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European Commission - DG Taxation and Customs Union

EU Corporate Tax Policy

Rolf DIEMER
Principal Administrator
Unit for Analysis and Co-ordination of Tax Policies
Directorate for Analyses and tax policies
Directorate General for Taxation and Customs Union

Main Themes

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- **Background**
- **Pressure for tax co-ordination**
- **Company tax obstacles in the Internal Market**
- **Commission two-pronged strategy**
- **Existing legislation and targeted initiatives**
- **Longer term strategy**
  - **Home State Taxation**
  - **Common Consolidated Corporate Tax Base**

Background: Some key facts on EU taxation

- No Community taxes in the strict sense (but VAT own resources)
- very different structure of taxation systems in Member States
  - overall taxes as % of GDP
  - share of different types of taxes
  - share of CIT in GDP ranges from 0,6% to 8,6% in Member States (in 2002)
  - share of CIT in total taxation ranges from 1,5% to 20,5% (in 2002)

Background:
Legal base for Community action

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- Article 12: “any discrimination on grounds of nationality shall be prohibited”

  - also for taxation general rule
- Art. 25-27: harmonisation of customs tariffs and other charges related to international trade - already abolished within the EU
- Art. 90: forbids tax discrimination which directly or indirectly offers advantages to domestic “products” as compared to those from other Member States - infringement procedures, ECJ !!!
- Art. 91-93: abolition of export subsidies within the EU and harmonisation of turnover taxes, excises and other indirect taxes (unanimity) - Single Market
- Art. 94, 308: approximation of legislation by means of directives wherever this is necessary to improve the functioning of the Single Market or meet other Community objectives - direct taxes
- link to basic Treaty freedoms: free movement of goods / free movement of workers / freedom of establishment for companies and individuals / freedom to supply services cross border / free movement of capital

Background: Spectrum of taxation

Internal Market :

- Certain aspects of indirect taxation - e.g. VAT - require a high level of harmonization [Legal Base, indirect tax, article 93 EC Treaty]
- Some other aspects of Member States' tax systems require an approximation [Legal Base, direct tax, article 94 EC Treaty]

Other Elements :

- There are areas where a certain amount of co-ordination is necessary, e.g. the direct taxation of potentially mobile tax bases such as company taxation and taxation of savings; 'soft approach' such as the Code of Conduct
- Some other aspects of Member States' tax systems do not need to be harmonized, approximated or co-ordinated (subsidiarity), e.g. the structure of personal income tax

A brief look back (company taxation)

Some key events:

- Neumark-Report 1962
- Tempel-Report 1970
- Merger-Directive; Parent-Subsidiary-Directive, Arbitration Convention 1990
- Ruding-Report 1992
- Tax Package agreed 1997 - finally adopted 2003
- Commission services study "Company Taxation in the Internal Market" 2001
- Interest & Royalties Directive 2003

Increasing pressures for tax co-ordination

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- **Remove the (company) tax obstacles and tax-induced distortions to location of investment**
- **Internal Market efficiency – e.g. compliance costs resulting from 25 different and sometimes incompatible tax systems**
- **Companies increasingly see EU as one "home market", not as 25 national markets**
- **Code of Conduct – roll back of harmful practices**
- **State Aid – clarification and increased Commission action**
- **ECJ – ongoing series of cases identifying problems with Member State tax systems *vis a vis* the Treaty**

Company tax obstacles in the Internal Market

- **Deficiencies in existing EU legislation and its implementation in some Member States**
  - **e.g. anti-abuse rules in merger- and parent-subsidiary directive**
  - **too narrow scope of the directives etc.**
- **Cross-border loss-offset for subsidiaries practically absent**
- **Cross border restructuring**
  - **merger directive**
  - **transfer taxes**

Company tax obstacles (continued)

- **Double taxation treaties**
  - incomplete network
  - equal treatment principle of Treaty conflicts with distinction between residents and non-residents ("LOB")
  - triangular cases
- **Increasing costs of complying with transfer pricing rules**
  - documentation requirements
  - identification of comparables
  - divergences in Member States' interpretation and application of OECD guidelines

Company tax obstacles (continued)

- **Insufficiencies in existing transfer pricing dispute resolution instruments (notably EU Arbitration Convention):**
  - no rules on suspension of tax collection
  - problematic penalty clause
  - unclear starting point for the 2-year first phase period
  - lack of guidance on second (panel) phase
  - numerous other interpretation problems
  - until recently ratification problems

Effects of existing company tax obstacles

- **Abstracting from international tax planning, higher tax burden for trans-national companies compared to otherwise identical national companies**
  - **(e.g. due to absence of horizontal loss compensation)**
- **(Economic) double taxation resulting from incompatibilities between national tax systems**
  - **(e.g. due to insufficiencies of Parent/Subsidiary Directive)**
- **Extra tax burden in case of cross-border economic restructuring**
  - **(e.g. due to insufficiencies of Merger Directive)**
- **High compliance costs because of the necessity of dealing with up to 25 different tax systems in the EU**
  - **(e.g. transfer pricing difficulties linked to separate accounting)**

Increasing importance of the ECJ in the direct tax field

- **starting point: the four fundamental freedoms - free movement of services, goods, persons; freedom of establishment**
- **Member States must not *discriminate* against foreign EU nationals/residents or *restrict* free movement/establishment**
- **Development of EU Tax Law has largely taken place via these Treaty provisions as interpreted by the ECJ in cases referred by national courts (preliminary rulings)!**
- **The ECJ has taken a “firm” line**
- **The number of cases have increased significantly in recent years**

EU Corporate Taxation: Basic Commission approach

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- **Communication 'Tax Policy in the European Union (May 2001)**
  - **Pragmatic & evolutionary approach, based on the subsidiarity principle**
  - **'… provided that they respect Community rules, Member States are free to chose the tax systems that they consider most appropriate and according to their preferences ...'**
- **Company Tax Communication & Company Tax Report (October 2001)**
  - **Re-affirmed that rates are for Member States to decide**
  - **Identified tax obstacles and set out remedies: a twin track strategy for their removal: short term measures & long term consolidated corporate tax base**

Twin-track strategy for removing the tax obstacles

- **targeted measures to address tax obstacles to cross-border economic activity in the Internal Market**
  - directives
  - non-binding initiatives (EU-guidelines; working parties etc.)
- **comprehensive solution: providing companies in the long-term with one set of corporate tax rules for their EU-wide activities (common tax base)**
  - studies (allocation of tax base etc.)
  - pilot projects (European Company Statute, SMEs)

Follow-up Communication November 2003

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- **Communication "*An Internal Market without company tax obstacles – achievements, ongoing initiatives and remaining challenges*" [COM(2003)726] adopted on 24 November 2003**
- **Review of strategy for removal of cross-border tax obstacles**
- **Website:** **http://europa.eu.int/comm/taxation_customs/whatsnew.htm**

Initiatives Diagram

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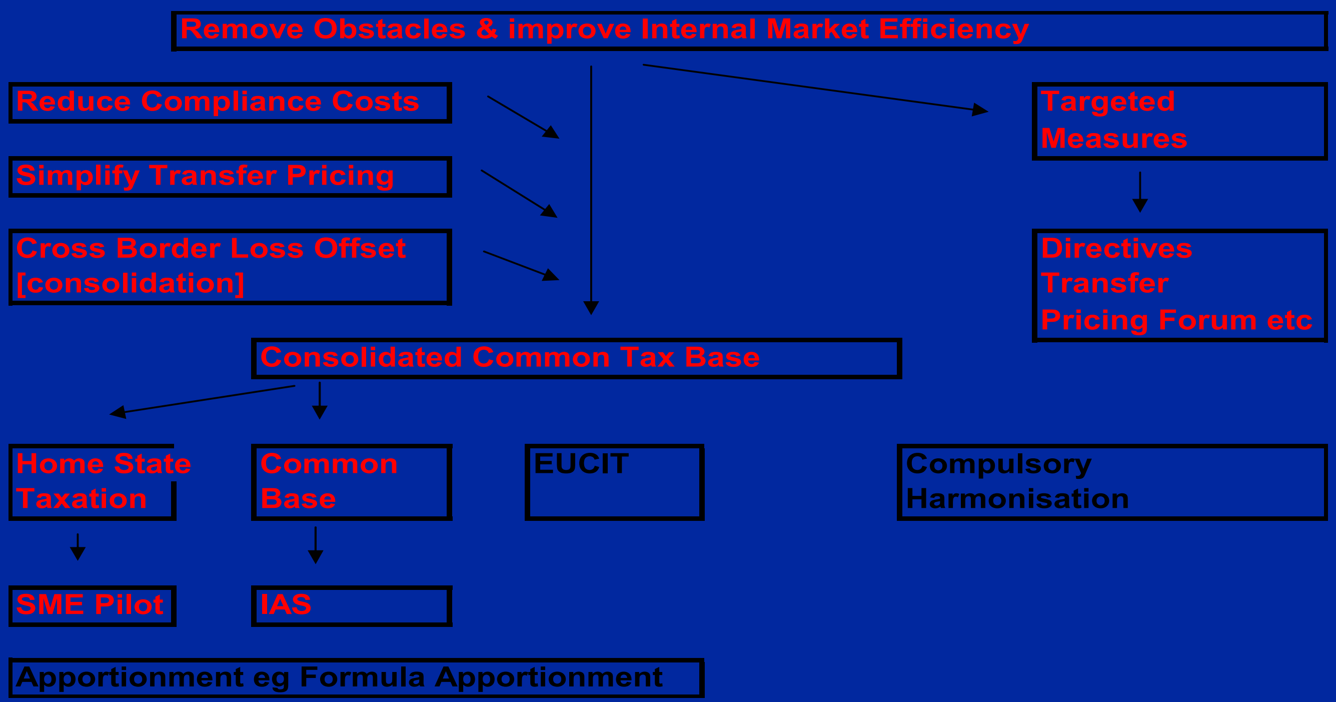

イニシアティブの図式

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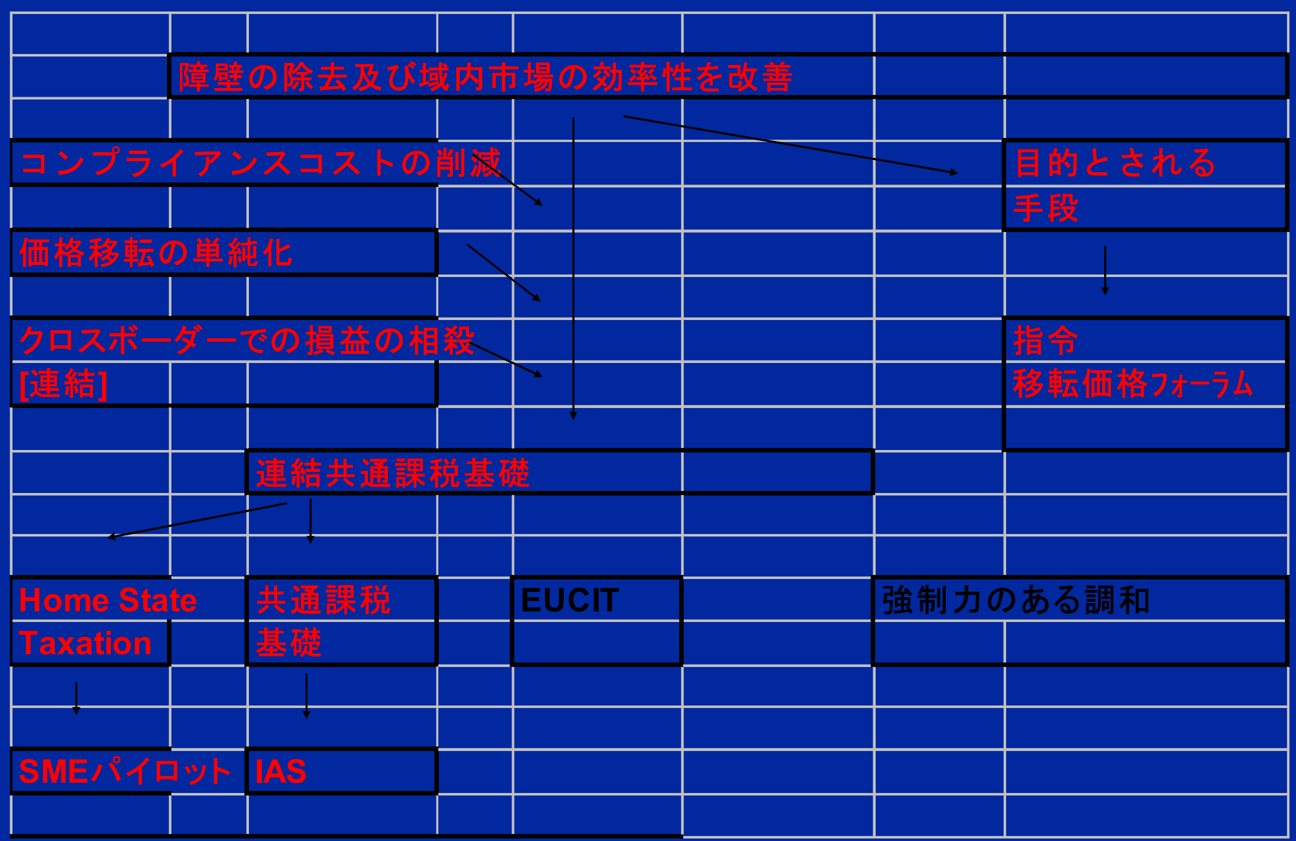

Interest and Royalties Directive 2003/49/EC

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- <u>Objective :</u> Elimination of withholding taxes on interest and royalty payments between
  - subsidiaries and parent companies
  - subsidiaries and permanent establishment of parent companies
  - sister companies
  - NOT: between subsidiary and grandparent company
- This was a long-standing request by business as such withholding taxes can be the source of administrative problems and can even lead to effective double taxation
- Directive entered into force on 1 January 2004

Interest and Royalties Directive 2003/49/EC (continued)

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- Problem: Based on political Agreement 1999
- Proposal for Amendments: COM(2003) 841
  - update of list in annex as updated Parent-Subsidiary-Directive and Proposal for Merger Directive (esp. SE)
- Technical Adaptations Directive 2004/66/EC
  - update of list in annex for new Member States
- Amending Directive for Transitional Periods for certain new Member States (COM(2004) 243) – 2004/129/EC?

Parent-Subsidiary Directive

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- Objective of the Directive: **Elimination of tax obstacles for groups of companies in the EU by abolishing withholding taxes on dividend payments**
- **Commission proposal (COM(2003) 462 final) and adopted by Council on 22 December 2003 (2003/123/EC)**
- **New Amendments**
  - **Update of list of eligible companies to broaden the scope of application, e.g. inclusion of European Company**

Directive 2003/123/EC

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- **Participation Threshold "Fading-out":**
  - now: 25 %
  - 2005-2006: 20 %
  - 2007-2008: 15 %
  - as of 2009: 10 %
- **Clarification concerning permanent establishments**
- **if credit method, imputation of corporate tax of third and lower tier subsidiaries**
- **Application from 1 January 2005**

Update Merger Directive (cont'd)

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- <u>Objective of the Directive:</u> Provide for deferred taxation of capital gains from cross-border company restructuring in the form of mergers, divisions, transfers of assets, exchanges of shares
- Commission proposal (COM(2003) 613 final) end of July 2003
  - amendment of list in annex
  - new operation: split-off
  - clarification concerning tax-neutral transformation of branch into a subsidiary

Update Merger Directive

- Commission proposals (continued)
  - new operation: transfer of registered office of an SE
  - use of treasury shares as remuneration for contribution
  - clarification for avoidance of duplication of hidden reserves
- Technical discussions in Council are continuing
- Adoption?

Cross-Border Loss Off-Set

- **Proposal from 1990 withdrawn**
- **Preliminary studies: 2 options**
  - **minimum solution: Deduction and Recapture**
  - **other solution: Consolidation (Danish or Austrian Model?), but potentially overlapping with comprehensive solution**
- **Proposal for spring 2005?**

Joint EU Transfer Pricing Forum

- Members: representatives from MS and acceding counties, business community; OECD as observer
- objective: exchange of best practice; non-legislative solutions
- Numerous meetings; timetable until 2004
- now extension for two years under way
- detailed information at website:

http://europa.eu.int/comm/taxation_customs/taxation/company_tax/transfer_pricing.htm

Work Programme JTPF (Issue 1)

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1. **Priority:** Implementation of the EU Arbitration Convention and related issues of mutual agreement procedures

- Improving the effectiveness of mutual agreement procedures (under double tax treaties and the Arbitration Convention)
- Improving the functioning of the arbitration phase
- Interaction of the mutual agreement/arbitration procedure with administrative and judicial appeals
- Commission Communication of April 04 proposing Code of Conduct on more uniform and efficient application of arbitration convention and DTA mutual agreement procedures to be adopted by ECOFIN in November

2. <u>Priority:</u> EU Documentation Requirements

- **Problem: Different transfer pricing documentation rules in 25 Member States for same transaction**
- **Need to balance interests:**
  - **Business claims compliance costs are increased by onerous documentation requirements and penalties**
  - **Tax administrations need to assess application of arm's length principle (transfer price and conditions)**
- **EU Documentation requirements? Masterfile concept?**
- **Report planned for end 2004**

Work Programme JTPF (Issue 3)

3. Priority: avoidance of double taxation

- advance pricing agreements?
- requirement of agreement of both tax administrations prior to transfer pricing adjustments?
- etc.

- Important to note:
  - *The protocol extending the EC arbitration convention now becomes effective as from 1 November 2004*

"Legal strategy"

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- asymmetric effects of the legal approach: even where a ruling forces a number of Member States to introduce new tax rules they often do so in vastly differing ways ("the Court can only destroy but not positively legislate")
- Commission: "more pro-active strategy in the field of tax infringements" (Tax Policy Communication of May 2001); and
- provision of non-binding guidance to Member States on application of EU law:
  - Discussions started with MS in Commission Working Group (Lankhorst-Hohorst case on thin capitalisation rules)
  - Occupational pensions & Investment funds
  - Dividend Taxation Communication
  - exit taxes? (Lasteyrie de Saillant case)

- **Legal analysis of double taxation treaties in the light of the EC Treaty principles**
  - **Communication in spring 2005?**
  - **"most favoured nation" clause?**
  - **EU model Treaty or EU variant of OECD model?**

Long Term strategy
- a common consolidated tax base

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- Reduce compliance costs of 15 (soon 25) tax systems
- Reduce Transfer Pricing problems
- Allow cross border loss offset
- Simplify EU corporate restructuring
- Avoid double taxation
- Remove many discriminatory situations and restrictions

- i.e. a logical approach to a single market, in line with traditional Member State 'single tax base approach for whole of their jurisdiction'

Which base?

- **Communication & April 2002 Conference identified:**
  - **Home State Taxation**
    - A multinational group can opt for computing its tax base according to the rules of the Member State where its headquarter is based
  - **Common Consolidated Base Taxation**
    - A multinational group can opt for computing its tax base according to completely new harmonised EU rules
  - **European Corporate Income Tax (EUCIT)**
    - Corporation tax would be levied at the European level and revenues would go (at least partly) to the EU budget
  - **Compulsory Harmonisation**
    - All companies in the EU would compute their tax base according to harmonised rules

Comprehensive Approaches (continued)

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- **All options would offer companies the possibility of using a single tax base for all their EU-wide activities**
- **All, except EU CIT, would require a mechanism for allocating tax base / tax revenues between Member States**
- **In all cases, except perhaps EU CIT, Member States would set the tax rates**
- **All have specific advantages and disadvantages**
- **Communication 2003 presents further work on Home State Taxation and Common Consolidated Tax Base**

Revenue Allocation

- Various practical experiences in the US, Canada, Switzerland and Germany
- Different options for the EU:
  - Micro level - formula apportionment
  - Micro level - VAT
  - Macro or sectoral level
- Need for tests with real data
- Commission research to be published

Home State Taxation (HST)

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- Based on the mutual recognition by Member States of each others tax rules
- A group of companies can choose to calculate their tax base according to the rules of the Member State where its headquarters is based – the 'home state'
- Each Member State then taxes its share of the overall taxable group profits at its own tax rate
- Web site:

  http://europa.eu.int/comm/taxation_customs/taxation/consultations/home_state_sme.htm

Pros and Cons of "Home State Taxation”

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- **Pros**
  - based on the Single Market idea of mutual recognition
  - no need for unanimous agreement of Community measures
  - allows a group of Member States to start
  - no time-consuming development of new laws
  - both administrations and companies can work on the basis of existing laws, traditions etc.
  - details of the proposal relatively advanced
  - could provide a pragmatic intermediary step in the development of more ambitious approaches

Pros and Cons of "Home State Taxation" (continued)

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- **Cons**
  - risk of getting stuck with an unsatisfactory intermediary solution (e.g. transitional VAT system)
  - different treatment for participating companies (up to 25 home states)
  - possible discrimination problems
  - despite research technical problems remain (double-taxation agreements with third countries; treatment of minority shareholders)
  - tax audits and control unclear
  - reluctance by Member States
  - need to define 'home state' and 'home state group'

Particular suitability of Home State Taxation (HST) for SMEs

- **HST addresses the tax issues which hamper SMEs most in their cross-border activities: compliance issues, loss-compensation on start-ups etc.**
- **Lower amount of tax ‘at stake’ for Member States**
- **specific State Aid rules (exemption regulation) at EU level / Art. 87 (3) b) EU-Treaty / often specific tax relief for SMEs in MS ➲ potential competition/discrimination problems less acute**
- **problems linked to HST less important for SMEs (e.g. double-taxation treaties; definition of ‘home state’ etc.)**

Outline of possible Pilot project - HST for SMEs

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- EU definition of SMEs
- 5 year test period
- Special rules for changes of ownership, business expansion etc
- Only company taxation – e.g. not VAT
- Simple allocation formula of consolidated tax base (where the Home State permits consolidation)
- Home State tax audit – general rules on mutual assistance in EU continue to apply
- Multilateral or bilateral agreements could establish HST, but EU framework desirable (as 'soft law')
- Participating MS would need to monitor the pilot to assess progress

Progressing a HST pilot scheme

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- Successful and supportive public consultation in 2003
- Technical discussions with Member States in 3/2004
- Outline of project and questionnaire published in 7/2004
- Extended Impact Assessment
- Informal ECOFIN Council of 10 and 11 September in Scheveningen (NL) - Non-Paper
- Commission Recommendation setting out 'best practice' in principle planned for 2004

- **Concept:**
  - additional EU tax base that is available as option for internationally active group
  - formulary apportionment of tax base to MS with subsequent application of national tax rates
- **Pros**
  - coherent and systematic approach from industry perspective
  - common treatment for all participating Member States and companies

- **Cons**
  - **developing a completely new EU tax base is a complex and time-consuming task**
  - **Member States would have to administer two tax systems**
  - **possible discrimination problems?**
  - **potential technical problems (double-taxation agreements with third countries; treatment of minority shareholders)**
  - **reluctance by Member States, presumably in particular against a common EU tax base that is more attractive than the domestic one**
  - **no existing practices; traditions etc.**
  - **legal system in case of dispute unclear (which jurisdiction?)**

Common Consolidated Base Taxation & IAS / IFRS

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- **Issues Paper published on use of IAS/IFRS and public consultation held in 2003**
- **‘examines general principles of IAS…..clear that IAS accounts would represent at the most a starting point for arriving at a tax base and not the tax base itself’ [para 1 Summary]**
- **To what extent can IAS financial statements satisfy tax requirements?**
- **detailed information available at website:** **http://europa.eu.int/comm/taxation_customs/taxation/consultations/ias.htm**

IAS/IFRS - Questions & issues

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- General Principles
  - The user - investor orientated accounting standards
  - Materiality - precision of accounts compared to tax returns and different levels of materiality depending on size of company
  - Substance over form - differing approaches across EU / fear of legal uncertainty and inconsistency
  - Fair value accounting - unrealised gains and losses, objectivity of estimates

IAS/IFRS - Questions and issues (cont'd)

- Number of companies (discrimination, MS ‘permit/require’)
- Consolidation (IAS financial consolidation or new tax specific method or no consolidation)
- Dependency
- Legislative framework and legitimacy (endorsement process (QMV), Regulation, Directive, Recommendations)
- Spill-over from accounting difficulties? - eg IAS 32 & 39
- SE as a pilot

- **Wide interest in a common tax base: IAS/IFRS work raised the level of debate**
- **IAS/IFRS a neutral starting point for further discussions**
- **Tax/Accounting dependency is key – not just for an IAS derived tax base, but any EU-wide common tax base**
- **Need to study the range of dependency across the EU**
  - **With pure dependency you cannot have a common tax base unless <u>all</u> companies use IAS**
  - **IAS (& Accounting Directives) will not produce a final tax base, therefore some <u>adjustments will be needed</u>**

Progress on IAS/IFRS and Common Tax Base (continued)

- **Need to study in more detail individual tax principles e.g. depreciation, approach this via study of individual IAS**
- **More research - progress on the accounting front and extension of IAS/IFRS application will be important**
- **Work via the neutral IAS/IFRS on the form of the tax base would also be applicable to any form of common base**
- **Allocation mechanism for the EU tax base – more research, to include quantitative modelling**
- **Need more input and support from Member States and business**

Progress on IAS/IFRS and Common Tax Base (continued)

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- **Informal ECOFIN Council of 10 and 11 September in Scheveningen (NL)**
  - **Non-Paper**
  - **Only minority of MS opposed work on CCBT**
- **Commission working group to be created soon for technical work on tax base**
- **Enhanced co-operation?**

Summary – Company Tax initiatives

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- **Background**
- **Short term targeted measures – *progress report, on 'target'***
- **Longer Term strategy – *slower progress, but it is long term***
  - **Home State Taxation - *SME pilot? - Initiative planned for 2004***
  - **Common Consolidated Tax Base – *IAS/IFRS starting point? – continued research and creation of working group***
- **Company Tax Website**

http://europa.eu.int:8082/comm/taxation_customs/taxation/company_tax/index.htm