costs, and uncertainty.

As pointed out in Chapter 2, national tax authorities probably find it more difficult to levy taxes on activities undertaken in other Member States. Hence, source-based taxes are easier to administer than residence-based taxes. Since the establishment of a single market will undoubtedly encourage cross-border activities, it follows that those Member

States relying on residence-based taxes are likely to incur higher enforcement costs as a result.

With regard to compliance costs, whilst they are difficult to measure, it is evident that the simpler the tax regime, the less these costs will be at both the domestic and international levels. The greater the difference in tax rules between Member States, the higher the overall costs of compliance, which can be especially onerous for small and medium-sized businesses as well as for small investors, thus discouraging them from making cross-border investments. However, according to the business survey undertaken on behalf of the Committee, compliance costs do not appear to be an important determinant of investment location decisions in the case of large firms.

Another important problem for businesses, and therefore an impediment to investment, concerns the lack of certainty surrounding Member States' tax rules. Such uncertainty arises not only as a consequence of frequent changes in tax legislation and inconsistent rulings within a tax administration, but also as a result of the interaction between taxation and inflation (in the absence of indexation) and differences in inflation rates among countries.

An additional source of uncertainty with respect to cross-border activities is the fact that Member States can unilaterally adjust transfer prices on products and services flowing across borders within a multinational firm, and that these adjustments may not be offset by a corresponding change by another Member State, a practice that the recently agreed Arbitration Convention is designed to address.

Transparency

As discussed in Chapter 2, transparency is obviously a desirable attribute of taxation. Not only does transparency in taxation enhance government accountability, it is also necessary to ensure that Member States do not hamper the establishment of the internal market by using hidden tax incentives to distort competition within the Community. Unfortunately, many incentives embodied in countries' tax regimes, particularly those affecting the tax base, are not transparent.

Tax convergence in the European Community

As obstacles to the mobility of goods, services, and factors of production within the Community are removed, a key question that arises is the extent to which independent action by national governments can be relied upon to reduce the existing tax differences between Member States, thus alleviating the problems posed by these differences, or whether some form of action in this regard is required at the Community level. Judging from the experience of the past decade, there has been some convergence of countries' tax regimes in the absence of such action.

As reported in Chapter 8, during the latter part of the 1980s three Member States (Belgium, Denmark and Portugal) adopted a system combining a corporation tax with relief provided at the shareholder level by means of reduced tax rates on dividends rather than by tax credits. Irrespective of the methods used by countries to integrate corporate and personal income taxes, according to the analysis in Chapter 8, the degree

of integration for the top-rate personal taxpayer appears to have been increasing since 1980, albeit without any clear indication of convergence among Member States.

With regard to statutory corporation tax rates, not only did they converge somewhat between 1985 and 1991 in EC countries, they also dropped by an (unweighted) average of roughly seven percentage points; that is from 46.9% in 1985 to 40.1% in 1991. Top personal tax rates also converged to lower levels in Member States during the same period. While some of the convergence in corporate and personal tax rates may have occurred as a result of tax competition among EC as well as non-EC countries, it seems to be due mainly to the growing desire of some countries to establish more neutral tax regimes from a domestic standpoint by cutting statutory tax rates and reducing tax concessions.

In most countries, however, the drop in corporation tax rates does not appear to have been accompanied by a broadening of the tax base, at least as far as depreciation allowances are concerned. Indeed, there was a general increase in depreciation rates permitted for tax purposes, which, when combined with the cuts in statutory corporation tax rates, meant that the value of such allowances did not change very much. Hence, there was little, if any, convergence in this particular aspect of the corporation tax base. On the other hand, some Member States (e.g. Belgium, Denmark, the Netherlands and Spain) curtailed or eliminated their investment tax credits.

The effect of all these tax changes on the overall incentive to invest is reflected in the corporate tax component of the cost of capital, which, on average, increased during the past decade, if differences in countries' interest and inflation rates are taken into account. A more interesting finding is that there was a marked convergence in the corporate tax component of the cost of capital across Member States over the decade as a whole, and that this convergence was attributable primarily to the downward convergence in countries' interest and inflation rates, rather than to deliberate action on the part of the national tax authorities. Only in the cases of Germany and the UK did tax reform make a significant contribution to the convergence of the corporate tax component of the cost of capital within the Community.

The threat posed to corporate tax revenues by tax competition

Judging from past experience, the Committee found no convincing evidence that independent action by national governments is likely to provoke unbridled tax competition among Member States and lead to a drastic and undesirable erosion of corporate tax revenues. On the contrary, there has been a noticeably upward trend in taxes on corporate income as a proportion of GDP since 1965. No statistical explanation for this upward trend was available, however. It could be due to a number of factors, notably improved corporate profitability or increases in the proportion of countries' businesses that are incorporated. (With regard to the latter, it is perhaps noteworthy that the upward trend in taxes on corporate income as a percentage of GDP occurred despite a large drop in the difference between the top personal tax rate on earnings and the statutory corporation tax rate on retained profits, which has reduced the tax incentive for non-corporate businesses and self-employed individuals to incorporate.) Hence, while such a trend should be interpreted with extreme caution, it is clearly not consistent with the substantial erosion hypothesis. Needless to say, past experience

may not be a reliable guide to the amount of tax competition that might eventually materialize in a single market, since establishment of the latter is likely to increase the sensitivity of investment to tax differences among Member States.¹

In fact, Chapters 2 and 7 provide a number of reasons for not expecting tax competition to lead to a serious erosion of corporation tax revenues. First, there is the necessity for countries to maintain the corporation tax as an adjunct to their personal income taxes. Second, in some cases it is in countries' interest to take advantage of the fact that taxes levied on multinational firms are often creditable abroad in so far as profits are repatriated. A third reason is the obvious fact that taxation is only one, albeit an important, determinant of firms' location decisions. On the other hand, it should be kept in mind that tax revenue losses can occur not just as a consequence of the flight of real investment from a country, but also as a result of multinational firms shifting taxable profits from high- to relatively low-tax countries.

It follows that, at present, the threat of overall tax atrophy does not seem to provide a sufficiently strong justification for the total harmonization of corporate taxes within the Community. However, the Committee is concerned about the tendency of Member States to introduce special tax regimes designed to attract internationally mobile business. The schemes normally cost the host country little in terms of tax revenue forgone. On the other hand, the losses in tax revenue by the country from which the investment is attracted can be considerable (obviously trying to match those special tax regimes in order to retain existing investment has equivalent cost). As a result there is a danger that such schemes will lead to atrophy in particular sectors. But even if action were necessary to prevent undesirable tax competition in specific sectors, harmonization is not necessarily the solution. The case for tax harmonization therefore largely rests on the extent to which it removes major distortions in resource allocation and competition, and to a lesser extent on whether it enhances the fairness, administrative feasibility, simplicity, certainty, and transparency of taxation in Member States.

A similar conclusion cannot be drawn with respect to withholding taxes on cross-border flows of interest from portfolio investment. In this case, the danger of tax competition leading to atrophy appears to be much more serious. However, recent experience suggests that any attempt by the EC to impose withholding taxes on cross-border interest flows could result in a flight of financial capital to non-EC countries.

¹ The most appropriate indicator of the extent to which corporate tax revenues may or may not have been eroded would be corporate taxes as a proportion of before-tax profits. Reliable and comparable data on before-tax profits were not available, however.

III — Policy recommendations

Although there has been some convergence of certain aspects of Member States' business tax regimes during the past decade or so, mainly as a result of spontaneous action by national governments, wide differences still remain. Some of these differences constitute distortions in the functioning of the internal market, and it is unlikely that such differences will be reduced much further through independent action by Member States. It follows that, in principle, these distortions can only be removed by measures agreed at the Community level. However, in considering what measures to recommend, the Committee has had regard to a number of other considerations, which, at present, argue in favour of limiting Community harmonization to the minimum necessary to remove discrimination and major distortions, in particular:

- (i) the fact that national governments in the Member States will want to retain as much flexibility as possible to collect revenue through direct taxes;
- (ii) the explicit or implicit linkage between corporate and personal income taxes in all Member States;
- (iii) the principle of subsidiarity;
- (iv) the need for unanimity on tax matters; and
- (v) to a lesser extent, experience in federations such as the USA, Canada and Switzerland, where legally binding harmonization measures are the exception rather than the rule, and those measures are directed mainly at interjurisdictional income flows. (It should be noted, however, that tax harmonization in these federal countries is greatly facilitated by the predominance of federal corporate taxes in Canada and the USA, and, though less significant, the existence of such taxes in Switzerland, as well as by the provision of federal equalization payments.¹)

For these reasons, the Committee takes the view that, at this stage in the Community's development, action at the Community level should be concentrated on the following priorities:

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

¹ Switzerland is in the process of reforming its tax legislation in order to bring together the cantons' tax legislation so as to reduce the existing disparities in their tax bases and rates.

- (b) setting a minimum level for the statutory corporation tax rate and 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 a whole; and
- (c) encouraging the maximum transparency of any tax incentives granted by Member States to promote investment.

As noted in the Introduction, the Committee does not consider that tax harmonization is justified solely in order to equalize the corporate tax component of the cost of capital in respect of enterprises undertaking purely domestic investment. Nor, in the short term, has the Committee sought to recommend an ideal corporation tax system, be it split-rate, classical, imputation, or any other type of system. Accordingly, at this stage of the Community's development, the Committee does not propose total harmonization of corporation tax systems. Nevertheless, the Committee believes that adoption by all Member States of a common system is a desirable long-term objective. The remainder of this chapter contains the Committee's recommendations, together with a proposed schedule for their implementation. More specifically, the Committee considers that Phase I recommendations ought to be implemented by the end of 1994. Preparatory work on Phase II recommendations should commence immediately, with a view to their implementation during the second phase of economic and monetary union. The Committee envisages that implementation of Phase III recommendations ought to be implemented concurrently with full economic and monetary union.

Elimination of the double taxation of cross-border income flows

Elimination of the double taxation of dividends distributed by a subsidiary to its parent located in another Member State

- (a) *Elimination of withholding taxes levied by source countries on dividends paid by subsidiaries to parent companies*

Withholding taxes levied on dividends paid by subsidiaries located in one Member State to parent companies located in another used to constitute a major obstacle to cross-border capital flows within the Community. Considerable progress has been made during the past year or so in eliminating such taxes, however, at least as far as intra-Community income flows are concerned. This progress involved the 'parent-subsidiary' directive requiring the elimination of double taxation of dividends, which was adopted by the Council in July 1990, and is currently being implemented by Member States.

However, the scope of the directive varies from one Member State to another with respect to the type of companies covered. Accordingly,

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). Subsequently, the directive should be extended to all other enterprises subject to income tax (Phase II).

Second, under the provisions of this directive, the withholding tax on dividends is eliminated only when the parent company's holding in its subsidiary exceeds a threshold of 25%. Member States are at liberty to establish a lower threshold, and the Committee understands that some of them do indeed envisage making use of this possibility on a reciprocal basis. Such an extension of the scope of the directive is highly desirable. Accordingly,

The Committee recommends a substantial reduction in the participation threshold prescribed in the parent-subsidiary directive (Phase I).

(b) Withholding tax on dividends

The above recommendations deal with transactions between parent and subsidiary. As regards other recipients of dividends, the Committee considers that a sufficient level of taxation at source should be ensured in order to combat tax evasion by shareholders residing in the Community. This would involve a uniform withholding tax, which would be waived provided the shareholder (individual or company) submits proof of being an EC resident taxpayer. The same waiver could be extended to third-country investors in appropriate circumstances. Such proof might entail shareholders submitting some sort of tax identification number as a proof of beneficial ownership, either directly to the company distributing the dividends, or to the financial intermediary or agency involved. In addition, a systematic exchange of information on dividend payments should be organized by Member States' tax administrations. Accordingly,

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

(c) Elimination of double taxation by the country of residence of the parent company

As regards the method of providing relief for double taxation with respect to cross-border dividend flows from subsidiaries to parent companies, both the exemption and the credit methods are widely used throughout the Community. Although, as pointed out in Chapter 2, both methods in their pure form have advantages as well as disadvantages, in seven Member States parent companies receiving dividends from a subsidiary located in another Member State can claim an exemption if the prescribed conditions are fulfilled. In the other Member States, the parent company may claim an indirect tax credit for corporation taxes paid. The tax credit method is imperfect, however, in so far as the tax credits are limited to the taxes due in the parent company's home country (that is, there is no refund if the amount of taxes paid abroad is higher than those due at home). Moreover, taxes on dividends can be deferred until dividends are actually repatriated by the parent company from its subsidiary. Consequently, in practice, the credit method is often equivalent to the exemption method. In contrast to the situation involving subsidiaries, in the case of income flows from permanent

establishments to parent companies, a majority of seven Member States prefer the credit method to the exemption method.

The Committee does not hold any strong views concerning the relative merits of the two methods of providing relief for double taxation, believing that both methods can coexist. Indeed, such coexistence is foreseen in the parent-subsidiary directive and the draft 'foreign losses' directive, both of which leave Member States free to choose either method, and it would be unrealistic to expect Member States to relinquish this choice. Nevertheless, the Committee considers that the exemption method would be preferable on the grounds of administrative simplicity provided it is accompanied by measures that prevent excessive tax competition among Member States. Such measures include a minimum degree of harmonization with respect to statutory corporation tax rates and the tax base, as recommended below.

**Elimination of withholding taxes levied by source countries
on interest and royalty payments between enterprises
in different Member States**

The Committee also urges the speedy adoption of the draft directive aimed at abolishing withholding taxes on interest and royalties. At the same time, however, the Committee believes that this directive should be extended to apply to *all* such payments between enterprises within the Community, on condition that the necessary steps are also taken to assure taxation of that kind of income. Accordingly,

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

Double taxation arising from transfer pricing disputes

The establishment of a single internal market will involve greater cross-border integration of business activities as firms increasingly organize their operations on a Community-wide basis. With the attendant expansion of cross-border flows of intermediate products and services within groups of firms, transfer pricing within the Community is bound to assume greater importance. In this regard, the Committee supports the 'arm's length' principle as the basis for determining transfer prices. However, disputes do arise with regard to the application of this principle when the tax administrations of the different Member States, in which an enterprise operates, interpret the principle differently. Double taxation occurs if an adjustment by one Member State to the transfer price of a product or service flowing across a border between related enterprises is not offset by a corresponding change by the other Member State. Therefore, the Committee endorses the recent agreement by Member States on the Arbitration Convention, which is designed to resolve such disputes, but which has not yet been ratified by Member States. Accordingly,

The Committee urges all Member States to ratify the Arbitration Convention as soon as possible (Phase I).

Once it is ratified, the Convention will help to eliminate intra-Community double taxation that has already occurred. This problem could be alleviated in the first place, however, if Member States instituted a procedure of advance rulings, which could be extended to cover inter-firm pricing of centrally incurred costs. Another possible solution would be for national tax administrations to consult each other through an *ad hoc* procedure prior to any profit adjustments. This would be facilitated by the development of simultaneous and joint controls of related enterprises. Such procedures would reduce the uncertainty as well as double taxation arising as a consequence of such adjustments. Therefore,

The Committee recommends that the Commission together with the Member States take action to establish appropriate rules or procedures concerning transfer pricing adjustments by Member States (Phase I).

Such rules should be consistent with the Committee's recommended guidelines for the tax base, which are discussed later in this chapter.

Offsetting by parents of losses incurred by branches or subsidiaries located in different Member States

The general absence of means by which Community-based groups of enterprises can offset losses incurred in one Member State against profits arising in another constitutes an impediment to cross-border investments which is likely to generate losses during the first few years. Therefore,

The Committee recommends that Member States adopt the draft directive dealing with losses of permanent establishments and subsidiaries in another Member State (Phase I).

However, the Committee notes that the draft directive provides only for the parent to offset the losses incurred by its subsidiary (or permanent establishment), but does not require loss offsetting between different subsidiaries of the same parent company. Since horizontal loss offsetting of this kind is not yet generally available within Member States,

The Committee recommends that all Member States introduce full vertical and horizontal offsetting of losses within groups of enterprises at the national level (Phase II).

The Committee also recommends extension of the draft directive to allow full Community-wide loss offsetting within groups of enterprises (Phase III).

Tax treaties

As noted in Chapter 3, some Member States have still not concluded bilateral income tax treaties between each other. Accordingly,

The Committee urges Member States not only to conclude bilateral income tax treaties where none exist between them, but also to complete those where their coverage is limited (Phase I).

In addition, it was also pointed out that very few Member States have concluded bilateral tax treaties between each other that deal with taxes on estates, gifts and inheritances. The Committee considers that such treaties should also be concluded as soon as possible.

While multilateral relations between Member States with respect to withholding taxes are becoming increasingly harmonized by means of Community directive, no such harmonization has been accomplished in the case of Member States' relations with non-Community countries. Consequently, Member States continue to conclude bilateral treaties with third countries that contain provisions (such as Article 16 of the USA Model Treaty 1981) which exclude cross-border dividend, interest and royalty payments from treaty protection in the case of 'treaty shopping'. Such agreements can discriminate against enterprises of other Community countries. Therefore, the Committee considers that there is a need for the coordination of Member States' policies at the Community level with a view to approximating their tax treaty provisions in areas covered by Community law (as in the case of withholding taxes on dividends, interest and royalties, for example), and to avoid conflicts with treaty provisions. Accordingly,

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

Finally, the Committee welcomes the work that the OECD has begun on the revisions of the 1977 model income tax treaty, and has noted that the interests of the Community in this regard are being taken care of by the Commission.

Corporation taxes

The three components of corporation taxes at the heart of the Committee's work were the system (that is, the manner and the extent to which tax relief is provided to shareholders in respect of corporation taxes levied on profits distributed as dividends), the statutory corporation tax rate, and the tax base. The Committee's recommendations concerning each of these aspects of the corporation tax are discussed in the three following subsections. A final subsection deals with the issue of corporation tax incentives.

Corporation tax systems

As shown in Chapter 4, the manner in which Member States currently provide relief for the double taxation of corporate profits distributed to individual shareholders in the form of dividends constitutes a source of discrimination against cross-border investment flows. Such discrimination tends to fragment capital markets in the Community. Obviously, this discrimination would be removed if all Member States could

be persuaded to adopt a classical corporation tax system, without any tax relief for dividends at the shareholder level. This bias would also disappear if all States adopted an imputation system and extended imputation credits to domestic shareholders for corporation taxes actually paid in other Community countries. Nor would there be any bias if all Member States adopted a classical corporation tax system, but taxed dividends from foreign as well as from domestic sources at a reduced rate at the personal level.

Adoption by all Member States of a common non-discriminatory corporation tax system is clearly desirable in principle, because it would foster the establishment of a single European capital market. It is by no means clear, however, which system is most desirable from the standpoint of the efficient allocation of new investment.

Given that the rationale underlying the corporation tax may differ from one country to another, particularly in an international context, and each type of system has its own merits and shortcomings, it is unlikely that all Member States would be willing to accept the same type of corporation tax system in the near future.

Nevertheless, the Committee believes that those countries which currently provide relief for dividends paid out of domestic-source income to domestic shareholders (whether individuals or institutions) either in the form of an imputation credit, or as a reduced rate of personal tax, should be required to extend similar treatment to dividends paid out of profits originating in other Member States. This would have two implications. First, companies would be able fully (or partly) to offset corporation taxes of other Member States against imputation taxes (which for this purpose include 'précompte' and equalization taxes as well as ACT). Second, tax relief would be given for dividends received by individual shareholders, irrespective of the source of these dividends.

The degree of relief given could reflect the rate of tax in the shareholder's country of residence, or the country where the dividends originate. In either case, the cost of such tax relief would be borne by the country of residence. (Any resulting tax revenue loss could be offset by Member States adjusting the statutory corporation tax rate.) As discussed above, foreign taxes levied on dividends from portfolio investment abroad received directly by individual shareholders could be creditable in their country of residence. Alternatively, such dividends could be exempt from, or face a lower rate of tax in the shareholder's country of residence. Accordingly,

The Committee recommends that existing discrimination in the taxation of dividends distributed from profits earned in another Member State be removed. To this end:

- (i) 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 the other Member State in respect of dividends remitted by a subsidiary, or profits earned by a permanent establishment (Phase I);
- (ii) 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 directly from companies in other Member States (Phase I).

