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Taxation in the Internal Market and the Commission Communication N° 582

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The future of corporate income tax systems has now been discussed for a very long time in the European Communities. Any consideration relating to direct taxation in the EC cannot elude the fact that strong differences still persist in the tax and legal systems of the Member States, even after 40 years of community practice: the Internal Market, from a fiscal perspective, is still composed of 15 different corporate tax regimes.

The EC Court of Justice has so far played a key role eliminating discrimination and distortion provoked by the Member States domestic tax legislations, but this is not enough. The role of the Court of Justice is necessarily limited to a case-by-case approach and should be integrated by a legislative undertaking.

The European Commission has thus been entrusted by the Council[1] with the task of carrying out a survey on the corporate taxation within the European Union. Two Panels of independent experts have been appointed:

- the first, composed by authoritative scholars, had the goal of analysing the difference among taxations levels within Member States;[2]
- the second one, formed by representatives of international institutions, had the duty of identifying tax measures capable to creating obstacles to the cross-border business activities within the Internal Market.[3]

The Panels' work is widely reported in the Commission Staff Working Paper *Company Taxation in the Internal Market* (SEC (2001) 1681) and constitutes the basis of the considerations and programs contained in the Communication *Towards an Internal Market Without Tax Obstacles* adopted on October 23, 2001.[4]

I. The Targeted Measures

The Commission, also taking into account the outcome of previous studies (and, in particular, the Report issued in 1992 by the "Ruding Committee") has identified the main obstacles to cross-border corporate operations: taxation of dividends and cross-border operations; lack of a widespread cross-border loss-offset regime, transfer pricing; difference among double taxation conventions.

In order to oppose such obstacles and distortions, the Commission has proposed a "two-track strategy", which includes targeted measures and comprehensive solutions aimed at creating a consolidated tax base. The targeted measures proposed by the Commission are summarised in Table 1.

II. The Comprehensive Solutions

As pointed out by the Commission, the targeted solutions would represent a temporary and partial remedy with respect to the tax obstacles identified, the basic issue being the existence of 15 different tax systems.

In other words, such issue might be overcome through providing multinational companies with a "consolidated corporate tax base for their E.U.-wide activities". The three models examined are outlined in the following paragraphs and are summarised in Table 2.

Table 1: The Targeted Measures

Area	Proposed targeted action
ECJ Rulings	Development of guidance on important ECJ rulings and coordination of the related implementation.
Merger and Parent – Subsidiary Directives	Extension and improvement of the field of application (to include further entities and indirect shareholdings). Reduction of the minimum holding threshold. Inclusion of specific transfer taxes (notably on immovable property) arising on cross-border restructuring operations in the Capital Duty Directive. Clarification of the scope of existing provisions, especially those concerning avoidance and abuse.
Cross-border loss-offset	Withdrawal of the proposal for a directive concerning cross-border loss-offset and presentation of an amended version. Alternative examination of a more complete scheme for the consolidation of group income along the lines of the Danish model, in order to achieve a greater symmetry between the taxation of profits and the offset of losses.
Transfer pricing	Development of commonly accepted practices, for instance with reference to Advance Pricing Agreements, documentation requirements and methodology. Improvement of the Arbitration Convention, which should also be made subject to ECJ interpretation (preferably by turning it into an instrument of Community legislation).
	Establishment of a Joint Forum on Transfer Pricing with Member States and business representatives.
Double taxation treaties	Improvement of the existing bilateral treaties in the light of the Internal Market principles and better co-ordination of treaty policy in relation to third countries

A. Home State Taxation

The Home State Taxation (HST) model, developed on the basis of the work carried out between 1993 and 1999 by the "Stockholm Group",[5] does not imply the introduction of a (new) single tax system, being rather based on a sort of recognition of the rules provided by the Member State which is the "home state" of the parent company of a multinational group.

More precisely, the home state precepts would be taken into account to calculate the profits of all the branches or subsidiaries of the group established in the EC. Profits thus calculated would be divided among the parent company, the branches and the subsidiaries and taxed by the competent Member States (*i.e.*, the Member State in which the operations are carried out) at the respective applicable tax rate.

No convergence of accounting rules, taxable base and tax rates is needed in order to introduce such a system, since the home state will apply its existing tax regime. Such approach would, nonetheless, involve a certain limitation of the Member States' tax jurisdictions, since taxable income derived in their respective territory would be determined according to another Member State's rules. Clearly, it will be necessary to establish rules regarding the allocation of the tax base to different countries. However, even if such rules will be set forth, HST might provoke de-localisation of investments, since enterprises will choose, as "home state", the Member State which applies the most favourable provisions concerning calculation of tax base. To this extent, HST will require (and, at the same time, promote) a certain degree of convergence among the tax bases of Member States.

B. Common Base Taxation

Taking a 1988 European Commission project as a starting point, UNICE, in a recent document relating to the future of corporate taxation in Europe, relaunched the idea of adopting common rules, proposing the calculation of a consolidated tax base.[6]

Taxable income so determined will be apportioned to the relevant Member States and taxed at the respective rates.

On a *par* with HST, CBT will also require the determination of rules with regard to the taxable base distribution among the Member States. Otherwise, the main difference between CBT and HST consists of the fact that the former prescribes common rules for the determination of the taxable base, whereas the latter make reference to the tax law of the parent company home state.

C. Eucit (European Corporate Income Tax)

The Eucit would consist in a single corporate income tax in Europe, which would apply on the consolidated E.U. profits of multinational enterprises.[7]

The project to adopt such tax is, without doubt, particularly ambitious, since it would require the adoption of:

- a common base;
- a common tax rate or, at least, an agreed band of rates;
- uniform accountancy rules.

Member States should also adopt common rules on the administration and collection of the Eucit.

As an alternative, the new tax might be collected centrally, and part of the revenue could also form part of the Community's own resources following the VAT system, while the remaining part of Eucit would be reallocated among Member States in accordance with agreed rules to be established. In such case, the administration at hand might be delegated to a structure formed on the basis of the Federal USA Internal Revenue Service, for example, a "European Revenue Service". Eucit would imply a new definition of provisions that govern the relationships among Member States domestic tax systems, thus diminishing the importance of the distinction between the residence and source.

The personal scope of the tax might concern, at the initial stage, the *Societas Europaea* only and then be extended in order to cover pan-European multinational enterprises above a certain turnover and provided that they operate in a given number of Member States.

While the Eucit system does not seem to have great possibilities to be accepted at the present stage, it is likely that – in a longer time frame – it may represent the final outcome of the integration process. In this respect, it might be opportune to remark on the negative ending of the proposal of directive concerning the harmonisation of the tax systems relating to companies and withholding tax on dividends, presented in 1975 and officially withdrawn in 1990. Such proposal, also, had a more limited scope than Eucit, since it did not pertain to the tax base issue.

Table 2: The Comprehensive Solutions

Model	Basic features
Home State Taxation (HST)	The model, based on the mutual recognition principle – provides that the parent company adopts the tax rules of its State of residence (Home State) in order to determine its own income as well as that of its foreign (E.U.) branches and subsidiaries. The consolidated tax base is calculated according to the rules of a single tax system, i.e., the residence State of the parent company. Taxable profits so determined are subsequently apportioned among the different entities (parent company, subsidiaries, branches) and taxed in the respective Member States.
Common Base Taxation (CBT)	The CBT scheme provides for a consolidated tax base, determined according to common E.U. rules to be established. Taxable profits so determined are subsequently apportioned among the different entities (parent company, subsidiaries, branches) and taxed in the respective Member States. Each State would be free to set its own tax rates.
European Corporate Income Tax (EUCIT)	A single corporate tax on income of E.U. companies, with a common base and a common rate. Part of the tax revenue could form part of the Community's own resources, the remaining part would be apportioned among Member States according to criteria to be established.

In addition, the issue of the legal means is not much clearer: sometimes there is a reference to international agreements among Member States, in other cases it is mentioned as an unusual community decision-making process in which the European Parliament should play a leading role, in accordance to a preliminary technical study of the European Commission.

III. The U.S. Experience: Apportionment Formula and Unitary Taxation

The issues of defining the "*taxable group*" and of the apportionment may receive a valid support from the United States experience. Indeed, in the United States there are fundamentally two methods of taxation of multinational enterprises: one based on the principle of *separate entities* (also known as *separate accounting*): each affiliate is treated as if it were a separate, independent entity. The other method, instead, does not consider each affiliate separately, but apportions the total income to each affiliate according to the share of total business activity in each State (*apportionment formula*). The latter is much more practical, since it does not require separate calculation and double taxation cases are reduced. The formula divides the total income of a multinational enterprise according to where the enterprise conducts its business activity. Thus, if the enterprise carries out 10 percent of its multi-jurisdictional activity in one State, the same proportion of the whole income is considered as having been accrued in that State. The apportionable income is calculated by giving equal weight to three business indicators: property, payroll and sales.

Under a *Unitary tax* approach, practiced by most States in the United States and by the Canadian provinces, a State refers to the process of combining the functionally integrated operations of a multi-state enterprise, considering the affiliated corporate group that operates as a single economic enterprise into a single unit for tax purposes. In that case, the State uses a formula (that may be apportionment formula, but only half of the States which apply unitary taxation use the apportionment formula) to determine the share of the combined profits of the multinational enterprise to which it will apply its tax rate.

In substance, unitary taxation refers to the process of determining from a functional perspective "*the taxable group*" whereas the apportionment stage disaggregates income according to a given formula.

Unitary taxation may be founded on a *water's edge* approach, limiting State tax claims to the activities of the enterprises located within the United States or on a *consolidated* approach, comprising the worldwide activities of the multinational.

The definition of the scope of (tax) consolidation depends on various elements, explained through a case-by-case analysis: for instance, it is examined whether the parent company and the affiliates engage in the same type of business; whether their operations may be integrated in a vertical process; whether they exhibit functional integration, centralised management or common shared management services.

IV. Subsequent Developments: The European Parliament Report and the European Company Tax Conference

The Commission Communication has been followed, more recently, by some relevant institutional documents from both the Council and the European Parliament.

The most important developments are those included in the Report, adopted on March 14, 2001, by the European Parliament.

As far as corporate income taxation is concerned, the Report acknowledges the role played by tax competition among Member States. Such competition is regarded as "*an effective instrument for reducing a high level of taxation*", which "*in the context of rules preventing improper conduct*", can also contribute to the removal of obstacles to the internal market.

In this perspective, the E.U. taxation policy should be guided by the subsidiary principle, while a comprehensive harmonisation of income taxes or the introduction of a minimum level of taxation, according to the European Parliament, "*makes no sense*".

Within such framework, the Report supports the Commission proposals with respect to the "*targeted actions*" and the consolidated corporate tax base, while expressing a priority interest for the Home State Taxation model, seen as "*an intermediate stage in moving towards a common tax base*". Also, the Report calls on the Commission "*to frame a multilateral tax agreement for the E.U.*", along the lines set by the Commission Communication 582/2001.

Meanwhile, the Conclusions of the General Affairs Council held on March 11, 2002 has ratified the proposal of a E.U. Joint Transfer Pricing Forum, which will be set up by the Commission and which will comprise all Member States and business experts. The Forum, according to said Conclusions "*will examine practical problems related to the application of tax rules on transfer pricing in the internal market and in particular those related to implementation of the Arbitration Convention*", with the objective of achieving "more *uniform application of transfer pricing tax rules within the E.U.*"

Finally, on April 29 and 30, 2002, the Commission hosted a European Conference on Company Taxation, attended by more than 500 high-level tax specialists from the public and private sectors in the European Union and in candidate countries.

As pointed out by Taxation Commissioner Frits Bolkestein in his opening keynote speech:

> "Without determined action on the tax front, the E.U. will fail to achieve its self-imposed objective of becoming, in this decade, the most competitive and dynamic knowledge-based economy in the world" and "the concept of a common consolidated tax base for the E.U.-wide activities of companies is ultimately the only means of tackling the various tax obstacles in the Internal Market "in one stroke"".

As an outcome of the Conference, it appeared that the Home State Taxation approach was not generally favoured, while the Eucit scheme was considered as unfeasible at the present stage of European integration.

On the contrary, the Common Base Taxation model gathered a widespread support. The introduction of the European Company and the binding adoption of the International Accounting Standards (IAS) for the consolidated accounts of E.U. listed companies from 2005 may thus become a unique opportunity to introducing a "*pilot project*" on the matter.

1 The official mandate to the Commission was entrusted on July 22, 1999 by the Permanent Representatives Committee.

2 Panel I was formed by Krister Andersson (Swedish Institute for Economic Research, Stockholm); Jacques Le Cacheux (Observatoire français de la conjoncture économique, Paris); Michael Devereux (Warwick University); Silvia Giannini (Università di Bologna); Cristoph Spengel (Universitat Manheim); Jean-Marc Tirard (avocat, Paris); Frans Vanistendael (Universiteit Leuven).

3 Panel II was formed by Philip Gillett (ERT); Bruno Gangemi (CFE); Piergiorgio Valente (EFFEI); Sylvain Plasschaerts (TEPSA); Wilfried Rometsch (Eurocommerce); Cristophe Quintard e Marina Ricciardelli (ETUC); Carlo H. Borggreve e Roland Walter (CEEP); Alfons Kühn e Harald Hendel (Eurochambres); Bruno Gangemi (CFE); Jos W. B. Westerburgen e Patrice Liazu (UNICE); Sven-Olof Lodin (IFA); Peter Zacherl e Fidelis Bauer (UEAPME).

4 Commission of the European Communities, *Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Towards an Internal Market Without Tax Obstacles. A Strategy for Providing Companies with a Consolidated Corporate Tax Base for their E.U.-Wide Activities*, Brussels, October 23, 2001, COM (2001) 582 final.

5 The *Stockholm Group* is composed by Sven-Olof Lodin (Sweden) Robert Baconnier (France), Malcom Gammie (United Kingdom), Hugh Ault (United States), Albert Rädler (Germany), Ad der Kinderen (The Netherlands), Jim Hausman (Canada), David Tillinghast (United States). For a wider description of HST, please see Lodin, S.O., Gammie, M., *Home State Taxation*, Amsterdam, 2001.

6 UNICE (Union of Employers' Confederation of Europe), *Home State Taxation and Common Base Taxation* (unpublished) and *Unice Memorandum on Cross Border Company Taxation Obstacles in the Single Market*, April 3, 2000.

7 The theoretical framework of the Eucit was developed by Lodin, S.O., Gammie, M., "The Taxation of the European Company", in *European Taxation*, 8/1999. See, also, Plasschaert, S., "An E.U. Tax on the Consolidated Profits of Multinational Enterprises", *European Taxation*, 1/1997, p. 2.

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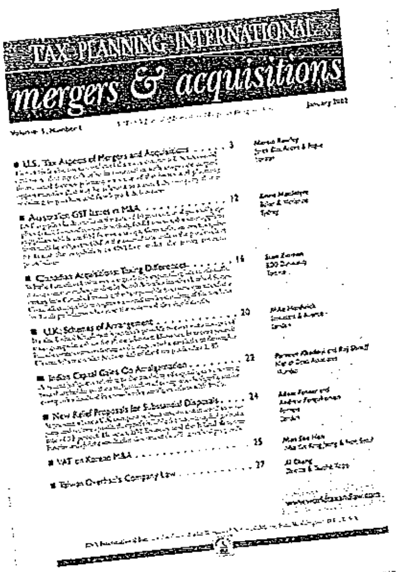

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