UNICE

Union of Industrial and Employers' Confederations of Europe
Union des Confédérations de l'Industrie et des Employeurs d'Europe

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COMPANY TAXATION IN THE SINGLE MARKET :

A BUSINESS PERSPECTIVE

1. Introduction

With Economic and Monetary Union approaching rapidly, company taxation issues have reappeared on the political agenda. Two assumptions underlie this renewed political interest. Firstly, that the transparency brought about by the single currency will increasingly identify taxation as a key factor in investment and location decisions and that this is likely to enhance the effects of tax competition. And secondly, that such competition is harmful because it erodes Member States' taxable bases, leading to a shift in tax burdens from capital to labour.

Over the past two years, the European Commission has issued several papers on tax strategy for the Single Market and a High level Group on tax policy was established jointly with Member States to discuss the issues concerned. The Council's reaction to the High level Group's recommendations clearly shows a narrowing focus towards maintaining Member States' tax revenues, with less and less priority being attached to the elimination of tax obstacles to cross-border business activities and investment, and with little attempt to consider with business the EU's global competitiveness.

This inwardness was reflected in the so-called tax "package" adopted by the ECOFIN Council in December 1997, whose main elements - taxation of savings and the Code of Conduct for business taxation - aim at protecting Member States' tax bases against "harmful" tax competition. Although the abolition of withholding taxes on intercompany interest and royalty payments was included in response to European business complaints about the cost and administrative burden they entail, the package does not equally meet the demands of Member States and the business community, given that the importance and impact of the abolition of these withholding taxes is minor in comparison with the other two components.

This situation is not satisfactory for the European business community. Despite several Commission initiatives, and the Ruding Committee's clear indication that action was needed to enable business to optimise the potential benefits of the Single Market, the only significant progress in the area of company taxation was made as long ago as 1990, before the Ruding report, when the Council adopted a package of three measures addressing some of the needs of business.

2. UNICE's position on the EU tax strategy

UNICE's general position on the EU tax strategy is guided by three main considerations.

Firstly, tax obstacles continue to stand out as one of the most glaring gaps in the operation of the Single Market. Action is now needed to remove them as a matter of priority.

Secondly, since most Member States have increased their overall tax burden in order to comply with the EMU budgetary criteria, the priority in the next few years must be to reverse this trend. The primary responsibility lies with Member States and EU initiatives should not be used as a pretext to thwart this objective. This is a central question for improving European competitiveness. According to Eurostat the EU as a whole has the highest ratio of compulsory levies to GDP compared with other developed economies (42.6% in 1997, unchanged from 1996); the ratio for Euro-11 is even higher (43.2% in 1997, up from 1996), indeed the highest observed since the beginning of the 1980s.

Thirdly, any "European" tax strategy must take account of the increasing globalisation of economic relations - a fact which the advent of electronic commerce will reinforce. It must therefore avoid excessively inward-looking and narrowly-based EU approaches.

In the light of these considerations, this paper is intended to provide a business perspective on work currently in progress following last December's Council agreement on a tax package and to give an outline of business priorities in the area of company taxation at EU level.

3. The Code of Conduct for business taxation

The Council Resolution of 1 December 1997 states that the Code of Conduct for business taxation (CoC) is designed "to curb harmful tax measures" which may affect the location of business activity in the Community. The Resolution also acknowledges "the positive effects of fair competition and the need to consolidate the competitiveness of the EU and the Member States at international level".

Based on the CoC a special working group of the Council was set up to examine which measures, regimes and practices fall within the scope of the definition of harmful tax competition. The CoC Group is expected to submit its initial report to the ECOFIN Council at the beginning of December 1998. Since its proceedings are secret, UNICE cannot at this stage comment on any of the eighty or so individual measures which the CoC Group is reported to be examining. Nevertheless, UNICE hopes that the general comments below will be considered by the CoC Group and guide any decision that might be taken by the Council in respect of measures falling within the scope of the Code.

- Labour versus capital taxation

One of the main reasons for the Code, as put forward by the Council, is the fact that the erosion of the tax base resulting from harmful tax competition has led Member States to tax non-moveable bases, particularly labour, more heavily than would have been the case otherwise. This reasoning seems to be flawed in two ways.

In the first place, it takes for granted that the business activities that benefit from “harmful” tax regimes within the EU would have stayed within the EU if taxed under a “normal” system (and will stay in the EU if the Code is “successful”).

Secondly, it assumes that the amount of lost revenue, if any, resulting from tax competition would allow a discernible alleviation of the tax burden on labour, which seems to be an exaggeration of the budgetary effects of the sort of tax competition covered by the CoC. This might be the reason why no significant quantitative support has been given to this claim.

- Tax competition

Over the past few years, UNICE has repeatedly underlined the need for a reduction of the overall tax burden on European business and industry, most recently in its report "*Benchmarking Europe's competitiveness: from analysis to action"* (January 1998) in which it stressed the importance of reducing public spending, the overall tax burden and the tax wedge on labour. Could curbing "harmful" tax competition be helpful in this respect?

The hope that the abolition of special regimes would lead to an overall reduction of the tax burden on business might be idle in the light of Member States' intention – implicit in their reasoning for the Code – to use any additional revenue to alleviate the tax burden on labour.

On the contrary, it is much more likely that a "successful" CoC would lead to an overall increase in the tax burden. In this context tax competition is the only counterweight against the constant upward pressure on government revenues in the EU, all the more so since certain Member States have already attempted to expand the scope of the Code to include general low-tax systems prevailing in other Member States. In UNICE's view there should not be any question that this type of tax competition must be allowed to continue in the future, as acknowledged by the Commission's approval (July 1998) of the general Irish corporation tax rate of 12.5% applicable to all companies. Other Member States already apply tax rates below 30%.

However UNICE does not support tax competition through special regimes unconditionally. There are rules that should be observed in competing through such regimes.

First and foremost, special regimes should not discriminate, i.e. they should be accessible to all companies under the same conditions regardless of whether they are domestic or foreign (without the need to move their seat for the latter). A selective ruling policy which discriminates between foreign investment and investment by domestic companies is one example. State aid by way of preferential and selective tax measures is another one. In this respect, UNICE wonders about the interaction between the CoC and the Commission's draft notice on the application of state aid rules to measures relating to direct business taxation, on which it will submit a separate position paper shortly.

Secondly, one could agree with the premise that special regimes should not include rules that are in flat contradiction with internationally accepted taxation principles such as the arm's length principle and the substance requirements. It is questionable, however, whether the CoC would be needed in such situations as there are already sufficient means available to tax administrations to combat them.

If the CoC confines itself to seeking repeal of regimes that do not meet the above requirements, there would be no reason for UNICE to complain. The CoC, however, is potentially more far-reaching and could also abolish regimes that are neither discriminatory nor in conflict with internationally accepted taxation principles.

- Co-ordination versus harmonisation

The CoC has been heralded as the first step towards more co-ordination of Member States' tax policies. Although from a business perspective the CoC is not the most attractive example, the concept of co-ordination as such seems to provide an appropriate means for dealing with certain tax policy matters under EMU that would be impossible to deal with through harmonisation directives or regulations, based on the normal EU institutional framework.

There is, however, a danger that this concept will be used beyond what it is meant for – "light-handed" co-ordination of national tax policies – and will be adopted by Member States as a convenient way to curb the involvement of other European institutions, including the European Parliament and to minimise the influence of the Court of Justice. On this basis UNICE is concerned that taxpayers - companies in the first place - would be denied the safeguards built into Community law.

- Double taxation

Currently, there are Member States that endeavour to combat foreign low-tax regimes by unilaterally subjecting to domestic taxation low-taxed foreign-source income, even though the foreign operations have economic substance and, based on these Member States' general tax systems, such income would normally not be subject to domestic taxation (e.g. Germany and France).

Given that generally applicable low-tax regimes are not, and should not be, in conflict with the CoC, it would seem inappropriate to allow these Member States to continue their taxation of foreign source income insofar as it is derived from such regimes.

- Lack of consultation with business

The proceedings of the CoC Group are secret. So far, no opportunity has been given to business and industry to be heard by the Group. This approach runs counter to the EU's explicit commitment to openness and transparency. UNICE expects that, at the very least, the Group's initial report will be made public in advance of the Council deliberations, allowing all interested parties to comment.

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In conclusion, while UNICE cannot prejudge the outcome of discussions in the CoC Group, it is concerned that the Code is potentially too far-reaching and Eurocentric, and that it is likely to lead to an increase in the overall tax burden on business where a reduction is urgently needed. In addition, some of its assumptions are questionable and its proceedings should be more open.

4. Other elements of the 1997 "Package"

The December 1997 package also included a call for the Commission to bring forward proposals for Directives on a common system of taxation of savings and on the abolition of double taxation of intercompany interest and royalty payments. Both proposals are now on the Council's table.

Some Member States have expressed reservations, making progress on the abolition of interest and royalty withholding taxes dependent upon reaching an agreement on the taxation of savings. Since such an agreement appears difficult to achieve, the only component of the package on which progress seems likely is the CoC. In this context, UNICE would call for separate adoption of a directive on interest and royalty withholding taxes at the earliest opportunity.

- Abolition of withholding taxes on intercompany payments of interest and royalties

Whereas Member States like to present the current proposal for the abolition of withholding taxes on intercompany interest and royalty payments as the “big advantage” for business and industry in the overall package, this presentation overestimates the importance of the proposal and UNICE wishes to make very clear that, though the proposal is welcomed in general (there are some elements that deserve criticism), it is no more than a small step compared with what still needs to be done. UNICE has already issued a statement on the draft directive concerned (attached) and it will continue to support its adoption in an adjusted form.

- Taxation of savings

The proposal on the taxation of savings has the same background as the CoC and is aimed at protecting the tax base of Member States against "poaching by their peers". The difference is that, where the Code attacks special regimes the use of which by businesses is perfectly legal, the proposal on the taxation of savings is mainly presented as an instrument for combating fraudulent behaviour. However, in its current form, the proposal would have negative effects on European business and industry, such as flight of capital to locations outside the EU, with adverse consequences for European financial centres, potential damage to the Eurobond market and increased cost of corporate financing, added administrative burden and, in some cases, discrimination in the treatment of EU non-residents. UNICE would, in addition, caution against unilateral adoption by the EU of a measure in this area unless and until equivalent measures are agreed on a wider international basis.

5. UNICE's priorities for the elimination of "Harmful Taxation"

UNICE's objective is to seek an improvement of fiscal conditions in the EU that will facilitate the growth of trade and investment, and enable business to compete on equal terms in the EU and world marketplaces.

Consequently, UNICE believes that a balanced approach to the EU tax strategy requires greater emphasis on what might be called "harmful taxation" in the context of operation of the Single Market. A definition of this concept could read as follows: *“Harmful Taxation”* *occurs in those situations where the application of Member States' tax regimes results in a) double taxation, b) discrimination or c) any other impediment to business optimization of the Single Market.*

Without exception the areas where UNICE has urged Community action, in addition to the issue of interest and royalty payments, fall within the scope of this definition. Below, they are addressed briefly. The attendant costs and complications for business resulting from lack of appropriate measures in these areas were detailed in a UNICE report for the European Commission in July 1996.

- Obstacles to cross-border business integration

This issue appears to be of the most urgent nature and should be given serious consideration by the Commission and Member States. An examination of the problems encountered in this area, based on pilot studies carried out by two European multinationals, is attached to this paper.

There are clearly many obstacles to cross-border business integration and it should be noted that the imputation systems as applied by certain Member States constitute a distortive element in connection with cross-border mergers.

In the longer run, the option of a European Company Statute should provide an appropriate instrument to overcome legal and tax obstacles which effectively prevent the emergence of integrated business units on an EU-wide scale. In UNICE's view these aspects are as important for companies as those examined last year by the Group of Experts on European systems of worker involvement. The possibility of setting up a similar group charged with examining the tax obstacles should be given serious consideration.

While UNICE does not believe that full harmonisation of company taxation will ever be needed in the EU, the possibility of introducing an optional single European Corporation Tax - applicable on a consolidated result and levied by a single body - deserves to be studied. It should be emphasized that a properly structured European Corporation Tax would eliminate in a single measure many of the current tax obstacles to cross-border business activities and investment.

- Improvement of the Arbitration Convention

Last spring, the UK Presidency obtained the Council's political commitment to renew the Arbitration Convention for resolving transfer pricing issues. Now that renewal of the Convention seems to be secured it is time to start discussions on possible improvements to make it a more efficient instrument.

The first cases have now been made subject to the arbitration procedure and it has become clear that some Member States intend to interpret the Convention in a way which either lengthens the procedure considerably or will even exclude the taxpayer from using it after it has first gone through the national appeal procedures. This seems unacceptable, being contrary to the intent of the Convention, and an effort should be made to stop these practices.

- Cross-border loss compensation

With some adjustments the Council should take up the Commission proposal of January 1991 again. There is no doubt that this is a technically complicated subject, but it must be possible to find solutions which are workable and acceptable to all parties if the Commission, Council Working Group and company tax experts were brought together to examine the issue. It is important to stress that essentially the budgetary effects will be limited to the cost of timing differences which could be kept within manageable proportions if the system was properly structured. In relation to this issue UNICE also urges renewed attention for the proposal on loss carry-over.

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Apart from the interest and royalties proposal and the three areas mentioned above, there are a number of other issues that could be brought under the heading of harmful taxation. These four, however, are the most urgent ones.

6. Conclusions

UNICE is keen to work with the Commission and the Council in addressing the company taxation challenges and opportunities presented by the process of completion of the Single Market and the establishment of EMU.

It hopes that current and future work on this theme will result in development of a balanced approach that responds adequately to the needs of European companies, including SMEs.

It is ready to discuss these matters in a spirit of transparency and constructive dialogue with all EU authorities.

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Attachment
5 October 1998

UNICE COMMENTS

ON THE PROPOSAL FOR A COUNCIL DIRECTIVE ON A COMMON SYSTEM OF TAXATION APPLICABLE TO INTEREST AND ROYALTY PAYMENTS BETWEEN ASSOCIATED COMPANIES OF DIFFERENT MEMBER STATES (COM(98) 67 FINAL)

On various occasions UNICE has requested that the abolition of withholding taxes on intercompany royalty and interest payments should be put high on the list of priorities in the field of company taxation, as withholding taxes represent a potential obstacle to international capital flows. UNICE therefore welcomes the Commission's initiative to submit to the Council a proposal to this end and it wishes to express its full support.

UNICE particularly welcomes the extension that has been given to the scope of the Directive, compared to its predecessor, in that payments between associated companies are now generally covered rather than only those between subsidiary and parent.

However, UNICE feels that there are still some areas in which the draft Directive is open to improvement.

Holding Period

UNICE believes that the Directive should apply to a company from the date it becomes a member of a group, with EU Member States allowed to apply a withholding tax only if a company leaves a group within two years after becoming a member. Requiring the continuous ownership of a company for two years for the Directive to apply would unnecessarily penalise growing companies and those expanding through acquisition. UNICE believes that the requisite holding period mentioned in article 3 of the proposed Directive should be reduced to one year, since in UNICE's view ownership for a full year is sufficient to indicate a serious investment.

Holding Percentage

Bearing in mind that the ultimate goal is to eliminate withholding taxes on all royalty and interest payments, the minimum level of ownership required under the Directive should be as low as possible. UNICE suggests a level of 10% since it represents an important business commitment, indicating the type of relationship that would merit avoiding the consequences of withholding taxes.

Article 6 and 7

UNICE supports the general anti-abuse clause as laid down in article 6, but it has a major problem with the additional provisions in article 7. The intention of the Directive is to exempt intercompany interest and royalty payments from withholding tax. Whether or not the state of the recipient taxes the interest and royalties is a matter of national tax policy and has nothing to do with abuse of the Directive. Moreover, these provisions seem to be premature pending the outcome of the discussions in the Code of Conduct Group. UNICE therefore urges the Council to delete article 7.

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Attachment

Obstacles to cross-border business integration

The results of two pilot studies

Pilot Study on establishing a branch structure

Two European multinationals, currently operating through separate legal entities in each European country (country legal entities; CLEs), have made pilot studies in which the business of each of the CLEs is transferred to a local branch of a European legal entity (ELE) established in one of the countries of the European Union in exchange for shares in this ELE. Such a branch structure – in the absence of the possibility to form a European Company as yet – comes closest to the operational structures that multinational companies have developed since the creation of the Common Market.

Although the transfer to a branch structure is facilitated by the adoption of the merger directive, through which the taxation of the hidden reserves in the CLEs is deferred, various other tax issues may make such transfer still prohibitively expensive. The attached matrix gives an overview of the relevant issues, which are explained in more detail below.

The issues are split into four headings:

- *tax costs upon conversion* are once-off costs arising on the transfer to the branch structure;
- *ongoing tax costs* are costs of a recurring nature after creation of the branch structure;
- *parallel legal structure* reflects the shareholding structure that results from the business transfers into the branch structure:
  * the top holding of the group holds directly or indirectly the shares of the CLEs;
  * these CLEs hold the shares in the ELE;
  * the latter is the owner of the branches in the various EU countries.
- Under *miscellaneous* we have listed issues which cannot be quantified but which undoubtedly complicate the smooth operation of a branch structure.

<u>Conversion costs</u>
Transfer taxes will be due upon transfer of the assets to the ELE. The merger directive does not cover these taxes.
Pre-conversion losses refer to accumulated losses that cannot be transferred to the new branch structure.

Provisions to be released relate to provisions which have reduced taxable profit in the past, but which need to be released and added to taxable profit upon transfer of the business.
De-grouping refers to the fact that a removal of assets out of a tax group might trigger capital gains tax.

<u>Running costs</u>
Limitations on loss compensation result from losing the possibility to offset losses in one business activity against profits in another business activity within the same country. This might be replaced by a possibility to offset branch losses against profits in the head office country, but this depends on the tax legislation in that country.
Branch profit taxes are still applied in Germany and Greece.

<u>Parallel legal structure</u>
Dividend withholding taxes: The parallel legal structure leads to a dividend carrousel - the ELE distributes dividends to the CLEs; these CLEs will subsequently distribute their profits to the top holding, which might well be located in the same country as the ELE. The profits flowing through this dividend carrousel might well be caught by dividend withholding taxes in those cases where the percentage of shares in the ELE held by the CLEs do not exceed the thresholds for exemption of dividend withholding taxes.
Unwinding: In order to avoid the disadvantages of the dividend withholding taxes and the delay in making funds available to the top holding because of the dividend carrousel, the CLEs would need to transfer their shares in the ELE to the top holding. This, however, leads to significant tax costs in those countries that levy tax on the capital gains - even though they still keep their deferred claims on the hidden reserves in the branches' assets.

<u>Miscellaneous</u>
Potential exclusion of joint ventures from the branch structure: In those cases where parts of the business are operated by joint ventures, it will not be possible to include them in the branch structure with the 100% owned businesses.
Profit allocation between countries: The creation of a branch structure will not solve the issue of profit allocation between countries. The risk of double taxation by no means disappears.
Administrative complexity of branch operations: Several sets of accounts will have to be kept for each branch. This will not be an easy task if the business is operationally run on a pan-European scale.

Conclusion

For both pilot companies, the tax costs of conversion into a branch structure are relatively high. This forces the relevant companies to continue with their historically established structures, which puts them at a competitive disadvantage compared with their more recently established (often non-European) competitors.
The ongoing tax costs – on the face of it – are at more acceptable levels, but might still turn out to be prohibitive because of their recurring nature.
The parallel legal structure with its dividend carrousel is a cumbersome structure, but the alternative – unwinding the parallel legal structure – leads to prohibitively high costs.

The pilot studies have assumed a structure which optimises the use of the merger directive.
However, more problems would be encountered if a European Company were to be created through cross-border legal mergers. The findings from the two pilot studies seem to confirm that it is highly unlikely that established European multinationals will make use of the European Company Statute – if and when it is adopted - unless the tax issues as outlined above are solved.

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BRANCH STRUCTURE / EUROPEAN PILOT STUDY
21-Apr-98

Based on a pilot study of two multinational companies with local operations in Europe
Indication of the taxation effects which would be incurred by the two pilots upon a transfer to a branch structure

	Austria	Belgium	France	Germany	Greece	Italy	Netherlands	Portugal	Spain	Sweden	UK
Conversion											
Transfer taxes	L	-	-	M	L	L	P	M	M	-	M
Pre-conversion losses	-	M	-	-	-	-	P	-	P	-	-
Provisions to be released	-	-	L	M	-	M	-	-	-	-	-
De-grouping / capital gains	-	-	-	M	-	-	-	-	-	-	M
Running											
Limitations on loss compensation	-	-	-	-	-	-	-	-	-	-	-
Branch profit tax	-	-	-	M	L	-	-	-	-	-	-
Other	-	-	-	L	-	-	-	-	L	-	-
Parallel legal structure											
Dividend withholding taxes	L	L	-	L	L	M	L	L	L	L	L
Unwinding	-	-	P	-	-	L	-	-	P	P	P

Miscellaneous
Apart from the issues included in the above matrix there may be other issues such as:
- the potential exclusion of joint ventures from the branch structure;
- the profit allocation between countries;
- the administrative complexity of branch operations.

Legend
-: no additional tax costs surfaces in the two pilots, but there may well be problems in other cases / upon more detailed investigation
L: limited additional tax cost (indicatively < ECU 5m)
M: material additional tax cost (indicatively > ECU 5m, but < ECU 25m) *
P: prohibitive additional tax cost (indicatively > ECU 25m)

*)"L" and "M" classifications under the heading "Running" might well turn out to be prohibitive because of their annual recurrence