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Towards an Internal Market without tax obstacles

A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities

TABLE OF CONTENTS

1. INTRODUCTION

Reform of EU company taxation is crucial for achieving the Lisbon-goals.

The European Union has set itself the **strategic goal** *"… to become the most competitive and dynamic knowledge-based economy in the world …"*. This objective was first established at the European Council in Lisbon in March 2000 and reiterated by the Stockholm European Council of March 2001. Generally, the Lisbon Council also called for building up a supportive general framework for economic activity in the EU. The taxation of companies can play an important role in achieving this objective and creating a level-playing field for businesses in the EU. However, while important steps have been taken in other policy areas, little has happened here and Member States essentially operate the same company tax systems as they did before the set-up of the Internal Market. This mismatch in development needs to be addressed now and the imminent enlargement of the EU makes it all the more urgent.

The Commission services have prepared a comprehensive study on the subject.

The May 2001 Communication "Tax Policy in the European Union" [COM(2001)260] identified both general objectives and a number of specific priorities in direct and indirect taxation. This Communication takes this process a step further in that it addresses the more detailed issue of the direct taxation of companies in the European Union.

The study "Company Taxation in the Internal Market", the Executive Summary of which is annexed to this Communication, has examined whether the current application of company taxation in the Internal Market creates inefficiencies and prevents operators from exploiting its full benefits. This would imply a loss of **EU welfare**, undermine the **competitiveness of EU businesses** and thus be counter to the Lisbon objectives.

In accordance with a specific Council mandate, the Commission explains its strategy on company taxation in the EU over the next few years.

This Communication supplements and builds on that study. It sets out the Commission view of what needs to be and what can be realistically done in the area of company taxation in the EU over the next few years in order to **adapt company taxation in the EU to the new economic framework** and to **achieve a more efficient Internal Market without internal tax obstacles**. For this purpose, a number of concrete initiatives are presented at the end of this Communication.

Both documents together respond to the mandate given to the Commission by the Council of Ministers in July 1999 to investigate the impact of differentials in the effective level of corporate taxation in Member States on the location of economic activity and investment and of tax provisions that constitute obstacles to cross-border economic activities in the Internal Market and remedies thereto.

Some history of company tax initiatives on EU level

Since the founding of the European Communities, company taxation has received particular attention as an important element first for the establishment and then the completion of the Internal Market. Several studies like the Neumark-report of 1962 and the Tempel-report of 1970 have been presented and a number of initiatives designed to achieve a limited degree of harmonisation of the corporate tax system, base and also rates have been taken. The Commission had put forward appropriate proposals for directives in 1975 and, more focussed on loss-compensation, in 1984 and 1985. Those were later withdrawn. A draft proposal of 1988 for the harmonisation of the tax base of enterprises was never tabled, due to reluctance of most Member States.

Recognising the lack of success in progressing the above initiatives, the Commission Communication on company taxation in 1990 [SEC(90)601] suggested that, subject to the principle of subsidiarity, all initiatives should be defined through a consultative process with the Member States. On that basis, following on from Commission proposals which originated in the late 1960s, three measures - two directives and a convention - were finally adopted in July 1990 [the Merger Directive 90/434/EEC, the Parent-Subsidiary Directive 90/435/EEC and the Arbitration Convention 90/436/EEC]. A proposal on loss-offset cross-border is still pending in the Council COM(90)595]. In 1994, the Commission withdrew a first proposal aimed at abolishing withholding taxes levied on cross-border interest and royalty payments between associated companies of different Member States. A new proposal was however made in 1998 [COM(1998)67].

The 1990 approach was developed further in 1996/1997 in a Commission Communication [COM(97)495]. The 'tax package', and notably the Code of Conduct for business taxation, have introduced a new dimension to the discussion. The Single-Market driven approach was supplemented with the objectives of stabilising Member States' revenues and promoting employment which are now taken up and re-assessed in the above-mentioned recent Communication on the priorities of EU tax policy.

In 1999/2000 the Council, in order to supplement the ongoing work on the 'tax package' which had been agreed by EU Finance Ministers in December 1997, requested a comprehensive study on company taxation to be carried out by the Commission.

2. The Need to adapt Company Taxation in the EU to a changing environment

The 1992 Ruding report had little impact.

The last comprehensive study on company taxation in the European Community was the "Report of the Committee of independent experts on company taxation" of 1992, commonly known as Ruding Report. In response to a Commission request this report examined the relation between company tax systems and the functioning of the forthcoming Internal Market. However, its detailed and valuable findings and recommendations met with limited support and failed to achieve much progress.

The Internal Market and globalisation have changed the framework for company tax in the EU.

Today, general developments call for a renewed assessment of the EU strategy in the field of company taxation. The overall **economic framework has changed** since the early nineties:

- The EU has experienced a wave of international mergers and acquisitions.
- The emergence of electronic commerce and the increased mobility of economic factors make defining and safeguarding the company tax base more difficult.
- Economic integration in the Internal Market and Economic and Monetary Union continues to progress and the non-fiscal economic, technological and institutional barriers to cross-border trade continue to be pulled down.

- Large EU companies now view the whole EU as their "home market" and accordingly seek to establish effective pan-European business structures. This results in EU-wide re-organisation and centralisation of business functions within a group of companies.
- The concerns of tax payers, be it corporate or individual ones, now receive more attention.
- There is now, via the Code of Conduct for business taxation, supportive similar action at OECD level and also the enforcement of EU State Aid rules, the real prospect of eliminating harmful preferential tax regimes within the Internal Market.

All the elements of company tax systems in the EU gain in importance.

Given these developments the **importance of all the features of company tax systems** almost automatically increases. This is because Member States compete with *all* elements of their tax systems, both specific and structural, for investments and economic activity to be located within their territory.

Enlargement will accentuate these developments.

Many of these developments, which both raise new, and emphasise existing problems with the taxation of companies and their EU-wide operations, will be accelerated by **enlargement**. Hence, there is a clear need to adapt Company Taxation in the EU to this changing environment.

Various requirements determine the efficiency of the EU company tax system and the competitiveness of EU businesses.

For assessing the overall importance of these problems and possible solutions, it is necessary to consider **economic efficiency**. From an economic point of view company taxation in the Internal Market must

- contribute to the international competitiveness of EU businesses in line with the strategic goal established by the Lisbon European Council;
- ensure that tax considerations distort as little as possible economic decisions by operators;
- avoid unnecessary or unduly high compliance costs and tax obstacles to cross-border economic activity;
- not hinder the possibility of general tax competition while tackling all harmful or economically undesirable forms of tax competition.

But the overall welfare effects can only be determined in a broader economic assessment.

A company taxation system that meets these objectives will *a priori* increase welfare. However, to assess the *overall* level of welfare, the financing and supply of public goods and services, their complex relation to tax revenues and the efficiency of public administration would also have to be taken into account.

Moreover, as set out in the above-mentioned Communication on “Tax Policy in the European Union” [COM(01)260], in the Community context tax policy must support and reinforce other EU policy objectives. This also applies for company taxation policy.

3. THE IMPACT OF DIFFERENCES IN THE EFFECTIVE LEVELS OF COMPANY TAXATION ON INCENTIVES TO INVEST WITHIN THE INTERNAL MARKET

Purpose of the analysis

Marginal and average effective corporate tax rates are presented.

The Commission services study on company taxation presents estimates of effective corporate tax rates (marginal and average) on domestic and transnational investments in the 15 EU countries (as well as the USA and Canada in certain cases) taking into account different forms of investments in the manufacturing sector as well as different sources of finance.

The methodology for calculating effective tax rates

The most commonly used indicators for analysing the impact of taxation on investment behaviour are based on a forward looking concept and involve calculating and comparing the effective tax burden for hypothetical future investment projects or, alternatively, the effective tax burden for hypothetical future model firms behaviour, using the statutory features of the tax regimes.

These approaches permit international comparisons and are especially tailored to provide an indication of the general pattern of incentives to investment that are attributable to different national tax laws as well as to the working of the international tax regime.

Other methodological approaches based on historical data can also be used to compute effective corporate tax burdens. They address questions other than those addressed in this study and they may give rise to different results.

In the Commission services study, the main body of the computation builds on methodology involving calculating the effective tax burden for hypothetical future investment projects in the manufacturing sector. In technical terms, the analysis relies on a revised and extended methodology of the so-called King & Fullerton approach, set out by Devereux and Griffith (1998). This computation is supplemented by data arising from the computation of the "European Tax Analyser" model which utilises the model-firm approach set out by the University of Mannheim.

Effective tax rates have been calculated for a so-called "marginal" investment (where the post-tax rate of return just equals the alternative market interest rate) or for an "infra-marginal" or "average" investment project (i.e. one that earns extra-profits).

It is worth-noting that the numerical results depend heavily on the assumptions underlying both the hypothetical investment and the future firm behaviour as well as the economic framework. Differences in the assumptions underlying the hypothetical investment and the economic framework can give rise to somewhat different numerical results.

Moreover, these approaches do not permit to take into consideration in the computation all the relevant features of tax systems. However, the most important features of taxation systems such as the rates, major elements of the taxable bases and tax systems are included.

The economic methodology allows for valuable general conclusions but some caveats are necessary.

The broad range of data computed does not intend to present "universally valid values" for the effective tax burden in different countries, but rather **to give indicators, or illustrate interrelations in a series of relevant situations**. In fact, effective tax rates in a particular Member State depend on the characteristics of the specific investment project concerned and the methodology applied.

A number of **general conclusions** can nevertheless be formulated on the basis of the results. These can help explain how Member States' tax regimes create incentives to allocate resources. A striking feature of the quantitative analysis is that, across the range of different situations, **the**

relevant conclusions and interpretations remain relatively constant.

Taking into account that the quantitative results depend heavily on the underlying assumptions and that the applied methodologies do not allow taking into account all the relevant features of taxation, **the numerical results** should be understood as **summarising and quantifying the essential features of the tax system**, as is the case for any computation based on forward-looking methods.

As such, the analysis does not provide empirical evidence of the impact of taxation on actual economic decisions. Although **empirical studies show that there is a correlation between taxation and location decisions**, due to the weaknesses of existing methodologies and due to the lack of data, none of the existing methodologies could have been usefully adopted in the Commission services study without considerably extending the range of work.

Taxation is only one of the determinants of investment and financing decisions.

Taxation is, of course, only one of the determinants of investment and financing decisions. A series of other structural and economic conditions are important determinants of investment behaviour. Which factors are relatively more important very much depends on the individual type of investment decision.

Neutrality and distortion effects

Effective tax rates differentials are high inside the EU.

Even allowing for the above considerations, the results of the quantitative analysis for 1999 are quite informative. There is **large variation in the effective tax burden** faced by investors resident in the different EU Member Countries, as well as in the way each country treats investments in or from other countries (see tables at the end of this Communication).

The range of differences in domestic effective corporate taxation rates is around 37 percentage points in the case of a marginal investment (between -4.1% and 33.2%) and around 30 percentage points in the case of a more profitable investment (between 10.5% and 39.7%).

In the international analysis, the range of variation of the effective tax rates of subsidiaries located in different host countries can also reach more than 30 percentage points. Similarly, the range of variation of the effective tax rates for subsidiaries operating in a given country can reach more than 30 percentage points depending on where their parent company is located.

In each Member States, tax systems tend to favour investment in intangibles and machinery and debt is, by far, the most tax-efficient source of finance.

Across the range of domestic and cross-border indicators there is a remarkable consistency as far as the relative position of Member States, notably at the upper and the lower ranges of the ranking, are concerned.

When the domestic analysis is updated to take into account the 2001 tax regimes, the overall picture is broadly unchanged in comparison to 1999. However, as a consequence of a pattern of generally declining statutory tax rates (albeit with relatively small reductions apart from Germany), more profitable investments benefited from reductions in effective tax rates in a number of countries. As a result, the range of differences in domestic effective tax rates in the case of a more profitable investment decreased from 30 to 26 percentage points.

These high differentials may have an **influence on the international competitiveness of EU companies** located in different Member States and represent **incentives for companies to choose the most tax-favoured locations for their investments**, which may not be the most efficient location in the absence of taxes. If this is the case, differences in the effective levels of company taxation may imply an inefficient allocation of resources and, therefore, welfare costs. The study has not attempted to quantify the size of any efficiency loss or welfare cost that might be associated with existing differences in effective corporation tax rates in the European Union. Nevertheless **the size of tax differentials and dispersions deserves attention,** considering that some externalities as well as the different legitimate goals of tax policy may justify a certain deviation from the objective of neutrality of taxation**.**

The overall national nominal tax rate is the most relevant tax driver affecting competitiveness, incentives to locate and financing decisions.

The EU wide spread cannot be explained by one single feature of the national tax systems. However, the analysis of general regimes tends to show that – leaving aside preferential tax regimes - the different national nominal tax rates (statutory tax rates, surcharges and local taxes) can explain most of the differences in effective corporate tax rates between countries both in the domestic and transnational analysis. **Tax rates differentials more than compensate for differences in the tax base**. These conclusions are to be considered when discussing the compensatory effects of a broad tax base compared to a relatively low tax rate on the effective tax burden. The relative weight of rates in determining the effective tax burden of companies rises when the profitability of the investment rises. Consequently, **any compensatory effects of a lower tax base on effective tax rates tend to disappear when the profitability rises**.

To the extent that taxation matters, introducing a common tax rate in the EU would be likely to go some way in reducing locational inefficiencies.

Simulating the impact of hypothetical harmonisation of particular features of taxation system in isolation shows that:

- **Introducing a common statutory tax rate in the EU would have a significant impact by decreasing the dispersion** - both between parent companies and between subsidiaries - of marginal and average effective tax rates across the EU countries. No other policy scenario has such a significant impact on the dispersion of effective tax rates.
- **Scenarios implying a common tax base or a system consisting in applying the definition of the home country tax base** to the EU-wide profits of a multinational **tend to increase the dispersion in effective tax rates** if overall nominal tax rates are kept constant.

It should however be noted that these conclusions are the result of a static analysis. They therefore do not assess the dynamic effects and possible reactions induced by the harmonisation of particular features of taxation in isolation. In a dynamic context it is possible that the transparency associated with the harmonisation of the taxable base would induce a convergence of the statutory corporate tax rates thus implying a reduction in the dispersion of effective tax rates.

The quantitative analysis of the Commission services study has drawn a picture of corporate tax rates differentials inside the EU and the reasons underlying these differences on the basis of a robust and internationally known theoretical framework. The Commission wishes to draw the attention to the main results of this picture: effective tax rates differentials are high inside the EU and the overall national tax rate is the main tax driver for these differentials. When harmful preferential tax regimes are eliminated within the EU, differences in the nominal tax rates will offer alternative possibilities of arbitrages. In the context of the imminent enlargement this trend could be compounded.

The level of taxation is a matter for Member States to decide.

The Commission services study has not analysed the evolution of effective tax rates over time and the effects of tax competition. Neither, as mentioned above, has the Commission study assessed the size of possible welfare losses associated with the existing differences in effective rates of corporate taxation in the EU Member States. Therefore, at this point in time, there is no convincing evidence for the Commission to recommend specific actions on the approximation of the national corporate tax rates or the fixing of a minimum corporate tax rate.

Moreover, the objective of tax neutrality is obviously not the only legitimate goal of tax policy and taxation ultimately involves a political choice and a trade-off between pure economic efficiency and other legitimate policy goals. To what extent the possible inefficiencies for the Internal Market due to the differences of national practices in corporate taxation can be accepted is, ultimately, a matter of political choice.

In this context, it is worth recalling that: "*The **level of taxation** in this area is, however, **a matter for Member States to decide**, in accordance with the principle of **subsidiarity***", as is stated in the recent Communication on the Tax Policy in the European Union [COM(2001)260].

However, the Commission will carefully monitor the trend of the effective levels of corporate taxation in the EU Member States in order to understand the dynamic effects of reforms in progress.

4. REMOVING THE TAX OBSTACLES TO CROSS-BORDER ECONOMIC ACTIVITY IN THE INTERNAL MARKET

Tackling the obstacles

Cross-border economic activities in the Internal Market are still hampered by substantial company tax obstacles.

The Commission services study has identified a number of fields in which company tax systems comprise or lead to **obstacles** to cross-border trade, establishment and investment or hamper cross-border economic activity in the Internal Market. The additional tax or compliance burdens associated with doing business in more than one Member State caused by these obstacles **undermine the international competitiveness of European companies and waste resources**. The various obstacles are analysed in detail in the study and the annexed Executive Summary gives an overview about the key issues. In particular:

- Profits have to be allocated on an arm's length basis by separate accounting, i.e. on a transaction by transaction basis. This gives, *inter alia*, rise to numerous problems on the fiscal treatment of intra-group **transfer pricing**, notably in the form of high compliance cost and potential double taxation.
- **Cross-border flows of income** between associated companies are often subject to additional tax. In particular, withholding taxes on *bona-fide* intra-group payments of dividends, interests and royalties contain a risk of double-taxation and are not in line with the Internal Market idea. Moreover, the scope of the Parent-Subsidiary Directive (90/435) is too narrow and its implementation in Member States is very different, which reduces its effectiveness.
- There are major limits on **cross-border loss relief** which may lead to (economic) double-taxation. Generally, losses of subsidiaries are not tax-effective at the level of EU parent companies and losses of permanent establishments can be offset against headquarter profits only under specific circumstances.
- **Cross-border restructuring operations** give rise to substantial tax charges. The Merger Directive (90/434) provides for the deferral of corporate tax on such operations but its scope is too narrow and its implementation in Member States is very different, thus reducing its effectiveness. Capital gains taxes and transfer taxes on cross-border restructuring operations are often prohibitively high, thus forcing companies to leave economically sub-optimal structures untouched.
- As a result of conflicting taxing rights, there is a considerable potential for double taxation. This holds for all of the issues which have been identified as obstacles. The specific problems relating to **double taxation conventions** in the EU add to these difficulties.
- Certain tax systems contain a **bias towards domestic investment**. This is, for instance, the case for imputation systems granting specific tax credits only to domestic shareholders which are still operated by a number of Member States.

15 tax jurisdictions in the Internal Market lie at the root of the obstacles.

- Most of these problems stem from the fact that companies in the EU need to comply with up to ***fifteen*** **different sets of rules**. Taking into account that these companies increasingly target the EU as ***one*** **market**, this conflicts with economically efficient business plans and structures. The multiplicity of tax laws, conventions and practices entails substantial compliance costs and represents in itself a barrier to cross-border economic activity.

Both targeted and comprehensive solutions are necessary to overcome these obstacles.

There are two types of solutions for removing the company tax obstacles to the Internal Market, those targeted at particular obstacles and those which in a comprehensive manner remedy all or most of the obstacles 'at a stroke'. They all aim to eliminate the risk of double taxation and tax charges on cross-border re-structuring and to reduce compliance costs and legal uncertainty. They all have specific advantages and disadvantages.

In the Commission's opinion only a **two-track strategy** provides a realistic prospect of removing the obstacles and hence ensuring that the full potential of the Internal Market is realised and the Lisbon objectives achieved.

- Targeted measures will help to address the most urgent problems in the short- and mid-term.
- A comprehensive solution under which companies can operate one consolidated corporate tax base for their EU wide activities will provide a systematic and longer term solution.

Targeted actions in specific areas are necessary as a first step.

A comprehensive solution will provide a better and more definitive response to the current problems but it still requires further technical work before making specific proposals. The targeted remedial measures are in any event needed in the short term to improve the existing body of EU legislation on company taxation and to ensure, via appropriate soft-law initiatives and collaboration with all stakeholders, that these are evenly applied. Some targeted measures such as action on double taxation treaty problems can, at the same time, be **preparatory steps for a comprehensive scheme**, others will continue to be necessary (e.g. those addressing cross-border restructuring operations). The focus in the immediate future will thus be the improvement of the current rules and their application.

Targeted measures

The Commission will, in concert with Member States, develop guidance on the impact of ECJ case law.

The study identifies a need to develop a more general understanding of the impact of important rulings by the European Court of Justice (ECJ) on Member States' company tax rules and double taxation treaties. The Commission considers that the publication of guidance in this area would be helpful not only to Member States but also to businesses and national courts. Such guidance would facilitate compliance with the Treaty and make a significant contribution to the removal of tax obstacles to the Internal Market. It should, to the largest extent possible, involve the European Parliament through the existing mechanisms for the consultation of Parliament.

> → The Commission proposes to develop **guidance on important ECJ rulings** and to co-ordinate, via appropriate Communications from the Commission, the implementation of these. It will therefore continue and expand its programme of meetings with Member States that started in 2001.

The Commission will propose to extend and improve the existing direct taxation directives.

The Parent-Subsidiary and Merger Directives are widely recognised as having played a major role in removing tax obstacles for groups of companies with the EU. The Commission has already presented proposals for amendment of the directives in 1993 [COM(93)293]. The study shows that there are various ways in which the Directives could be extended and improved so as to cover a wider range of companies, taxes and transactions. In particular, the Directives' scope should include all entities subject to company tax and especially the companies which will in future be run under the European Company Statute (*Societas Europeae* - SE).

The Commission will issue guidance on the most important implementation issues.

The Parent-Subsidiary directive needs to be amended to cover both direct and indirect shareholdings. Alternatively a lower minimum holding threshold would have a similar remedial effect. Where the merger directive applies, specific transfer taxes arising on cross-border restructuring operations (notably on immovable property) should be included in the Capital Duty Directive [69/335/EEC and 85/303/EEC]. Moreover, the scope of these and certain existing important provisions in the directives needs further clarification.

> → The Commission will give priority to tabling the necessary **amendments** to the existing proposals for extension of the **Merger Directive and the Parent-Subsidiary Directive** in 2003, following technical consultations with Member States in the course of 2002.
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> → At the same time, the Commission will issue **detailed guidance** on how it considers those provisions, notably those concerning avoidance and abuse, should be implemented.

An innovative solution is needed on cross-border

The problem of cross-border loss offset is at the same time one of the most important issues for industry and yet the most difficult to address through specific measures. The study has examined two rather different *loss offset.*

targeted measures which would lead to the following alternative results:

The Commission will in any event withdraw its current proposal for a directive in this field.

- An amended version of the existing **Commission proposal** [COM(90)595] in this area. This would allow parent companies to take into account the losses incurred by both permanent establishments and subsidiaries situated in another Member State.

- A more complete scheme for the consolidation of group income along the lines of the **Danish joint taxation system** which in certain cases enables Danish parent companies and in addition to their branches also their foreign subsidiaries to be taxed jointly in Denmark, thereby enabling the parent to take into account losses incurred by foreign subsidiaries (and branches). This would attempt to achieve a greater symmetry between the taxation of profits and the offset of losses.

Given that Member States have been reluctant to consider any EU initiative in this area, a **new round of technical preparatory meetings** are required before any action can be reasonably launched. The discussions will have to take into account that the issue of loss-compensation and possible group consolidation is intimately linked to the comprehensive solutions which are discussed further below.

→ The Commission will **withdraw its old proposal for a directive** concerning cross-border loss-offset and, starting in 2002, convene consultative meetings with Member States on the technical possibilities for taking this issue further. In parallel to the progress on more comprehensive solutions it will in particular examine the Danish model and report on its legislative intentions in this area before the end of 2003.

There are effective means for avoiding or removing double taxation resulting from transfer pricing.

The obstacles and problems identified concerning the taxation of intra-group transactions (transfer pricing) are varied in nature but all are increasingly important and call for urgent action. The Commission considers it important to take into account the legitimate concerns of tax administrations and businesses and to **develop commonly accepted practices** in this field. This can be achieved through a **dialogue at EU level**.

Advance Pricing Agreements and co-ordination among Member States and between Member States and businesses should be encouraged.

For instance, the Commission wishes to encourage Member States to introduce or expand bilateral or multilateral **Advance Pricing Agreement** programmes. It also suggests better **co-ordination between Member States of documentation requirements** and of the application **of the various methods**. Such co-ordination should build upon and complement the OECD activities in this field. All this would reduce the compliance costs and the uncertainty relating to transfer pricing.

The Arbitration

Other areas require a more traditional solution. The Arbitration Convention (the prolongation of which currently still awaits ratification in all Member States) has been in place for many years but its application still gives rise to numerous problems. Given the importance of these problems and the unique character of the **Arbitration Convention**, the

Convention must be improved and turned into an instrument of EU law.

Commission recognises its improvement as a priority issue. The shortcomings of the Convention must be removed and its provisions should be made subject to interpretation by the Court, preferably by turning it into an instrument of Community law. Moreover, subject to safeguards to prevent aggressive tax planning, a framework should be established for prior agreement between the tax administrations involved or at least consultation before tax administrations enforce transfer pricing adjustments.

→ The Commission will in the first half of 2002 convene a standing **'Joint Forum on Transfer Pricing'** with Member States and business representatives in order to

- examine the issues which can be addressed without legislative initiatives, e.g. develop and exchange best practice on Advance Pricing Agreements and documentation requirements,
- consider the scope for improving and rendering more uniform transfer pricing methodologies within the OECD guidelines,
- examine necessary improvements to the Arbitration Convention with a view to presenting a formal proposal for a Directive in 2003, thus turning it into an instrument of Community legislation.

→ The Commission will determine the nature of further initiatives in the light of the discussions in the Forum, having regard *inter alia* to the expiry of the present Arbitration Convention in 2005.

A common approach to double-taxation treaty issues will help to overcome the current complexities.

While evidently those Member States concerned must complete their network of double taxation treaties with the other Member States, no other specific action offers itself as "obvious" solution to the complex problems relating to EU double taxation treaty issues. The Commission considers, however, that the current tax treaties of Member States should be improved in order to comply better with the principles of the Internal Market enshrined in the EU Treaty and that **better co-ordination** of treaty policy in relation to third countries is necessary. Moreover, there is a compelling need for binding arbitration where conflicts arise between treaty partners in the interpretation and application of a treaty, leading to possible double taxation or non-taxation.

The Commission believes in the perspective of an EU version of the OECD model convention.

In the Commission's opinion the most promising way forward towards achieving these objectives in a coherent way is, in the long term, to agree an **EU version of the OECD model convention and commentary** (or of certain articles) which meet the specific requirements of EU membership. This would leave intact the existing bilateral system. Clearly, such an exercise requires careful preparatory technical work in concert with Member States.

> → The Commission intends, following technical discussions with Member States, to come forward in 2004 with a **communication** on the need to adapt certain provisions of **double taxation conventions** based on the OECD model to comply with **Treaty principles**. This will constitute a first step towards the possible elaboration of an EU model tax treaty.

Obviously, the Community and its Member States should at the same time continue to support the OECD work both in the area of transfer pricing and concerning double taxation treaties.

Small and medium-sized enterprises must be taken into account.

It should be noted that none of these possible remedies is geared specifically towards larger or small- and medium-sized enterprises. However, it follows from the nature of the problems and their effects that internationally active **small and medium-sized enterprises will also benefit** from the removal of the tax obstacles. Generally, there are good reasons to grant small and medium-sized enterprises proportionate simplification and standardisation arrangements for reducing their tax compliance cost. Depending on the type of measure such initiatives are either appropriate at national level or should, as for instance currently in the area of VAT, explicitly be supported on EU level.

5. PROVIDING COMPANIES WITH A CONSOLIDATED CORPORATE TAX BASE FOR THEIR EU-WIDE ACTIVITIES

The need for a comprehensive approach

Only a consolidated corporate tax base for the EU-wide activities of businesses ultimately provides an answer to the challenges of company tax systems in the EU today.

The above targeted solutions would go some way towards remedying the tax obstacles. However, even if all of them were implemented, they would not address the underlying problem of dealing with up to 15 different tax systems. Only providing multinational companies with a **consolidated corporate tax base** for their EU-wide activities will really, through a **single framework of company taxation,** systematically tackle the majority of the tax obstacles to cross-border economic activity in the Single Market. Companies with cross-border and international activities within the EU should in future be allowed to

- compute the income of the entire group according to one set of rules and
- establish consolidated accounts for tax purposes (thus eliminating the potential tax effects of purely internal transactions within the group).

It is important to note that this approach does not infringe Member States' sovereignty to set corporate tax rates. They would apply their national tax rate to their specific share of the overall tax base as computed according to a commonly agreed allocation mechanism.

A consolidated corporate tax base for the EU-wide activities of companies is the only means which will

- significantly reduce the compliance costs resulting from the need to deal with 15 tax systems within the Internal Market;
- do away, within the EU, with transfer pricing problems;
- allow for the offsetting and comprehensive consolidation of profits and losses on an EU basis;
- simplify many international restructuring operations;
- reduce, without extending into the personal tax field, some of the complexities arising from the co-existence of the classical and exemption approaches to international taxation;
- avoid many situations of double taxation and
- remove many discriminatory situations and restrictions.

A consolidated corporate tax base will improve company tax systems in the EU in economic terms.

A consolidated corporate tax base for the EU-wide activities of companies would contribute to **greater efficiency, effectiveness, simplicity and transparency** in company tax systems and remove the hiatuses between national systems which provide fertile ground for avoidance and abuse. It would reduce compliance costs, allow the EU to reap the full benefits of the Internal Market, thus increase the competitiveness of EU business and lay the foundations for achieving the goals set by the Lisbon European Council.

The Commission therefore believes it is only logical to **steer** its **company taxation policy towards achieving a comprehensive solution** to the existing cross border tax obstacles in the Internal Market. Future work should be directed towards how to achieve the objective of a consolidated corporate tax base with cross border loss relief, and how best to design and agree on the necessary allocation mechanism.

→ **The Commission believes that it is necessary to**

- **provide companies with a consolidated corporate tax base for their EU-wide activities;**
- **develop an appropriate apportionment mechanism** which can be agreed by all participants**;**
- **and, for Member States, to determine the applicable national corporate tax rates.**

Possible comprehensive approaches and technicalities

There are different technical means for achieving a consolidated corporate tax base.

The Commission services study has identified **various technical possibilities** for providing companies with the necessary consolidated tax base for their EU-wide activities ("Home State Taxation"; "Common (Consolidated) Base Taxation"; "European Corporate Income Tax"; "harmonised single tax base in the EU"). The approaches essentially differ in the degree of ambition they show towards a harmonisation of the tax base in the EU, the level of change required for their implementation and the political circumstances of their possible introduction. The approaches are summarised in the attached Executive Summary. All of these approaches

- have particular advantages and disadvantages;
- could provide a tax solution for the European Company Statute (*Societas Europeae* - SE);
- still raise technical difficulties, notably concerning the application of double-taxation treaties;
- would require the development of an agreed mechanism for allocating the consolidated corporate tax base to the various Member States;
- *in short*: require **further analysis**. As the study shows, it is not possible to present and implement a particular technical solution now.

Consolidation on an EU-wide basis is the key feature.

Member States decide the applicable corporate tax rates.

By definition, an essential element of all the solutions is that there is group consolidation on an EU-wide basis. Currently not all Member States apply that principle even at the domestic level and only two, under relatively restrictive conditions, at the international level. Under all approaches Member States would retain the right to set company tax rates which the quantitative analysis found was the most important factor in determining the effective tax rate. This essential sphere of national competence in the area of company taxation would – intentionally – remain untouched and **Member States** would be left with the **autonomy** to adjust the most important element for tax revenues. The introduction of a single or common tax base could lead to some Member States adapting their tax rates to reflect changes in the tax base, but this would be for each Member State to decide.

Good prospects for practical progress

Enhanced co-operation can help to advance.

In theory all the comprehensive approaches could be designed such that not all Member States would have to participate. It is important to note that the Treaty of Nice highlighted the possibility for enhanced co-operation by a group of Member States where agreement by all 15 is not possible, although the full benefits available under a comprehensive approach will only be realised if all Member States participate. Nevertheless, this may be particularly appropriate for Home State Taxation, which presupposes the participation solely of Member States with a fairly similar tax base. However, **a group of Member States** could equally take advantage of this mechanism provided by the Treaty in order to introduce any of the other comprehensive approaches. In any event, in line with the principles agreed at the Nice European Council, the recourse to this instrument must not, among other things, undermine the Internal Market, constitute a barrier to or a discrimination of trade, distort the conditions of competition, or affect the competences, rights and obligations of the non-participating Member States.

Tax administrations will also gain substantial

It should be noted that it is not just companies who suffer from excessive compliance costs, tax administrations incur high costs as well. The area of transfer pricing is one such example. Moreover, the co-existence of 15 company tax systems in one Internal Market creates considerable scope *benefits.*

for tax evasion and tax avoidance. Accordingly, any remedial measures will also to some extent **benefit the efficiency and effectiveness of tax administrations**. As all the remedial measures, targeted or comprehensive, call for more mutual assistance and administrative co-operation between Member States this will ensure that tax audits continue and indeed should become more effective. This will also help to make sure that none of the remedies under consideration results in tax evasion.

To some extent, the IAS may serve as a starting point for developing a common tax base.

Moreover, it is noteworthy that, after the (currently outstanding) adoption of an appropriate Commission proposal for a regulation by the European Parliament and Council [COM(2001)80], as from 2005 listed EU companies will have to prepare their consolidated accounts in accordance with International Accounting Standards. The increasing integration of financial markets and the creation of pan-European stock exchanges can be expected to accelerate accounting harmonisation even further. Although not directly related to taxation, this development may generally help the future development of a common corporate tax base and to some extent the IAS may serve as a useful point of reference.

The European Company Statute (Societas Europeae -* SE*)

A consolidated corporate tax base is very promising for the European Company Statute.

The agreement on the European Company Statute at the European Council of Nice in December 2000 underlines the urgency of the situation. After the formal adoption of the appropriate legislative acts (i.e. the amended proposals for a Council Regulation (EEC) on the Statute for a European Company [COM(91)174] and for a Directive [COM(91)174] complementing the Statute for a European Company with regard to the involvement of employees) this new legal form will become available for companies in the course of 2004. By that date, the current and future body of EU company tax legislation, such as the Parent/subsidiary and Merger Directives, must be made available to companies that choose this new legal form.

However, this might not be sufficient to make the Statute an attractive company law vehicle. The **full benefits** of establishing a European Company (SE) will only be achieved if existing companies can form such an entity without incurring additional tax set up costs, and avoid some of the existing tax obstacles of operating in more than one Member State. As things stand neither of these are provided for and its success could therefore be jeopardised. The concept of the European Company Statute is closely linked to that of a common company taxation system. The work on the technicalities that are necessary for providing companies with a consolidated corporate tax base for their EU-wide activities will therefore be particularly beneficial for future SEs, and an appropriate '**pilot project**' might usefully be introduced for such companies.

→ The Commission intends to make sure that the current body of EU company tax law will be fully applicable to companies formed under the **European Company Statute** as from 2004. At the same time, it will – in parallel to the other work in this area - explore the particular potential of a comprehensive company tax regime and of a consolidated corporate tax base for the EU-wide activities of companies to be applied to SEs.

Stimulating a broad debate

Only a high level of support will make the consolidated corporate tax base the success necessary for achieving the Lisbon goals.

The Commission's endorsement of the fundamental concept of a common company taxation system in the form of a consolidated corporate tax base for the Internal Market as the most promising way to increase efficiency and company competitiveness is a major development. Notwithstanding the possibilities provided by enhanced co-operation and/or the introduction of Home State Taxation by a group of Member States change of this order is a major undertaking. It requires a high level of support from a wide range of interested parties and operational decisions on possibly taking a comprehensive approach forward can only be assessed in the light of Member States' reactions to this Communication.

The Commission therefore believes that the first step should be a **structured dialogue involving all stakeholders: Member States and candidate countries, business representatives and economic operators, senior tax professionals and academics, as well as the social partners**. This will take place in the Council, in the European Parliament and in the Economic and Social Committee but as the Commission recognises the need to widen the institutional debate it wishes to involve other **specific fora**. The purpose is twofold. First, to present this Communication and raise awareness that, without action on company taxation systems, the Internal Market will not provide the full potential economic benefits it could and that the Community and its citizens therefore risk foregoing potential growth, employment and welfare. Second, to ensure support for the necessary further analysis and development of one or more of the approaches outlined so that implementation could be formally proposed.

→ The Commission will therefore, in the first half of 2002, organise a **European Company Tax Conference** in conjunction with the Presidency for high level government representatives from EU Member States and candidate countries, business leaders, economic operators, senior tax professionals, social partners and academics on the future of company taxation in the Internal Market. The objectives will be:

- to provide a forum for the presentation of the various comprehensive approaches,
- to foster discussion between the parties involved,

- to assist the Commission in determining the best way forward with the project.

After the conference and the following broader debate in the EU the Commission intends to report on its subsequent policy conclusions by 2003.

6. WAY FORWARD AND CONCLUSION

The Commission proposes a strategy for action for achieving a consolidated corporate tax base for the EU-wide activities of companies.

A number of specific and general measures in the field of company taxation have been identified in this Communication and the Commission proposes a **two track strategy** directed towards:

- Immediate action on targeted measures
- And, at the same time, the launch of a wider debate on general comprehensive measures

with the **objective** of

- providing EU businesses with a consolidated corporate tax base for their EU-wide activities.

The Commission will:

- provide guidance on and co-ordinate, via appropriate Communications from the Commission, the implementation of jurisprudence by the European Court of Justice;

- step up its efforts of monitoring the implementation of EU tax law by Member States and work together with Member States towards common guidance notes in this field;

- amend its existing proposals for extension of the Merger Directive and the Parent Subsidiary-Directive with a view to broadening the scope and the coverage of both individual taxes and types of transactions;

- withdraw its old proposal for a directive concerning cross-border loss-offset with a view to its replacement after technical discussions with Member States and other stakeholders;

- present a proposal for a Directive with a view to renewing and improving the Arbitration Convention;

- establish an 'EU Joint Forum on Transfer Pricing';

- prepare for a Communication on the issue of double taxation conventions of Member States with a view to the eventual conclusion of either a multilateral convention or an agreed EU model;

- insist that the current body of EU company tax law will be fully applicable to companies formed under the European Company Statute as from 2004. At the same time, it will – in parallel to the other work in this area - explore the particular potential of a comprehensive company tax regime and of a consolidated corporate tax base for the EU-wide activities of companies to be applied to SEs.

- launch a broad debate on the future of company taxation in the Internal Market and the need for fundamental reform to achieve the EU objectives of becoming the most competitive and dynamic knowledge-based economy in the world as agreed at the Lisbon European Council June 1999. In this context, the Commission will undertake to organise a European Company Tax Conference in conjunction with the Presidency for high level government representatives from EU Member States and candidate countries, business leaders, economic operators, senior tax professionals, the social partners and academics on the future of company taxation in the Internal Market. The objectives will be:

    - to provide a forum for the presentation of the various comprehensive approaches

    - to foster discussion between the parties involved

    - to assist the Commission in determining the best way forward with the project.

  After the conference and the following broader debate in the EU the Commission intends to report on its subsequent policy conclusions by 2003.

Table 1 Cost of Capital and Effective Marginal Tax Rate by country, years 1999 and 2001

Table 2 Effective Average Tax Rate by country, years 1999 and 2001

Table 3 Effective Average Tax Rate when the subsidiary is financed with retained earnings, year 1999

Table 4 Effective Average Tax Rate when the subsidiary is financed with new equity, year 1999

Table 5 Effective Average Tax Rate when the subsidiary is financed with debt, year 1999

Table 1 Cost of Capital and Effective Marginal Tax Rate by country, years 1999 and 2001
-by asset, source of finance and overall
-only corporation taxes

	2001			1999			COST OF CAPITAL 1999								EMTR 1999		
Country	Corporate tax rates (1)	Cost of Capital	EMTR	Corporate tax rates (1)	Cost of Capital	EMTR	Intangibles	Industrial Buildings	Machinery	Financial Assets	Inventories	Retained earnings	New equity	Debt	Retained earnings	New equity	Debt
Austria	34.00	5.7	12.6	34.00	6.3	20.9	5.9	6.1	5.9	7.3	6.3	7.5	7.5	4.0	33.3	33.3	-25.0
Belgium	40.17	6.4	22.4	40.17	6.4	22.4	5.2	7.0	5.3	8.0	6.7	8.0	8.0	3.5	37.5	37.5	-42.9
Germany	39.35	6.8	26.1	52.35	7.3	31.0	5.4	7.2	5.8	10.0	7.9	9.7	7.6	3.2	48.4	35.5	-56.2
Denmark	30.00	6.4	21.6	32.00	6.4	21.9	4.2	8.1	5.4	7.1	7.1	7.5	7.5	4.4	33.3	33.3	-13.6
Spain	35.00	6.5	22.8	35.00	6.5	22.8	6.5	6.7	5.4	7.4	6.4	7.7	7.7	4.1	35.1	35.1	-21.9
Greece	37.50	6.0	16.9	40.00	6.1	18.2	6.8	5.1	6.1	5.1	7.4	7.6	7.6	3.4	34.2	34.2	-47.1
France	36.43	7.3	31.8	40.00	7.5	33.2	5.2	8.5	8.4	8.0	7.4	9.0	9.0	4.6	44.4	44.4	-8.7
Finland	29.00	6.4	21.3	28.00	6.2	19.9	6.1	6.1	5.6	6.8	6.8	7.2	7.2	4.5	30.5	30.5	-11.1
Italy	40.25 (2)	4.3	-15.9	41.25 (2)	4.8	-4.1	2.9	4.6	3.8	7.7	5.0	5.5	5.5	3.6	10.0	10.0	-38.9
Ireland	10.00	5.7	11.7	10.00	5.7	11.7	5.3	6.8	5.2	5.5	5.5	5.9	5.9	5.2	15.2	15.2	3.8
Luxembourg	37.45	6.3	20.7	37.45	6.3	20.7	5.2	6.8	5.3	7.7	6.5	7.7	7.7	3.7	35.1	35.1	-35.1
Netherlands	35.00	6.5	22.7	35.00	6.5	22.6	5.1	6.9	5.9	7.4	6.9	7.7	7.7	4.1	35.1	35.1	-21.9
Portugal	35.20	6.3	21.0	37.40	6.5	22.5	6.7	6.2	5.2	7.7	6.5	7.9	7.9	3.9	36.7	36.7	-28.2
Sweden	28.00	5.8	14.3	28.00	5.8	14.3	5.0	6.0	5.0	6.6	6.6	6.7	6.7	4.3	25.4	25.4	-39.5
UK	30.00	6.7	24.8	30.00	6.6	24.7	5.5	8.2	5.6	6.9	6.9	7.7	7.7	4.8	35.1	35.1	-25.0

Note. Each asset column represents an average across all three types of finance, with weights of 55% retained earnings, 10% new equity and 35% debt. Each finance column represents an unweighted average across all 5 assets. The overall average is an average across all 15 types of investment, with the same weights.
(1) including surcharges and local taxes
(2) Under the Italian "dual income" system, the statutory corporate tax rate of 36 % in 2001 and 37 % in 1999 (net of surcharges and local taxes) is reduced to 19 % in certain cases. In the above marginal case this lower rate applies, except to debt where the higher rate applies.

Table 2 Effective Average Tax Rate by country, years 1999 and 2001
- by asset, source of finance and overall

- only corporation taxes

EFFECTIVE AVERAGE TAX RATES												
Country	Corporate tax rates (1) 2001	Overall Mean 2001	Corporatetax rates (1) 1999	Overall Mean 1999	1999					1999		
					Intangibles	Industrial Buildings	Machinery	Financial Assets	Inventories	Retained earnings	New equity	Debt
Austria	34.00	27.9	34.00	29.8	28.6	29.2	28.4	33.2	29.9	33.9	33.9	22.3
Belgium	40.17	34.5	40.17	34.5	30.7	36.1	31.0	39.2	35.3	39.1	39.1	25.8
Germany	39.35	34.9	52.35	39.1	33.9	39.0	34.9	46.8	40.8	46.1	40.1	27.7
Denmark	30.00	27.3	32.00	28.8	21.3	34.7	25.3	31.2	31.2	32.3	32.3	22.1
Spain	35.00	31.0	35.00	31.0	31.1	31.8	27.4	34.2	30.7	35.2	35.2	23.3
Greece	37.50	28.0	40.00	29.6	35.5	30.4	33.4	11.6	37.1	34.4	34.4	20.8
France	36.43	34.7	40.00	37.5	30.6	40.6	40.1	39.0	37.1	42.1	42.1	28.8
Finland	29.00	26.6	28.00	25.5	24.8	24.8	23.1	27.3	27.3	28.8	28.8	19.3
Italy	40.25	27.6	41.25	29.8	24.9	29.8	27.4	36.1	31.1	31.8	31.8	26.1
Ireland	10.00	10.5	10.00	10.5	8.9	15.8	8.2	9.8	9.8	11.7	11.7	8.2
Luxembourg	37.45	32.2	37.45	32.2	28.6	33.7	29.2	36.6	32.9	36.6	36.6	24.0
Netherlands	35.00	31.0	35.00	31.0	26.7	32.4	29.2	34.2	32.5	35.1	35.1	23.3
Portugal	35.20	37.0	37.40	32.6	33.2	31.8	28.6	36.5	32.8	37.0	37.0	24.5
Sweden	28.00	22.9	28.00	22.9	19.6	23.4	19.7	25.7	25.7	26.0	26.0	17.1
UK	30.00	28.3	30.00	28.2	24.2	33.7	24.7	29.3	29.3	31.8	31.8	21.6

Note. Each asset column represents an average across all three types of finance, with weights of 55% retained earnings, 10% new equity and 35% debt. Each finance column represents an unweighted average across all 5 assets. The overall average is an average across all 15 types of investment, with the same weights.
(1) Including surcharges and local taxes

Table 3 Effective Average Tax Rate when the subsidiary is financed with retained earnings, year 1999 - only corporation taxes; weighted average of parent finance

EATR % / from \ to	Austria	Belgium	Denmark	Finland	France	Germany	Greece	Ireland	Italy	Luxembourg	Netherlands	Portugal	Spain	Sweden	United Kingdom	Mean
Austria	(33.9) *	39.1	32.3	28.8	42.1	46.1	34.4	11.7	31.8	36.6	35.1	37.0	35.2	26.0	31.8	33.4
Belgium	29.9	(39.1)	28.7	25.0	38.1	42.1	30.4	8.1	28.0	32.6	31.2	33.0	31.2	22.2	27.9	29.2
Germany	20.1	26.4	18.8	14.3	29.8	(46.1)	25.4	-5.7	17.9	23.4	21.6	23.8	21.7	11.0	17.7	19.0
Denmark	30.1	35.4	(32.3)	25.0	38.4	42.4	30.6	7.8	28.1	32.8	31.3	33.2	31.4	22.2	28.0	29.8
Spain	29.7	35.1	28.4	24.6	38.1	42.1	30.2	7.4	27.8	32.5	31.0	32.9	(35.2)	21.8	27.6	29.2
Greece	32.9	34.5	32.9	31.8	37.5	41.5	(34.4)	27.9	27.5	33.4	33.5	33.9	33.5	30.3	33.2	33.2
France	29.5	34.8	28.3	24.5	(42.1)	41.8	30.0	7.5	27.6	32.3	30.8	32.7	30.8	21.7	27.5	28.6
Finland	30.6	35.9	29.2	(28.8)	38.9	42.9	31.0	8.3	28.6	33.3	31.8	33.7	31.9	22.7	28.5	30.5
Italy	30.3	35.5	29.0	25.3	38.4	42.4	30.7	8.4	(31.8)	32.9	31.5	33.3	31.5	22.5	28.2	30.0
Ireland	32.7	38.0	31.2	27.6	41.0	45.0	33.2	(11.7)	30.7	35.4	34.0	35.8	34.0	24.8	30.6	33.8
Luxembourg	29.4	34.8	28.2	24.4	37.8	41.8	29.9	7.1	27.5	(36.6)	30.7	32.6	30.7	21.6	27.3	28.8
Netherlands	33.9	39.1	32.3	28.8	42.1	46.1	34.4	11.7	31.8	36.6	(35.1)	37.0	35.2	26.0	31.8	33.3
Portugal	30.2	35.5	29.0	25.2	38.4	42.3	30.7	8.3	28.3	32.9	31.4	(37.0)	31.5	22.5	28.2	29.6
Sweden	30.8	36.1	29.4	25.7	39.1	43.1	31.2	8.5	28.8	33.5	32.0	33.9	32.1	(26.0)	28.7	30.9
UK	30.3	35.6	29.0	26.5	38.6	42.7	32.9	22.1	28.3	33.1	31.6	33.5	31.6	24.8	(31.8)	31.5
Canada	40.1	44.5	32.3	33.4	43.8	50.4	34.4	11.7	38.3	38.5	37.1	48.4	41.2	28.4	31.8	37.0
USA	31.8	36.9	30.3	29.1	39.7	43.5	33.0	25.0	29.9	34.4	33.0	38.6	35.0	27.6	30.7	33.2
Mean	30.0	35.4	29.0	25.5	38.4	43.0	31.1	9.9	28.0	32.9	31.2	33.3	31.6	22.9	28.4	30.1

* The data into parenthesis represent the corresponding domestic effective average tax rates

Table 4 Effective Average Tax Rate when the subsidiary is financed with new equity, year 1999 - only corporation taxes; weighted average of parent finance

EATR % from \ to	Austria	Belgium	Denmark	Finland	France	Germany	Greece	Ireland	Italy	Luxembourg	Netherlands	Portugal	Spain	Sweden	United Kingdom	Mean
Austria	(33.9)**	39.1	32.3	28.8	42.1	40.1	34.4	11.7	31.8	36.6	35.1	37.0	35.2	26.0	31.8	33.0
Belgium	30.6	(39.1)	29.3	25.6	38.8	36.9	31.1	8.8	28.7	33.3	31.9	33.7	31.9	22.9	28.6	29.4
Germany	21.0	27.2	19.6	15.1	30.7	(40.1)	29.2	-4.8	18.7	24.2	22.4	24.7	22.5	11.9	18.6	20.1
Denmark	30.1	35.4	(32.3)	25.0	38.4	36.4	30.6	7.8	28.1	32.8	31.3	33.2	31.4	22.2	28.0	29.3
Spain	29.7	35.1	28.4	24.6	38.1	36.1	30.2	7.4	27.8	32.5	31.0	32.9	(35.2)	21.8	27.6	28.8
Greece	36.0	34.5	36.6	37.4	37.5	35.5	(34.4)	39.5	27.8	34.8	36.1	35.3	36.1	36.6	38.0	35.8
France	29.9	35.2	28.6	24.9	(42.1)	36.2	30.4	7.8	27.9	32.6	31.1	33.0	31.2	22.1	27.8	28.5
Finland	30.6	35.9	29.2	(28.8)	38.9	36.9	31.0	8.3	28.6	33.3	31.8	33.7	31.9	22.7	28.5	30.1
Italy	30.9	36.1	29.6	25.9	39.0	37.1	31.4	9.0	(31.8)	33.6	32.1	34.0	32.2	23.1	28.8	30.2
Ireland	32.7	38.0	31.2	27.6	41.0	39.0	33.2	(11.7)	30.7	35.4	34.0	35.8	34.0	24.8	30.6	33.4
Luxembourg	33.9	39.1	32.3	28.8	42.1	40.1	34.4	11.7	31.8	(36.6)	35.1	37.0	35.2	26.0	31.8	32.8
Netherlands	33.9	39.1	32.3	28.8	42.1	40.1	34.4	11.7	31.8	36.6	(35.1)	37.0	35.2	26.0	31.8	32.9
Portugal	30.8	36.1	29.6	25.9	39.0	37.1	31.3	9.0	28.9	33.5	32.1	(37.0)	32.1	23.1	28.8	29.8
Sweden	30.8	36.1	29.4	25.7	39.1	37.1	31.2	8.5	28.8	33.5	32.0	33.9	32.1	(26.0)	28.7	30.5
UK	30.3	35.6	29.0	27.5	38.6	36.7	34.1	29.8	28.3	33.1	31.6	33.5	31.6	26.5	(31.8)	31.9
Canada	45.2	49.5	32.3	36.8	45.4	50.3	34.4	11.7	43.3	40.2	38.8	58.4	46.2	30.1	31.8	39.6
USA	33.5	38.5	31.7	32.4	41.4	39.5	34.6	34.7	31.6	36.1	34.7	43.6	38.4	31.5	33.1	35.7
Mean	30.8	35.9	29.8	26.5	39.0	37.5	31.9	11.9	28.6	33.3	32.0	33.9	32.3	24.0	29.2	30.4

* The data into parenthesis represent the corresponding domestic effective average tax rates

Table 5 **Effective Average Tax Rate when the subsidiary is financed with debt, year 1999 - only corporation taxes; weighted average of parent finance**

EATR % / from \ to	Austria	Belgium	Denmark	Finland	France	Germany	Greece	Ireland	Italy	Luxembourg	Netherlands	Portugal	Spain	Sweden	United Kingdom	Mean
Austria	(22.3) *	33.1	29.2	26.8	36.2	35.0	28.3	15.9	33.5	31.4	30.8	31.9	30.8	24.5	29.1	29.7
Belgium	32.3	(25.8)	31.5	29.3	38.4	37.3	30.7	18.6	35.8	33.8	33.2	34.2	33.2	27.0	31.5	31.9
Germany	27.8	31.5	26.7	24.3	35.0	(27.7)	31.9	11.7	31.9	29.6	28.9	30.1	28.9	21.6	26.9	27.6
Denmark	29.4	32.7	(22.1)	26.4	35.7	34.6	27.9	15.4	33.1	31.0	30.3	31.4	30.4	24.1	28.7	29.4
Spain	30.1	33.3	29.4	27.0	36.4	35.2	28.5	16.1	33.7	31.6	31.0	32.1	(23.3)	24.7	29.3	29.9
Greece	36.0	34.4	36.6	37.4	37.5	36.3	(20.8)	39.5	35.2	34.8	36.1	35.3	36.1	36.6	38.0	36.4
France	31.7	34.9	31.0	28.7	(28.8)	36.8	30.2	17.9	35.3	33.2	32.6	33.7	32.7	26.4	31.0	31.1
Finland	28.5	31.8	27.9	(19.3)	34.9	33.7	27.0	14.5	32.2	30.1	29.4	30.6	29.5	23.2	27.8	28.7
Italy	31.5	34.7	30.8	28.5	37.7	36.5	30.0	17.8	(26.1)	33.0	32.4	33.4	32.4	26.3	30.8	31.1
Ireland	24.5	29.6	24.2	21.5	31.0	29.9	26.4	(8.2)	28.3	26.2	25.5	28.3	25.5	19.3	23.8	26.0
Luxembourg	30.6	33.9	29.9	27.6	36.9	35.7	29.1	16.7	34.2	(24.0)	31.5	32.6	31.6	25.3	29.9	30.4
Netherlands	30.1	33.3	29.4	27.0	36.4	35.2	28.5	16.1	33.7	31.6	(23.3)	32.1	31.0	24.7	29.3	29.9
Portugal	31.6	34.8	30.9	28.6	37.8	36.6	30.1	17.9	35.1	33.1	32.5	(24.5)	32.5	26.4	30.9	31.3
Sweden	28.2	31.5	27.6	25.1	34.5	33.4	26.6	14.2	31.8	29.8	29.1	30.2	29.1	(17.1)	27.4	28.5
UK	29.0	32.3	28.3	27.5	35.3	34.1	30.0	29.8	32.6	30.6	29.9	31.0	29.9	26.5	(21.6)	30.5
Canada	40.1	42.8	31.4	34.7	40.8	44.4	30.6	18.3	43.1	36.3	35.7	49.3	40.9	29.7	31.4	36.6
USA	32.7	35.8	31.7	32.4	38.7	37.6	31.9	34.7	36.2	34.2	33.6	39.7	36.2	31.5	33.1	34.7
Mean	30.1	33.0	29.5	27.5	36.0	35.0	28.9	18.7	33.3	31.4	30.9	31.9	31.0	25.5	29.6	30.2

* The data into parenthesis represent the corresponding domestic effective average tax rates

Annex

Executive Summary of the Commission Services Study on

"COMPANY TAXATION IN THE INTERNAL MARKET"

[SEC(2001)1681]

Introduction

1. The conclusions of the ECOFIN Council in December 1998 requested the Commission to carry out an analytical study on company taxation in the European Union. This study should illuminate differences in the effective level of corporate taxation and identify the main tax provisions that may hamper cross-border economic activity in the Single Market. On this basis an assessment should be undertaken of the effects on the location of economic activity and investments. In July 1999 the Permanent Representatives Committee (COREPER) refined this request into a formal mandate for the Commission asking for a factual analysis and a policy assessment with a view to EU company taxation.

2. The Commission has been assisted by two specifically created panels of experts one focussing on the method for calculating the effective tax rates in Member States and the other on the remaining tax obstacles to the proper functioning of the Single market. The first panel was composed of academics with appropriate experience and scientific reputation in relevant theoretical works. The second panel included experts from among the business community and social partners at the Community level. The individual members of the second panel were designated by the respective organisations.

The Ruding report and the impact of the Internal Market

3. This study takes the report of the Committee of Independent experts on Company Taxation into account that was asked by the Commission in 1990 to determine whether differences in business taxation and the burden of business taxes among Member States lead to major distortions affecting the functioning of the Single Market and to examine all possible remedial measures (Ruding Committee). The underlying analysis of this earlier study is mostly still topical. In this context it has to be noted that little progress has been achieved in the field of company taxation as a result of its findings and recommendations. However, the context for studying company taxation in the EU has since then changed in various ways. Moreover, the mandate given to the Commission by the Council for the present study is broader than that given by the Commission to the expert committee in 1990 as it explicitly requests the analysis of tax obstacles in the Internal Market.

4. The overall economic framework has changed significantly since the early nineties. An unprecedented wave of international mergers and acquisitions, the emergence of electronic commerce and the increased mobility of factors with

the growing development of "tax havens" all change the scenery under which European Member States levy taxes on company profits. These general global developments are still on-going and are particularly strong within the Internal Market.

5. Most significantly, the Internal Market had not been established yet in 1990. The same holds for Economic and Monetary Union. Both developments impact on how the functioning of company tax systems within the EU has to be evaluated. As economic integration in the Internal Market proceeded, the economic, technological and institutional barriers to cross-border trade continued to wane. At the same time, taxation systems adapted to this process only very gradually. The pattern of international investments is therefore likely to be increasingly sensitive to cross-border differences in corporate tax rules in an environment now characterised by full mobility of capital. Moreover, while considerable progress has been made in the removal of the wide range of barriers to the establishment of the Internal Market (including the recent agreement on the European Company Statute), the tax impediments to cross-border activities within the Internal Market are becoming increasingly important. These elements describe important specific EU dimensions on company taxation which did not exist in the same way in 1990.

6. EU businesses are presently confronted with a single economic zone in which 15 different company tax systems apply. This causes losses of economic efficiency, generates specific compliance costs, and contributes to a lack of transparency. The Internal Market and Economic and Monetary Union also strongly impact on the way EU companies carry out business in the Community and set the - intended - incentive to create effective pan-European business structures. This is because EU companies increasingly no longer define one Member State but rather the whole EU as their "home market". The resulting structural changes lead to the EU-wide re-organisation and centralisation of business functions within a group of companies, many of which were traditionally present in many or even all Member States. Such re-organisation can be achieved via internal realignments, via mergers and acquisitions or through the creation of foreign branches. These tendencies, in turn, impact on the taxation of these companies. EU companies argue that their perception of the EU as their "home market" generally does not correspond to a tax reality, unlike the USA for US companies. Thus, a variety of legal and economic factors define a specific "EU dimension" for analysing company taxation.

The effective level of company taxation in the EU

7. From the point of view of economic efficiency, tax systems should ideally be "neutral" in terms of economic choices. In such an analytical framework, the choice of an investment, its financing or its location should in principle not be driven by tax considerations. From this perspective, and in an international context, similar investments should not face markedly different effective levels of taxation purely because of their country location. Differences in the effective levels of corporate taxation may in fact imply welfare costs because economic activity may not take place in the lowest (pre-tax) cost location by the lowest

cost producers. If the impact of differences in tax regimes favours one location over another, or one producer over another, then goods may be produced at a higher pre-tax cost. Therefore, the size of these tax differentials and dispersions deserves attention.

8. However, a full welfare cost assessment of differences in effective corporation tax rates would require a broader analysis, taking into account the existence of other taxes and other economic parameters, as well as national preferences for equity and the provision of public goods. Moreover, to the extent that there are pre-existing distortions and/or imperfections in the market economy (market failures), taxes may be used to internalise these externalities (e.g. pollution), thereby enhancing economic efficiency. It is impossible to precisely quantify the size of tax differentials needed to correct or mitigate market failures. However, the larger the tax differentials, the larger the market failure must be unless there is to be a loss of efficiency and welfare. It should be stressed that this study has not attempted to quantify the size of any efficiency loss or welfare cost that might be associated with existing differences in effective corporation tax rates in the European Union.

9. In any event, taxation ultimately involves a political choice and may entail a trade-off between pure economic efficiency and other legitimate national policy goals and preferences. Furthermore, in the Community context, the subsidiarity principle and Member States' competences in the field of taxation have to be taken into account when assessing differences in effective tax rates between Member States.

10. The purpose of the analysis of differences in the EU corporations' effective level of taxation is twofold. First, it gives summary measures of the overall relative incentive (or disincentive) provided by each country's tax law to undertake various types of investments at home or in another EU Member State. Second, it identifies the most important tax drivers influencing the effective tax burdens, that is the weight of each of the most important elements of the tax regimes in the effective tax burden.

11. The analysis does not provide evidence of the impact of taxation on actual economic decisions. Although empirical studies show that there is a correlation between taxation and location decisions, because of the weaknesses of the existing methodologies and their limitations due to lack of available data, it has been considered that none of the existing approaches could have been usefully adopted in the current study without considerably extending the range of the work.

12. Taxation is, of course, only one of the determinants of investment and financing decisions. The existence and quality of economic infrastructures, the availability of qualified work, as well as the short and medium-term outlook in different markets and countries are among the other important determinants of investment behaviour. The geographical accessibility of markets, transport costs, environmental standards, wage levels, social security systems and the overall attitude of government all play an important role too. Which of these factors are relatively the more important very much depends on the individual

type of investment decision. Nevertheless, as economic integration in the EU proceeds in the context of the Economic and Monetary Union and the Internal Market, in an environment where capital is fully mobile, the pattern of international investment is likely to be increasingly sensitive to cross-border differences in corporate tax rules.

13. The study presents estimates of effective corporate tax rates on domestic and transnational investments in the 15 EU countries (as well as the US and Canada in certain cases) taking the tax systems in operation as of the year 1999. In addition, it presents estimates of effective corporate tax rates on domestic investments for the EU Member States in 2001. In view of the structure and magnitude of the German tax reform approved in 2000, the effects of this reform, as of the 1st January 2001, are separately analysed. The calculations consider primarily corporation taxes in each country, but also include the effect of personal income taxation of dividends, interest and capital gains.

14. The most commonly used indicators for analysing the impact of taxation on investment behaviour are based on forward-looking approaches which permit international comparisons and are especially tailored to provide an indication of the general pattern of incentives to investment that are attributable to different national tax laws as well as on the most relevant tax drivers that influence the effective tax burdens. In this study, the main body of the computation of the effective corporate tax burden builds on the methodology involving calculating the effective tax burden for a hypothetical future investment project in the manufacturing sector. In technical terms, the analysis relies on a revised and extended methodology of the so-called King & Fullerton approach, set out by Devereux and Griffith (1998). This computation is supplemented by data arising from the application of the "European Tax Analyzer" model which utilises the model-firm approach set out by the University of Mannheim and ZEW (1999). Considering that each methodology is based on different hypotheses and restrictions, the comparison of the results of these approaches permits the testing and, possibly, confirmation of the general trends arising from the computations.

15. The results of the application of these approaches depend heavily on the assumptions underlying both the definition of the hypothetical investment in terms of assets and financing or of the future firm behaviour in terms of total cash receipts and expenses, assets and liabilities over time and of the economic framework. As far as the economic framework is concerned, the value of the real interest rate is a crucial element. The existing studies based on these approaches assume different hypotheses in relation to the economic framework and the definition of the investment. This study, for example, like the Ruding report, calculates effective tax rates at a given post-tax rate of return, whereas other studies[1] compute the effective tax rate for a given pre-tax rate of return. Differences in the assumptions underlying the hypothetical investment and the economic framework can give rise to somewhat different numerical results.

1 see, for instance: Baker & McKenzie, Survey of the Effective Tax Burden in the EU, Amsterdam; 1999 and 2001

16. These approaches do not permit, for methodological reasons, taking into consideration in the computation all the relevant features linked to the existence and functioning of different tax systems. For instance, the effects of consolidating profits and losses throughout the EU are not included because the model assumes all investments are profitable. Neither is it possible to quantify or include compliance costs. However, the most important features of taxation systems such as the rates, major elements of the taxable bases and tax systems are included. The results produced should therefore be understood as summarising and quantifying the essential features of the tax system.

17. Effective tax rates can be calculated for a so-called "marginal" investment (where the post-tax rate of return just equals the alternative market interest rate) or for a "infra-marginal" investment project (i.e. one that earns an extra-profit). This study has analysed both marginal and infra-marginal (average) effective company tax indicators. These reflect different hypotheses related to the underlying methodology, as well as to the domestic or international localisation of the investment, the profitability of the investment or of the firm considered, and the size and behaviour of the companies. The computations have been supplemented by "sensitivity analysis" which tests the impact of different hypotheses on the results.

18. The broad range of data computed does not intend to present "universally valid values" for the effective tax burden in different countries, but rather to give indicators, or illustrate interrelations, in a series of relevant situations. In fact, effective tax rates in a particular Member State depend on the characteristics of the specific investment project concerned and the methodology applied.

19. A number of general conclusions regarding both the differences in the effective tax burdens and the identification of the most relevant *tax* drivers which influence these tax burdens, can nevertheless be formulated on the basis of the results. Therefore, explanations can be given on how Member States tax regimes create incentives to allocate resources. A striking feature of the quantitative analysis is that, across the range of different situations, the relevant conclusions and interpretations remain relatively constant.

20. When domestic investments are considered, the analysis for 1999 suggests that there is considerable variation in the effective tax burden faced by investors resident in the various EU Member States, depending on the type of investment and its financing. However, the Member States' tax codes tend to favour the same forms of investment by assets and sources of finance. The range of the differences in national effective corporate taxation rates, when personal taxation is not taken into account is around 37 points in the case of a marginal investment (between -4.1% and 33.2%) and around 30 points in the case of more profitable investments (between 10.5% and 39.1% when the hypothetical investment methodology is applied and between 8.3% and 39.7% when the "Tax Analyser" model is applied). The introduction of personal taxation substantially increases the effective tax burdens and the observed differences. Moreover, the analysis suggests that, in practically every situation analysed tax systems tend to favour investment in intangibles and machinery and debt is the most tax-efficient source of finance.

A recent study by Baker and McKenzie conducted under different hypotheses concerning the economic context and the applied tax codes, shows that in the most similar economic situation to that considered in this study (pre-tax rate of return of 6% as against a post-tax rate of return of 5% considered in the Commission study), the range of variation is 32 points in the case of a marginal investment (from 4.9% to 36.8%). When the pre-tax rate of return is fixed at 10% (base case in the Baker and McKenzie computation), the range of variation is 23 points (from 6.8 to 30.1). This study also shows that the most tax efficient method of finance is debt and that the tax systems tend to favour investments in intangibles and machinery.

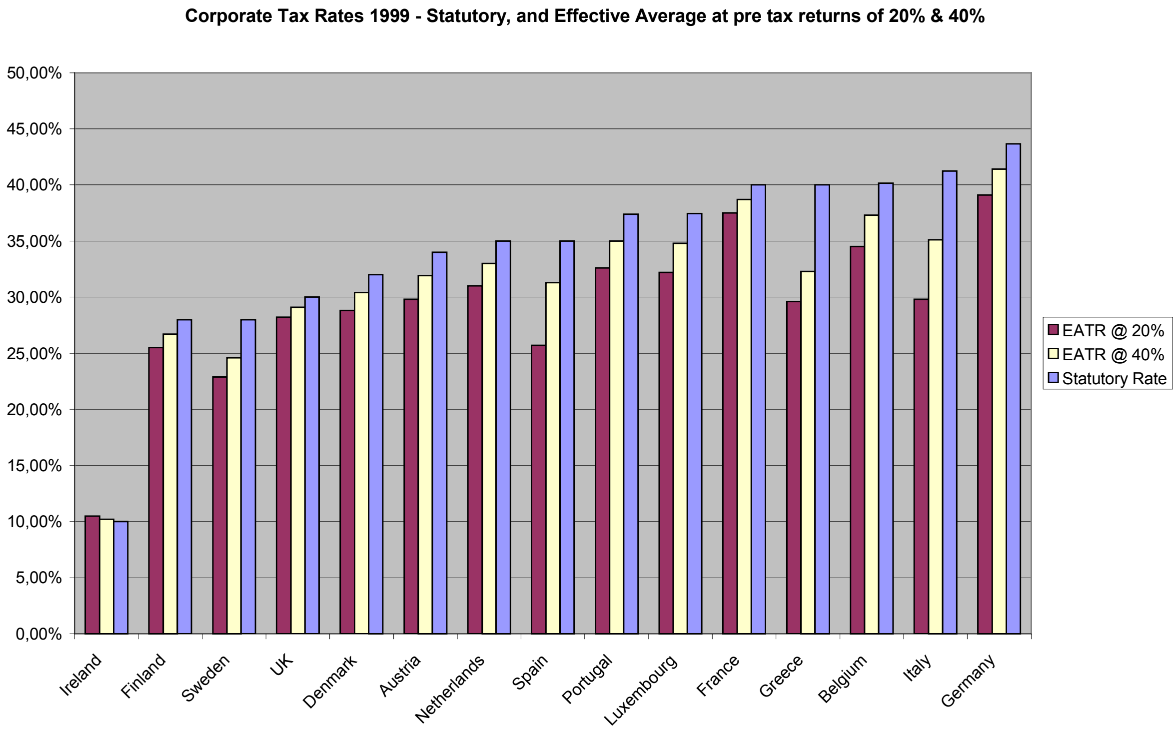
21. Differences between the effective tax burden in the EU Member States may be important for two reasons. First, differences in effective tax rates faced by companies located in different countries, but competing in the same market, may affect their international competitiveness: two different companies, competing in the same market, may face two different tax rates. Second, when multinational companies face only the tax rate of the country where the activity takes place then differences in the effective tax rates between countries could also affect the location choice of individual activities. This can occur either as a result of the provisions of international tax codes, for example when the repatriation of profits by way of dividend from a subsidiary to a parent results in no further taxation because the dividend is exempt, or as a result of tax planning. A multinational company may therefore face different tax rates, depending on where its activities are located. As indicated, this economic reasoning is based on pure tax considerations and cannot, on its own, explain the actual behaviour of companies.

22. Clearly, the EU wide spread cannot be explained by one single feature of the national tax system. However, the analysis of general regimes tends to show that – leaving aside preferential tax regimes - the different national nominal tax rates on profits (statutory tax rates, surcharges and local taxes) can explain many of the differences in effective corporate tax rates between countries. Although tax regimes are designed as more or less integrated systems (in general high tax rates on profits seem to correlate with a narrower taxable base and vice versa), tax rate differentials tend to outweigh the differences in the tax bases. The quantitative analysis also shows that the relative weight of rates in determining the effective tax burden of companies rises when the profitability of the investment rises and that, consequently, any compensatory effects of a lower tax base on effective tax rates tend to disappear when the profitability rises. The study conducted by Baker and McKenzie concluded that, in general, the composition of the tax base does not have a great impact on the effective tax burden and that the level of the tax rate is the truly important factor for the difference in the tax burden.

23. When <u>transnational investments</u> are considered, the results for 1999 show variations in the way each country treats investments in or from other countries. Thus, the effective tax burden of a subsidiary of a parent company in one country depends crucially on where that subsidiary is located. On the basis of the assumptions considered in this study, the range of variations of the effective tax burdens of subsidiaries located in different host countries can rise

above 30 points regardless of the method of financing of the subsidiary. This provides an incentive for companies to choose the most tax-favoured locations for their investment, which may not be the most favourable location in the absence of taxes. Similarly, subsidiaries operating in a given country face different effective tax burdens depending on where their parent company is located. Even in this case the range of variation can reach more than 30 points.

24. The analysis of the effective tax burden of transnational investment also gives an indication of the allocation effects of international taxation by capturing the



extent to which the tax treatment of transnational investments gives incentives to undertake transnational, as opposed to domestic, investment. The data show that, on average in the EU, outbound and inbound investment are more heavily taxed than otherwise identical domestic investments and, therefore, the additional components of the transnational system add somewhat to the effective tax rates on investment.

25. But, to the extent that companies are free to choose the most tax-favoured form of finance, then the international tax system works such that foreign multinationals operating in a host country are likely to face a lower effective tax burden than domestic companies. This seems to be true even when the treatment of multinationals is compared with the more favourable domestic treatment allowed for small and medium sized companies.

26. The spreads observed between the effective rates of taxation in the international analysis are the results of complex interactions between different tax regimes and cannot be explained by just one feature of taxation. However, as was the case for the domestic investment, the analysis tends to show that the most relevant tax component which provides an incentive to locate cross

border and to choose a specific form of financing is the overall nominal tax rate. This is, in general, an important tax driver when the incentives of taxation to use particular sources of finance and specific locations are considered. The tax base does however have a greater impact in specific situations when a country applies, for instance, particularly favourable depreciation regimes.

27. It is worth noting that across the range of domestic and cross-border indicators presenting the effective tax burden at the corporate level, there is a remarkable consistency as far as the relative position of Member States, notably at the upper and the lower ranges of the ranking, is concerned. In general, Germany, and France tend to show the highest tax burdens while Ireland, Sweden and Finland tend to be at the lower range of the ranking. Only Italy's ranking changes materially when the profitability of the investment changes. Due to the working of the dual income system, marginal investments are, in fact, subsidised, whereas more profitable investments suffer an effective tax burden which is in the middle range of the ranking.

28. When the domestic analysis is updated to take into account the 2001 tax regimes, the overall picture is broadly unchanged in comparison to 1999. However, as a consequence of a pattern of generally declining statutory tax rates (albeit with relatively small reductions apart from Germany), more profitable investments benefited from reductions in effective tax rates in a number of countries. As a result, the range of differences in domestic effective tax rates in the case of a more profitable investment decreased from 30 to 26 percentage points.

29. The German tax reform that entered into force at 1.1.2001 is a significant reform which implies a substantial cut in the corporation tax rate and in income tax rates, partly financed by the broadening of the tax base, including the abolition of the split rate system and the imputation system. However, despite these changes the German tax reform has only minor effects on the relative position of Germany in the EU country ranking and both the overall national corporate tax rate and the effective tax burden remains among the highest in the EU.

30. Simulating the impact of a hypothetical harmonisation of particular features of taxation systems in isolation on effective tax rates shows that:

Introducing a common statutory tax rate in the EU would have a significant impact by decreasing the dispersion - both between parent companies and between subsidiaries - of marginal and average effective tax rates across the EU countries. To the extent that taxation matters such a scenario would be likely to go some way in reducing locational inefficiencies within the EU.

By comparison, no other scenario would have such an impact. For example, introducing a common tax base or a system consisting in applying the definition of the home country tax base to the EU-wide profits of a multinational tends to increase the dispersion in effective tax rates if overall nominal tax rates are kept constant.
Moreover, two remarks have to be made concerning these results for a

common tax base. First, the methodologies applied do not permit to take into consideration all the elements of the tax bases. However, the "Tax Analyser model", whose results are similar to those arising from the simulations of hypothetical investment, does consider a more significant number of elements of the tax bases. Second, benefits which would arise under either a common consolidated tax base or a home country tax base approach such as loss consolidation and simplified transfer pricing cannot be modelled using the methodologies used in this report.

It is worth emphasising that these results are based on a static analysis and cannot capture the dynamic effects and reactions induced by the harmonisation of particular features of taxation in isolation.

31. The potential distortions in the allocation of resources reported in the analysis of transnational investments indicate that there can be an incentive for companies to alter their behaviour in order to minimise their global tax burden. Therefore the study has considered some stylised examples of tax optimisation strategy of companies by means of an intermediary financial company focusing the attention on the likely effects of an abolition of these tax reducing financing structures. However, the removing of these possibilities of optimisation strategy will not contribute, per se, to solving the problem of tax-induced resources mis-allocations. Since the main tax driver for effective tax rate differentials is the overall national tax rate, companies located in "high tax" countries will be able to compensate for the removal of these financial intermediaries by making greater use of differences in general tax rates and structuring their investments to take advantage of lower rates.

Tax obstacles to cross-border economic activities in the Internal Market

32. The Council mandate also asks for a "highlighting [*of the*] remaining tax obstacles to cross-border economic activity in the Internal Market" and calls for the identification of "the main tax provisions which may hamper cross-border economic activity in the Single Market". For this purpose the present study focuses on additional tax or compliance burdens which companies incur as a result of doing business in more than one Member State and which therefore represent a barrier to cross-border trade, establishment and investment.

33. The underlying cause of those additional tax and compliance burdens is the existence within the Internal Market of 15 separate tax systems. First, the fact that each Member State is a separate tax jurisdiction has a number of consequences. In particular:

- companies are obliged to allocate profits to each jurisdiction on arm's length basis by separate accounting, i.e. on a transaction by transaction basis;

- Member States are reluctant to allow relief for losses incurred by associated companies whose profits fall outside the scope of their taxing rights;

– cross-border reorganisations entailing a loss of taxing rights for a Member State are liable to give rise to capital gains taxation and other charges;

– double taxation may occur as a result of conflicting taxing rights.

34. Moreover, each Member State has its own sets of rules, in particular laws and conventions on financial accounting, rules for determining taxable profit, arrangements for collection and administration of tax and its own network of tax treaties. The need to comply with a multiplicity of different rules entails a considerable compliance cost and represents in itself a significant barrier to cross-border economic activity. The costs and risks associated with complying with more than one system may in particular discourage small and medium-sized enterprises from engaging in cross-border activity.

35. These fundamental problems hamper cross-border economic activity in the Internal Market and adversely affect the competitiveness of European companies. In economic terms they result in a loss of potential EU welfare. The imminent enlargement of the EU makes it all the more urgent to find appropriate solutions.

36. To some extent the problems faced by the EU reflect general difficulties in taxing international activities, and the work of the OECD and its forerunners has provided the basis for an extensive network of mainly bilateral double taxation treaties between Member States. The OECD has also published guidance on a range of international tax issues, in particular concerning the application of transfer pricing methods and on documentation requirements. In addition, the EU itself has taken several initiatives with a view to removing tax obstacles to cross-border co-operation and activity: Directive 90/434 ("merger directive"), providing for the deferral of taxation on cross-border reorganisation; Directive 90/435 ("parent-subsidiary directive"), eliminating double taxation on cross-border dividend payments between parent and subsidiary companies; and the Arbitration Convention (90/436), providing for a dispute resolution procedure in the area of transfer pricing. Although going some way to resolving the obstacles to cross-border activity they do not provide a solution which keeps pace with the growing integration in the Internal Market.

37. A basic concern of companies operating within the Internal Market is the removal of tax obstacles to income flows between associated companies. The Parent-Subsidiary Directive abolishes withholding taxes on payments of dividends between associated companies of different Member States. However, its effectiveness is reduced by the fact that it does not cover all companies subject to corporation tax and applies solely to direct holdings of 25% or more.

38. There is the further problem that - independent of the directive- certain systems of company taxation have an in-built bias in favour of domestic investment. For example, under imputation systems applied in a number of Member States a tax credit is granted to resident (individual or corporate) shareholders for the tax paid on company level; that credit is usually not available to non-resident

shareholders and is not normally granted in respect of foreign dividends. There is evidence to suggest that such systems form a serious obstacle to cross-border mergers within the EU and can have an influence on related business decisions (e.g. location of corporate seat).

39. Payments of interest and royalties between associated companies of different Member States are often still subject to withholding taxes that effectively create situations of double taxation. The Commission has already presented a proposal for a directive on this subject [COM(1998)67], and it is expected that this proposal will be adopted in the context of the "tax package".

40. In addition to obstacles to income flows, corporate restructuring can also be affected by one-off costs more directly linked to the restructuring operation itself. The tax-cost induced by cross-border mergers, acquisitions and internal reorganisations in the form of capital gains tax and various transfer taxes is often prohibitively high and forces companies to choose economically sub-optimal structures. Such obstacles place existing EU companies at a disadvantage as non-EU companies as new entrants will generally be better placed to set up the most suitable structure.

41. The <u>merger directive</u> provides for deferral of capital gains charges in a number of situations. However, a number of problems remain:

– First, not all situations are covered. Like the Parent-Subsidiary Directive, it does not include all companies subject to corporate tax. It does not cover all types of tax charge (e.g. transfer taxes) that can arise upon a restructuring. Moreover, it does not cover all types of operation which may be involved in a restructuring, e.g. the centralisation of production or other activities. Furthermore, the conversion of existing operations (subsidiaries) into branches may endanger the future absorption of tax losses accumulated pre-conversion.

– Second, the directive's usefulness is reduced by the fact that currently there is no EU company law framework for cross-border mergers. Companies are therefore obliged to have recourse to share for share exchanges or transfers of assets. The recent agreement on the European Company Statute will change this situation in one respect and allow, as from 2004, for companies to merge into a new legal structure.

– Third, the implementation of the directive differs significantly between Member States. Even though such differences are to some extent intrinsic to the legal instrument of a "directive", the study identifies significant disparities which undermine the overall aims sought by the directive. In particular Member States, in implementing the Directive, have imposed varying conditions for the tax deferral provided for under the Directive with a view to preventing tax avoidance, in some cases significantly limiting the scope of the Directive and leaving situations of double taxation unrelieved.

42. The study identifies particular difficulties in relation to cross-border loss-compensation which, from a business perspective, constitute one of the most important obstacles to cross-border economic activity. The current rules in Member States generally allow only for the offsetting of losses of foreign permanent establishments but not for those of subsidiaries belonging to the same group but located in different EU countries. If available, the loss compensation often takes place only at the level of the parent company or is deferred in comparison to domestic losses (which creates significant interest cost). The differences which exist in Member States' domestic loss compensation arrangements also impact on business decisions.

43. The current loss compensation arrangements entail a risk of economic double taxation where losses cannot be absorbed locally. This situation provides an incentive in favour of domestic investment and of investment in larger Member States.

44. In the area of transfer pricing, the tax problems for cross-border economic activity in the Internal Market have increased over the past years and are still growing. The problems consist essentially in high compliance costs and potential double taxation for intra-group transactions. A difficulty, according to business representatives, is that the transfer prices which are calculated for tax purposes often no longer serve any underlying commercial rationale in the Internal Market. There is in particular an increasing practice among larger companies to adopt, in EU intra-group trade, standard "euro" transfer prices for intermediate products, regardless of the production facility from which the goods are purchased within the group.

45. There is also a tendency among Member States, fearing manipulation of transfer prices, to impose increasingly onerous transfer pricing documentation requirements. Moreover, the application of the various methods for determining the "correct" (i.e. "arm's length") transfer price for a determined intra-group transaction is becoming increasingly complex and costly. New technologies and business structures (which imply, *inter alia*, more emphasis on intangibles) cause growing difficulties to identify the comparable uncontrolled transactions often required for establishing the arm's length price. In addition, there are substantial divergences in the detailed application of transfer pricing methods between Member States. The same holds for their implementation of the relevant OECD guidelines. EU businesses therefore face uncertainty as to whether their transfer prices will be accepted by the tax administrations upon a subsequent audit. The study indicates that the combined effect of these difficulties for companies can be a significant increase in compliance cost for international activities.

46. Double taxation in transfer pricing occurs when the tax administration of one Member State unilaterally adjusts the price put by a company on a cross-border intra-group transaction, without this adjustment being offset by a corresponding adjustment in the other Member State or States concerned. While inquiries made by the Commission services among Member States suggest that the number of transfer pricing disputes between Member States is fairly limited, a survey of multinational companies published by the accounting

firm Ernst&Young[2] reports a significant number of instances of double taxation arising from transfer pricing adjustments. This is consistent with representations made by business representatives, who complain moreover that the cost and time relating to the current dispute settlement procedures are often too high for enterprises with the result that it is often less costly to accept the double taxation. In this context the present study finds that the Arbitration Convention 90/436/EEC, which seeks to provide a binding dispute resolution procedure, is rarely used and that certain of its provisions may act as a deterrent for taxpayers to make use of it.

47. In short, the study concludes that, while there is evidence for aggressive transfer pricing by companies, there are equally genuine concerns for companies which are making a bona fide attempt to comply with the complex and often conflicting transfer pricing rules of different countries. Such concerns are becoming the most important international tax issue for companies.

48. The study also identifies the area of double taxation conventions as a potential source of obstacles and distortions for cross-border economic activities within the EU. Although the intra-EU network of double taxation treaties is largely complete, there nevertheless remain some gaps. Most treaties within the EU follow the OECD Model but there are significant differences in the terms of the various treaties and their interpretation. There are also instances of divergent application of treaties by the treaty partners, leading to double taxation or non-taxation. Business representatives also refer to the increasing complexity of treaty provisions as a source of compliance cost and uncertainty. What is more, the study shows that tax treaty provisions based on the OECD Model, in particular non-discrimination articles, are not adequate to ensure compliance with the EU law principle of equal treatment. Moreover, the lack of co-ordination in the treaty practice of Member States in relation to third countries, for example regarding limitation of treaty benefits, is liable to give rise to distortions and partitioning of the Internal Market.

49. The study also notes that certain areas of taxation which do not form part of company taxation may nevertheless entail significant obstacles to cross-border economic activity in the EU. This notably relates to the taxation of fringe benefits and stock options, of supplementary pensions as well as VAT. It is important to note that together with the company tax obstacles these difficulties have a cumulative effect for the companies concerned. As regards VAT, this is particularly true for small and medium-sized enterprises for which the nature of the various tax obstacles to cross-border economic activity is generally identical but which suffer from disproportionately - and sometimes prohibitively - high compliance cost for dealing with them.

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[2] Ernst-Young Survey: Transfer pricing 1999 Global Survey: Practices, Perceptions, and Trends for 2000 and beyond

Remedies to the tax obstacles in the Internal Market

50. There are essentially two approaches which could be envisaged for tackling the company tax obstacles in the Internal Market:

– Targeted solutions which seek to remedy individual obstacles

– More comprehensive solutions which seek to address the underlying causes of the obstacles.

51. A comprehensive approach providing EU businesses with a single common consolidated tax base for their EU activities would address most of the tax obstacles to cross-border economic activity that have been identified. A piecemeal approach only is unlikely to achieve this in a comparable manner. It should also be noted that clearly all proposals raise a number of technical issues which would need to be explored in greater detail.

52. Regardless of the basic approach of remedies, it is important to note that in the absence of political solutions taxpayers have been compelled to have recourse to the legal process to overcome discriminatory rules and other obstacles. In consequence, the European Court of Justice (ECJ) has developed a large body of case law on the compatibility of national tax rules with the Treaty. National courts are also increasingly being asked to give rulings in this area. While the ECJ has made a significant contribution to the removal of tax obstacles for companies, it is unlikely that the interpretation of the Treaty is sufficient to address all tax obstacles to cross-border activity. Moreover, ECJ rulings are confined to the particular case put to it and may therefore relate solely to individual aspects of a more general issue. The implementation of ECJ rulings is left to Member States, who often fail to draw the more general consequences which flow from them. There therefore seems to be scope for introducing a Community framework for exchanging views of the implications of significant ECJ rulings.

53. One important example for the aforementioned principle is the problem of the bias in favour of domestic investment in certain systems of company taxation, notably imputation systems, for which the case law of the Court has particular significance. Recent rulings, such as *Safir, Verkooijen* and *Saint-Gobain*, suggest that tax systems which provide a disincentive to cross-border activity or investment may be contrary to the Treaty provisions on the fundamental freedoms. Such rulings raise important issues for the design of Member States' tax systems for which more guidance on EU level would be desirable.

Targeted remedial measures

54. The various problems relating to the divergence of application of (both the existing and future) EU Taxation Directives across Member States could be tackled via a regular exchange of best-practices and/or some form of peer review. This could also give the opportunity to develop a more common understanding of important concepts in EU company taxation, notably tax avoidance. Ensuring a more uniform application of EU tax law is an important

step in order to reduce compliance costs and increase the efficiency of EU company taxation. At the same time, the need for litigation would be reduced.

55. The shortcomings identified in the Merger Directive and the Parent-Subsidiary Directive suggest the need for amendment of those directives. The Commission has already presented proposals for amendment of the directives suggesting, in essence, that their scope be extended to cover other entities subject to company taxation [COM(93)293]. In addition to this and with a view to clarifying the scope of certain important provisions in the directives, notably those concerning avoidance and abuse, further amendments to the Directive and/or more detailed guidance on how those provisions should be implemented could help.

56. As regards the merger directive, the study also identifies certain other areas where further amendments would facilitate cross-border restructuring. Within the logic of the existing Directive, it could first be examined to which extent specific transfer taxes arising on cross-border restructuring operations (notably on immovable property) could be taken into account. Second, the Directive could be clarified to make it clear that instances of economic double taxation should be avoided. One example for this could be to prescribe that capital gains arising on the sale of shares received in exchange for shares or assets are calculated on the basis of the market value at the time of the exchange, thus resolving previously accumulated "hidden reserves" without immediate tax consequences. A more radical change to the Directive would be to extend its scope so as to defer the triggering of tax charges where assets are moved to another Member State while preserving Member States' tax claims. The parent-subsidiary directive could be amended to cover both direct and indirect shareholdings or, alternatively, provide for a lower minimum holding threshold.

57. Finally, it may be noted that the recent agreement on the European Company Statute will provide a company law framework for cross-border mergers the absence of which has hitherto undermined the utility of the Merger Directive.

58. As regards cross-border offsetting of losses, the Commission in 1990 presented a proposal for a directive [(COM(90)595] allowing parent companies to take into account the losses incurred by permanent establishments and subsidiaries situated in another Member State. The Council failed to adopt the proposal and has ceased discussion of it. A review of the proposal conducted as part of the present study suggests that a number of technical amendments could be made to the proposal. For example, it could be envisaged calculating losses according to the rules of the State of the parent company rather than that of the subsidiary as under the proposal.

59. Alternatively, a similar result from the company's perspective could be achieved by devising a scheme similar to the Danish system of 'joint taxation'. In essence under the Danish arrangements a group of companies with a Danish parent company is taxed as if it were organised as a branch structure so that Denmark taxes the consolidated results of the group. The advantage of this

approach over the Commission proposal lies in the greater symmetry between the taxation of profits and the offset of losses.

60. There are a variety of measures available that would help remedy the various transfer pricing problems. The practical application of the Arbitration Convention could certainly be improved and its provisions made subject to interpretation by the Court. Moreover, Member States could be encouraged to introduce or expand bilateral or multilateral Advance Price Agreement programmes; such instruments, although costly, are an effective means of dealing with the uncertainty relating to transfer pricing. Subject to safeguards to prevent aggressive tax planning, a framework for prior agreement or consultation before tax administrations enforce transfer pricing adjustments could also be considered.

61. More generally, the compliance costs and the uncertainty could be reduced by better co-ordination between Member States of documentation requirements and of the application of the various methods, for example by developing best practices. Such co-ordination could take place in the context of an EU working group and should build upon and complement the OECD activities in this field. It would be possible to develop that process further in order also to address the concerns of business. The establishment by the Commission of a Joint Forum on transfer pricing comprising representatives of tax authorities and business might allow the currently conflicting perspectives of the two sides to be reconciled. While on the one hand tax administrations view transfer pricing as a common vehicle for tax avoidance or evasion by companies and as a source of harmful tax competition between Member States, business on the other hand considers that tax authorities are imposing disproportionate compliance costs. The study finds that both sides have legitimate concerns to which it is necessary to seek a balanced solution through a dialogue on EU level. A more uniform approach by EU Member States would also contribute to a stronger position in relation to third countries.

62. The filling of the few remaining gaps in the existing network of double taxation treaties within the EU would be helpful. Moreover, the current tax treaties of Member States could be improved in order to comply with the principles of the Internal Market, in particular in relation to access to treaty benefits. Better co-ordination of treaty policy in relation to third countries would also help. In addition, the study identifies a possible need for binding arbitration where conflicts arise between treaty partners in the interpretation and application of a treaty, leading to possible double taxation or non-taxation. The most complete solution to such problems would be the conclusion under Article 293 of the Treaty of a multilateral tax treaty between Member States, conferring interpretative jurisdiction on the Court. Another possibility, leaving intact the existing bilateral system, would be to elaborate an EU version of the OECD model convention and commentary (or of certain articles) which met the specific requirements of EU membership.

63. Despite the fact that tax compliance costs are regressive to the size of the company, the study finds that the nature of the obstacles is essentially the same for all companies. Therefore specific tax initiatives for small- and medium-

sized enterprises do not seem to be justified. There are however exceptions to this basic approach which could be usefully addressed mainly at Member State level. For instance, the administrative tax formalities, bookkeeping requirements etc. for small- and medium-sized enterprises should be less demanding than for bigger companies, also in cross-border situations. Moreover, the difficulties with the cross-border offsetting of losses hit small- and medium-sized enterprises particularly hard and therefore seem to deserve a specific remedy.

Comprehensive approaches on EU company taxation

64. The study also examines more general remedial measures aimed at minimising or removing the obstacles in a more comprehensive manner and analyses a number of comprehensive approaches that have been presented to the Commission. All aim to address the various tax obstacles by providing multinational companies with a common consolidated tax base for their EU-wide activities:

- Under the mutual recognition approach of "Home State Taxation" the tax base would be computed in accordance with the tax code of the company's home state (i.e. where the headquarter is based), thus building on the existing tax systems and the related experience and knowledge. This approach is conceived as an optional scheme for companies in Member States with a sufficiently similar tax base.

- Another possibility would be to devise completely new harmonised EU rules for the determination of a single tax base on European level. This again would be an optional scheme for companies existing as a parallel system alongside present national rules. Generally known as "Common (Consolidated) Base Taxation", this approach is advocated in particular by some business representatives.

- A further model suggested in some literature would be a "European Corporate Income Tax". This, although originally conceived as a compulsory scheme for large multinationals, could also be an optional scheme operating alongside national rules. Under this model the tax could be levied at the European level and a part or all of the revenue could go directly to the EU.

- Finally, the more ‘traditional’ approach would be to harmonise national rules on company taxation by devising a single EU company tax base and system as a replacement for existing national systems.

65. The most important fundamental advantages of providing EU businesses with a single consolidated tax base for their EU-wide activities, under whichever form, are as follows:

- The compliance cost resulting from the need to deal with 15 tax systems within the Internal Market would be significantly reduced.

– Transfer pricing problems within the group of companies would disappear, at least within the EU.

– Profits and losses would, in principle, be automatically consolidated on an EU basis.

– Many international restructuring operations would be fiscally simpler and less costly.

66. The business representatives of the expert panel assisting the Commission emphasised these fundamental points. Under a comprehensive approach of whatever precise design compliance cost would be reduced, many situations of double-taxation would be avoided and many discriminatory situations and restrictions would be removed.

67. By definition, an essential element of all the solutions is that there should be group consolidation on an EU-wide basis. At present not all Member States apply that principle even at the domestic level and only two at the international level. Under all approaches (with the possible exception of the European Corporate Income Tax) Member States would retain the right to set company tax rates.

68. To a varying extent, all comprehensive approaches could potentially be designed such that not all Member States would have to participate. In this context, it is important to note that the Treaty of Nice extended the possibility for enhanced co-operation by a group of Member States where agreement by all 15 is not possible. This may be particularly appropriate for Home State Taxation, which presupposes the participation solely of Member States with a fairly close tax base. However, a group of Member States could equally take advantage of this mechanism in order to introduce any of the other approaches.

69. A further key element of all the comprehensive approaches is a mechanism for allocating the common consolidated tax base to the various Member States. For this purpose the USA and Canada use a formula apportionment system which allocates the tax base according to a key composed of factors such as payroll, property and/or sales. Another solution available to the EU would be to apportion the tax base according to the (adjusted) value-added tax base of the companies involved. Under all of these Member States would be allocated a specific share of the overall tax base according to apportionment keys and apply their national tax rate to that share.

70. All the above models would meet the concerns inasmuch as they remove the need to comply with up to 15 different tax systems, largely eliminate the transfer pricing problems arising from separate accounting and effectively provide for cross-border loss compensation. They would also provide a tax solution for the European Company. An appraisal of the various models should take account of their respective characteristics.

71. An important point to note is that Home State Taxation does not require Member States to agree on a new common EU base because it is based on the

principle of mutual recognition by Member States of each other's tax codes. The other approaches all entail agreement on an entirely new tax code.

72. By contrast with a compulsory harmonised base, Home State Taxation, Common (Consolidated) Base Taxation and European Corporate Income Tax operate alongside and do not fully replace existing national systems. In certain circumstances however this can have the disadvantage that competing enterprises in other Member States are subject to different taxation rules. For example, under Home State Taxation three competing retail shops in Germany would compute their tax base under Belgian, French or German rules according to whether the home state of the group to which they belonged was Belgium, France or Germany. However, the differences may be relatively small given that an underlying assumption of the Home State Taxation model is that participating States will have similar tax bases. Under Common (Consolidated) Base Taxation or European Corporate Income Tax competing businesses may be subject to either local or Common (Consolidated) Base Taxation / European Corporate Income Tax rules, which may be quite different. It may however be possible to permit local companies to opt into the scheme, for example, where there are competition issues.

73. In addition the solutions based on a parallel rather than a single compulsory system raise a number of technical issues requiring further study. Among the main issues are those relating to restructuring, foreign income and double taxation treaties, and minority interests.

- First, as regards restructuring, since under Home State Taxation a company's tax base is determined in accordance with the rules of its parent's state, each time the ownership of a company changes and its shares are sold the method by which it computes its tax base could change. This equates in current terminology to a potential change of residence and is potentially very costly. For example a Belgian subsidiary sold by its German Home State Taxation parent to a French parent could find its tax base changing from German to French, or if France were not participating in Home State Taxation, back to a Belgian base. In contrast, as under Common (Consolidated) Base Taxation there would only be one tax base such a sale within the Common (Consolidated) Base area would not involve such a change, and even if a company were sold to a new parent from a non participating state treatment under the Common (Consolidated) Base system could perhaps be maintained.

- Second, the treatment of foreign income under Home State Taxation, Common (Consolidated) Base Taxation or European Corporate Income Tax is complicated by the current situation of bilateral double taxation agreements, the co-existence of exemption and credit relief tax systems and the need for a system of allocation. For example, a subsidiary in a state which operates the credit system, with a 3rd country branch may be entitled under its DTA to a credit for foreign tax paid by the branch. This could give rise to a claim under the DTA for the foreign tax credit even though the foreign income had been exempted under the Home State Taxation rules.

– Third, minority shareholders might find themselves receiving dividends under a taxation system which is incompatible with their existing local personal tax system. For example a minority shareholder might receive dividends paid under a Common (Consolidated) Base Taxation or European Corporate Income Tax imputation system whereas previously dividends had been paid under the local classical system. This can only be avoided if the payment of dividends by subsidiaries to minority shareholders remains subject to the local tax code which is the approach envisaged under Home State Taxation. This would imply additional record keeping.

74. These issues would not arise if Member States were to agree on the more traditional solution of a single harmonised company tax system, i.e. a common consolidated base with an agreed allocation system and method of dividend distribution. Nevertheless, despite their drawbacks, the other solutions meet the objectives of removing obstacles to cross-border activity without requiring such fundamental change. More generally, all the solutions would have the potential to contribute to greater efficiency, effectiveness, simplicity and transparency in EU company tax systems and remove the hiatuses between national systems which provide fertile ground for avoidance and abuse.

75. The assessment of tax obstacles in the Internal Market reveals that many of the factors causing compliance cost also tend to increase the administrative cost for tax administrations. This is particularly evident with a view to transfer pricing. Moreover, the co-existence of 15 company tax systems in one Internal Market opens considerable room for tax evasion and tax avoidance. Therefore, many remedial measures will also to some extent benefit the efficiency and effectiveness of tax administrations. Finally, almost all remedial measures, targeted or comprehensive, call for more mutual assistance and administrative co-operation between Member States which provides reliable means for ensuring that tax audits will continue to be made in an appropriate way and that none of the remedies under consideration results in illegitimate and/or illegal tax evasion.

76. In short, the report concludes that there are potentially significant benefits to be derived from providing, via a genuinely comprehensive solution, companies with a common consolidated tax base for the EU-wide activities. However, its findings are based mainly on the current stage of development of the research and further work would be necessary to implement any of the comprehensive approaches. Any solution going in this direction must obviously also take into account the competition rules laid down in the EC Treaty, in particular those concerning State Aids. Moreover, as already noted, the results of the quantitative analysis suggests that that the overall national tax rate is an important factor in determining the effective tax rate, and it is clear that a single or common base without further adaptations in practice would almost 'mechanically' accentuate this.