UNICE
Union of Industrial and Employers' Confederations of Europe
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**Joint ERT/UNICE contribution on:**
**- Transfer pricing issues and the Arbitration Convention**
**- Impact of tax arrangements on the optimal EU business strategy**
**Paper drafted as a contribution to the European Comission's panel on cross-border fiscal issues in the Internal Market**

## Executive summary

The ECOFIN Council has given the Commission a mandate to undertake a study into the differences in effective corporate tax in the Member States, and to identify the main tax provisions which may hamper cross-border economic activity in the Single Market. Following up on its mandate the Commission has set up two panels and has invited both UNICE and the ERT to send a representative to the business panel of the two. At the panel's first meeting, "Transfer pricing and arbitration problems" and the "Impact of tax arrangements on the optimal EU business strategy" were allocated to the ERT and UNICE as topics for further discussion and contribution. In consideration of the extent to which transfer pricing can be an obstacle as well, the ERT and UNICE have decided to address both issues in the same paper.

A most helpful listing of possible obstacles to cross-border economic activity within the EU was published on 13 August by the Commission services. Each of the obstacles listed hampers the proper functioning of the Single Market. Moreover, as cross-border activity increases the impact of the obstacles will increase proportionally. There is good reason to believe that this will happen as companies have replaced or are in the process of replacing an organisation aligned along national boundaries by structures organised along the lines of European-wide business or product groups. Management's profit responsibilities are shifted away from country level to a transnational level, which tends to make borders a less relevant factor in commercial decisions. Concentration, rationalisation and integration of business functions are an inherent part of this process of realignment.

It is beyond doubt that these developments will increase the impact of the obstacles to cross-border economic activity within the EU. This paper will discuss these obstacles in more detail, where necessary. In discussing the obstacles, the ERT and UNICE have not addressed SMEs separately. However, they wish to stress that many of the obstacles often have an even bigger impact on SMEs than on MNEs as the former have fewer resources to deal with them. In so far as the Commission list is self-explanatory, no further comments will be made. Where applicable, recommendations will be made, based on existing publications by the ERT, UNICE and the Commission. This paper will follow the sequence of the Commission's list.

The ERT and UNICE strongly believe that elimination of individual distortions offers a short-term agenda only. A truly pan-European solution to safeguard the proper functioning of the Single Market requires a more comprehensive answer to the distortions created by the existence of 15 different fiscal jurisdictions. Nevertheless, this does not free the Member States of their obligation to eliminate as many distortions as possible on the shorter term. This paper intends to give an overview of the most pressing distortions. Views on the longer term will be presented in due course.

As the list of distortions is a long one, priorities will have to be set. Therefore, the ERT and UNICE have ranked the following issues (***) as top priorities:

- Compliance costs; dealing with 15 different taxation systems
- Transfer pricing issues

- Cross-border loss compensation

A further imminent priority is cross-border consolidated profits taxation, as this would solve the top 3 priorities in one go. The ERT and UNICE acknowledge, however, that this will involve a longer time span than the elimination of individual obstacles. Therefore, they strongly encourage the Commission to start the work on the consolidation dossier immediately.

## 1. Compliance costs; dealing with 15 different taxation systems ***

### *1.1 Differences in accounting and bookkeeping rules*

These differences constitute an administrative burden as well as an obstacle to cross-border economic activities. However, the discussion on accounting and bookkeeping rules can not be separated from a more comprehensive discussion on the taxable base in Europe.

### *1.2 Tax competition effects*

It is the ERT's and UNICE's point of view that tax competition is not necessarily a harmful phenomenon. On the contrary, competition is a necessary counterweight to the constant upward pressure on government spending. However, the ERT and UNICE do support the idea that special regimes should not be discriminating, i.e. they should be available to everyone under the same conditions. Moreover, regimes should not include rules that are in flat contradiction with internationally accepted taxation principles.

### *1.3 Different concepts of avoidance*

The difference in concepts of avoidance, which has to be clearly distinguished from tax evasion, used throughout the EU is a source of uncertainties for enterprises operating their business in more than one Member State. Because of these differences enterprises need to know in quite some detail the rules of every Member State they are active in. Complying with the rules of one Member State does not automatically mean that a particular action will be endorsed in other member States. What is worrying as well is the ongoing effort with which Member States are trying to devise new and even catch-all anti-avoidance regulations. In this respect, the EU tax area would gain much in clarity if some widely agreed single concept of avoidance could be developed in a joint effort between both business and government.

### *1.4 Different tax penalties*

In principle, this should not be an issue. Only in those jurisdictions where taxpayers are easily liable for a tax penalty could a distortion arise.

### *1.5 Ruling practices*

A ruling practice within the limits of the law is not a cause for distortion. Especially as the international tax environment is complicated it is logical for both taxpayers and administration to try to reach prior agreement on the international aspects of company taxation. Where, however, ruling practices result in discrimination they have an adverse impact on taxation in the Single Market. The ERT and UNICE could envisage an obligation to publish rulings to eliminate the suspicion of discrimination.

### *1.6 Tax payment*

The ERT and UNICE support that this is an area where there is a need for harmonisation. Especially the time lag between the payment and reimbursement of taxes constitutes a cost to business. Therefore, the individual Member States should strive to keep costs of timing differences with regard to reimbursement to the minimum possible. The ERT and UNICE are concerned about the lack of progress in the fields of VAT and withholding taxes in this respect.

### *1.7 Corporation Income Tax*

The ERT and UNICE agree with the argument brought forward in the Commission's paper that the differences in CIT systems can give rise to distortions and may have an impact on investment decisions. The ERT and UNICE note, however, that this impact is very hard to quantify as tax is only one of many factors influencing investment decisions.

### *1.8 Other taxes on business*

Every extra tax as well as every difference between tax jurisdictions adds to the administrative burden on business and increases the risk of double taxation. Moreover, it is not clear whether the revenues from other taxes on business are rightly proportioned compared to the difficulties they give rise to. In this sense, the ERT and UNICE support the Ruding Committee's recommendation to levy only one corporate tax. In the ERT's and UNICE's opinion, taxes such as the German Gewerbesteuer, the French Taxe Professionele, the Italian IRAP and the Dutch Kapitaalsbelasting should be abolished. Furthermore, the transfer taxes that many Member States apply on the transfer of property, shares etc. should be subject to serious review as they can render necessary restructuring prohibitively expensive.

## 2. Ordinary income

The ERT and UNICE lend support to the Commission's assessment that the differences in the computation of taxable income throughout the EU complicate cross-border business activity in the EU. Therefore, they foresee increased co-ordination regarding the computation of the taxable base in the longer term. An optional system for cross-border consolidation could offer a solution in this respect. Due to the technical and political difficulties, this will be a long process. Nevertheless, some obstacles can be addressed individually on the shorter term. These concern the treatment of intangible, special incentives, and business expenses, which are addressed in some more detail in the paragraphs 2.5, 2.6 and 2.8.

### *2.5 Treatment of intangibles, i.e. goodwill*

The tax treatment of intangible assets (goodwill, trademarks and know-how) is a major obstacle to cross-border business restructuring. Among the Member States, there are big differences in the tax treatment of intangible assets. This applies in particular to situations in which intangibles are sold/acquired in the framework of an asset deal. In some Member States, tax depreciation of acquired intangibles is allowed, in others it is not. Furthermore, in most Member States (capital) gains upon the disposal of intangible assets are taxable. As moving an intangible asset from a Member State where a capital gain on an intangible is taxed to one where it can not be depreciated is prohibitively expensive, the difference in tax treatment is an issue that needs to be addressed. Adopting an EU approach, which for sold/acquired intangibles leads to either taxation of capital gains and subsequent depreciation, or exemption (or deferral until it is sold to outside the EU) of the gain and no depreciation, could solve this issue.

### *2.6 Special incentives*

The ERT and UNICE position on special incentives is that apart from exceptions that have a discriminatory effect, they are a viable instrument in promoting macro-economic goals and the Member States should be entitled to do so. Furthermore, the use of incentives aimed at areas that fall behind in terms of economic development or employment is specifically endorsed by the EU-treaty. The effect of these incentives should not be reversed at parent company level by way of specific claw back provisions.

### *2.8 Business expenses*

It is the ERT's and UNICE's view that any expense incurred in the running of a business should be deductible. Not only is it in principle not right to distinguish between different types of expenses but also the vast array of non-deductable expenses throughout the EU does little in bringing more clarity in taxation.

## 3. Taxation of capital gains

The ERT and UNICE share the Commission's view that differences in the taxation of capital gains within the EU might be a cause for distortion, especially regarding cross-border transfers of (intangible) assets (See also 2.5).

## 4. Cost of employees

The EU should develop a common approach with respect to private pension and social security payments for corporate employees who work and reside in two or more countries within the EU during their professional careers. This problem occurs frequently as companies increasingly have to move employees from one country to another to meet the needs of their businesses. The EU has not adopted a common approach to address the various tax and administrative problems related to private pension payments and social security payments.

These problems include the decision regarding the country in which the employer should deduct pension contributions and/or the country in which the employee should pay tax on pension and social security payments. Often, upon cross-border movement, the employee ends up with taxation of the pension contribution his employer pays on his behalf, whereas his pension itself is taxed at a later stage. A co-ordinated approach within the EU regarding the deductibility/taxability of payments to or from social security systems would reduce costs and significantly alleviate administrative complexity for many European companies. Moreover, a co-ordinated approach in this field should eliminate this impediment to the free movement of workers.

As stock options gain in importance as part of remuneration policies and employees move more frequently from one Member State to another, double or non-taxation is likely to arise, because almost every Member State treats stock options differently. Some tax the beneficiary to the stock option when it is granted whereas some others tax him when it is exercised. Some Member States also tax the beneficiary to a stock option when it is changed from a conditional to an unconditional option. Consequently, double or even triple taxation as well as non-taxation is likely to arise. This is a serious concern for European business and industry, in terms of both cost and hindrance to the free movement of employees. Therefore, the ERT and UNICE propose that the Member States agree on common rules regarding the taxation of stock options.

## 5. Transfer pricing issues ***

### *5.1 Introduction*

Although there are no firm figures, some estimates put the proportion of intra-community trade between associated enterprises as high as 60% and this figure is bound to rise even further. This increase can to a large extent be explained as the result of the structural changes most European companies have gone through in their efforts to optimally benefit from the opportunities offered by the Internal Market. This process will only be exacerbated by the introduction of the single currency.

At the panel's first meeting, the Commission representatives mentioned that they had not received complaints by tax administrations indicating that transfer pricing poses a serious problem to them. This, of course, does not come as a surprise as it is business that is mostly and primarily confronted with the cost and problems raised by the requirements set by 15 different tax jurisdictions in the Single Market. The enterprises are the ones that have to determine what prices, could be regarded as arm's length, to find comparables, put the related documentation together, defend these prices, incur the related compliance costs and run the risk of double taxation, whereas transfer prices within Europe are not even relevant from a business point of view. As neither the burden of proof nor the risk lies with the tax administrations, it is logical that their perception of transfer pricing issues differs from that of the business community.

No complaints from the side of tax administrations can only be seen as evidence that, in spite of all cumbersome requirements, European business and industry still make a serious and conscientious effort to comply with them.

Moreover, tax administrations are usually two to five years behind business developments as they depend on the tax audit cycle for their information. Therefore, many of the difficulties businesses face have not yet surfaced. Though they have no complaints, the Member States are not shy in securing their position in this area and they seem to approach transfer pricing with increasing vigilance. Not only have many new and burdensome requirements been published in the past years (France, UK), but many Member States have also voiced the intention to levy firm penalties from companies failing to comply with these.

### *5.2 Transfer pricing ****

This paragraph will address the major issues in the transfer pricing area as well as offer some recommendations for the way forward. The ERT and UNICE note that over the last years there has been a major change in how companies chose to conduct there business. A far-reaching realignment of business structures has taken place in the wake of the Single Market, leading to pan-European product-group based operations, for which country borders are essentially irrelevant. Consequently, there is a growing tension between the needs of such pan-european business operations and the constraints imposed on them by the fiscal fragmentation in the Internal Market. Dispute settlement through the Arbitration Convention is one route for solving the problems arising from this tension. European industry regards this Convention as a major accomplishment, although its procedure has not yet been fully utilised. The Arbitration Convention has had a positive effect on tax administrations' assessment of transfer pricing issues, but based on the - still limited - experience so far, UNICE and the ERT feel that there is scope for improvement and clarification of the arbitration procedure in view of positions taken by some Member States in interpreting the Convention's provisions. Some recommendations on this will be made in paragraph 5.3.

Concentration of production is the most obvious and high profile sign of realigning business operations. As a consequence of the strongly reduced number of production, facilities the cross-border inter-company trade between the few remaining manufacturing units and associated marketing/sales organisations in other Member States will grow exponentially. This growth in inter-company trade creates by itself already a larger risk because of the sheer volume and value of such trade. Where in the past export to affiliated companies in other Member States was the exception rather than the rule, it is now not unusual that manufacturing units export most of their products to affiliates. This makes transfer pricing an area of potentially high risk, with additional assessments that could easily run into tens or even hundreds of millions of Euros, whereas it is irrelevant from a business point of view.

The introduction of the Euro has further increased the friction between commercial logic and tax requirements. With the single currency in place, prices of goods will show a tendency to converge within the EU territory, as pricing becomes much more transparent. As a consequence, many companies are studying the possibility of introducing Euro Pricing, e.g. using one transfer price per harmonised product for the whole of Europe, regardless from which production facility the goods are purchased. Such pricing mechanism will inevitably lead to losses in less efficient manufacturing units. From a business point of view Euro Pricing would be a desirable management tool – no inter-company disputes about price levels and optimum efficiency in the sourcing structure. In fact this concept treats the various factories in Europe as production lines that happen to be based in different Member States but all belonging to the same single European manufacturing unit. Though Euro Pricing makes a great deal of sense commercially and is also fully in line with the concept of Europe as one domestic market, tax issues still pose a major, if not a prohibitive, hurdle.

Not only manufacturing, but also other functions within the group are being realigned. As the EU will be targeted as one market by pan-European business units instead of country based organisations, functions such as marketing, R&D and group financing will not be performed in each (separate) country, but will be centralised either at the head office or in designated countries throughout Europe. Consequently, often only for tax purposes, the costs of these functions will have to be allocated through some sort of cost sharing mechanism. As business integration in Europe proceeds at high speed, such cost sharing arrangements, sometimes involving a large number of units, are becoming more and more complicated and the risk of arrangements falling short of requirements set by the various tax administrations is becoming very real. UNICE and ERT feel that it is essential that the Member States address this issue by agreeing on mechanisms for allocating and recovering (centrally) incurred costs, which are easy to administer, efficient and as little cumbersome as possible.

Apart from the transfer pricing issues raised by conducting business through a pan-European business structure, there are also tax problems linked to the restructuring that is required in order to transform a traditional country-based organisation into a more modern transnational organisation. Such restructuring often makes it neccesary to move earning capacity cross-border, either by way of moving (parts of) the business itself or the shares of the company containing this business.

The taxation of capital gains on the transfer of shares is an important obstacle to cross-border intra-group restructuring and expansion within the EU by way of acquisitions or joint ventures. The taxation of these capital gains results in double taxation in so far as these gains made at the parent level reflect profits, which have already been or will be taxed at subsidiary level as well. The Merger Directive has only partially removed this obstacle. Moreover, the Member States's implementations of the Directive vary widely.

A further obstacle to restructuring is the tax treatment of intangible assets (goodwill, trademarks and know-how). Among the Member States, there are major differences in the tax treatment of intangible assets. This applies in particular to situations in which intangibles are sold/acquired in the framework of an asset deal. In some Member States, tax depreciation of acquired intangibles is allowed, in others it is not. Furthermore, in most Member States (capital) gains upon the disposal of intangible assets are taxable. As moving an intangible asset from a Member State where a capital gain on an intangible is taxed to one where it can not be depreciated is prohibitively expensive, the difference in tax treatment is an issue that needs to be addressed. Adopting an EU approach, which for sold/acquired intangibles leads to either taxation of capital gains and subsequent depreciation, or exemption of the gain and no depreciation, could solve this issue.

Clearly, there is a tension between creating a Single Market on the one hand and maintaining full sovereignty for the 15 fiscal jurisdictions that this market is composed of on the other hand. Therefore, a joint effort of both business and government to relieve that tension is needed. What are business' most immediate needs? First and foremost, business needs certainty. Certainty that could be based on commonly agreed rules that are practical and efficient. Certainty could also be derived from the introduction of an ex ante assessment of a company's transfer pricing system so that the company can be sure that as long as it stays within the parameters of this policy it will not be confronted with corrections. Such ex ante assessment should, however, not be a copy of the US APA procedure, which is far too burdensome, costly and time-consuming. Second, business needs a relief from the ever-increasing administrative burden that transfer pricing creates. Last but not least, there needs to be an instrument in place that can solve any disputes fast and efficiently. The Arbitration Convention, though some improvements could be made, appears to be the proper instrument to achieve the latter.

### *5.3 The Arbitration Convention ***

This paragraph will focus on the Arbitration Convention, which became operational on 1 January 1995 and was recently extended.

The aim of the Arbitration Convention, which is based on a proposal for a Directive on transfer pricing arbitration, brought forward in 1976, is to eliminate double taxation arising from transfer pricing disputes. It is based on Article 220 of the EU Treaty and provides a means to solve disputes, which goes further than the comparable Article 25 of the OECD guidelines on OECD model convention, forcing the countries involved to relieve the double taxation resulting from the transfer price correction effectuated by one of them.

In this sense, the adoption of the Convention was a major breakthrough in EU taxation and the preventative effect of the Convention should not be underestimated. However, even the limited experience gained so far indicates that there is some scope for improvement of the Convention. This paragraph will elaborate on the issues concerned as well as offer recommendations for improvements.

The convention does not contain a definition of the notions of “enterprise” and “permanent establishment” and does not address double taxation that may arise as a result of disputes concerning these notions. Consequently, Member States are in a position to take advantage of this shortcoming by refusing to initiate the arbitration procedure. In this respect, the lack of competence of the European Court of Justice is a serious disadvantage. Also, it will be necessary to make use of the definitions given in bilateral double taxation conventions (See Article 3 para. 2). However, not all relations between Member States are covered by a bilateral convention. Moreover, definitions remain uncertain if more than two Member States are concerned. Furthermore, double taxation conventions do not often contain many definitions, but mostly refer back to the national legislation of the states involved. Consequently, the application of the Convention may lead to different results if different Member States are involved. As the application of the Convention is not brought under the jurisdiction of the European Court of Justice, these differences may be hard to solve, and the solution reached, if any, will be different in every case.

If the Member States involved in a transfer-pricing dispute can not reach an agreement within two years after the procedure has been initiated; they are obliged to set up an advisory committee. The advisory committee set up under articles 7 and 9 is made up of a chair, two representatives of each Member State involved and an even number of independent members of the committee. For each case, a new committee has to be established. The different committees are under no obligation to take earlier decisions by other committee into account, which makes for a serious lack of certainty on behalf of the enterprise concerned. Also, it is unlikely that any common ground for the arbitration of transfer pricing disputes will ever be arrived at.

In summary, many of the problems related to the Convention find their source in the lack of clear definitions in the text. Although it was a political decision to draw upon national legislation for definitions, the ERT and UNICE are of the opinion that this decision could be reconsidered. The differences in treatment and the reduced security for taxpayers constitute a clear case for the use of definitions in the Convention.

The ERT and UNICE acknowledge that the form of a multilateral agreement was chosen to offer an instrument of dispute resolution between Member States. Involvement of the Commission or the European Court of Justice was not deemed necessary; neither with regard to the procedure itself nor with the outcome of the procedure. Although the ERT and UNICE understand the Member States’ reluctance to hand over dispute resolution, they do recommend to insert an article opening the possibility of complaint with either the Commission or the European Court of Justice in case access to the Convention’s procedure is denied or unduly postponed.

Another problem is that the cost of transfer pricing disputes remains with the enterprise involved. Article 5 allows the Member States to push through a correction regardless of the initiation and outcome of the arbitration procedure. Therefore, the company involved is left with the (interest)costs of the double taxation for as long as the procedure lasts or indefinitely if it is not resolved. From the other recommendations, it is clear that this period can be as long as 2.5 years or even longer, depending on the interpretation of the other articles of the Convention. In the ERT’s and UNICE’s view a transfer pricing dispute is primarily a dispute between tax administrations, the costs of which should not be visited upon the company involved. Therefore, the wording of Article 5 should be changed to stating that the transfer price cannot be corrected until the tax administrations have reached an agreement as to what the correct transfer price should be. Moreover, this would present the Member States with the necessary incentive to conclude the procedure as fast as possible.

Article 7 states that the Member States concerned have to reach an agreement within two years after the enterprise has brought its case forward to one of the Member States involved and have to set up an advisory committee if they fail to reach agreement within these two years. Some Member States, however, have taken the view that the 2-year term under the Convention does not start before the other state has formally notified that it does not accept the correction. Consequently, the real term within which the dispute is carried to a conclusion is actually indefinite. Again, the taxpayer can not turn to either the Commission or the European Court of Justice. Therefore, it should be made unambiguously clear that this interpretation of the Convention's wording is incorrect.

Article 7 para. 3 states that where the domestic law of a contracting state does not permit the competent authorities of that state to derogate from the decisions of their judicial bodies, there is no obligation for the competent authorities to proceed to arbitration unless and until the enterprise of that state has allowed the time for appeal to expire or has withdrawn such appeal before delivery of the decision. France and the UK have declared that they will apply this provision. Consequently, an enterprise of those states will have to make a choice between the national procedure and the Convention's procedure. Obviously, this is at odds with the purpose of the Convention, which is to provide an additional solution to transfer pricing disputes. Moreover, as long as the dispute is not resolved, the company involved is faced with the (interest) costs of the double taxation. Therefore, the ERT and UNICE recommend to remove this paragraph.

Article 8 states that a Member State is not obliged to initiate an arbitration procedure or set up the advisory committee if the enterprise confronted with double taxation is liable to a serious penalty. In the individual declarations annex to the Convention the Member States have listed what, in their opinion, constitutes a serious penalty. Both the nature as well as the seriousness of the penalties varies widely among the different Member States. Some Member States even mention the involuntary incorrect filing of the tax return as an action liable for a serious penalty. So in many Member States there is a risk that any infringement of tax legislation will not only trigger a penalty, but will also deprive an enterprise of its right to the Convention's procedure. Therefore, the enterprise can end up with both the penalty and unresolved double taxation. Although the ERT and UNICE underwrite the general gist of the article, its current effect can lead to unacceptable differences in the handling of transfer pricing disputes between the different Member States. Therefore, the ERT and UNICE are of the opinion that the annex, which lists what in the view of the different Member States constitutes 'liability to a serious penalty', should be replaced by a single list of definitions of what 'liability to a serious penalty' implies.

## 6. Cross-border offsetting of losses ***

### *6.1 Vertical and horizontal*

The current rules for cross-border loss compensation differ substantially between Member States, particularly with regard to subsidiaries. As regards branches, most Member States appear to allow such compensation through either imputation or deduction/reintegration methods. Where a foreign operation is incorporated - and this is still the normal pattern for most business sectors - most Member States do not allow any cross-border compensation whereas others do allow some, but only if certain conditions are met. The disparity in treatment of cross-border losses within the EU and the lack of possibilities for cross-border loss compensation has a number of drawbacks.

In the first place, there is the risk of economic double taxation of multinationals operating within the EU in those cases where losses are made that cannot be absorbed locally. Secondly, it inevitably leads to distortion of competition within the EU where companies based in countries with more lenient rules for cross-border loss compensation will be put in a favourable competitive position compared to those who are not. Thirdly, there is a negative impact on the competitiveness of multinationals with a European home-market where they compete with e.g. US-based companies. The latter operate from a tax-wise more integrated domestic market and full offset of losses within this market is a matter of fact. Finally, the current situation will lead to diseconomies, as investment decisions will be influenced by the prospective tax treatment of possible losses resulting from the investment.

This might induce companies to invest in those countries where a sufficient reservoir of taxable profits is available against which future losses, if any, can be set off. Where operations are initiated abroad with foreseeable substantial start-up losses, the possibility of cross-border loss compensation offered by branches will induce companies to opt for this legal form rather than for immediate incorporation of the foreign operation, even though the latter may well be the preferred structure for other reasons.

Inquiries within a group of EU-based multinationals have indicated that the costs that could have been saved if they had been allowed to offset losses incurred by subsidiaries in other EU Member States with the profits of the parent company, are considerable. This under the assumption that an automatic recoup after five years would take place, as is envisaged in the current draft Directive on cross-border loss compensation. The savings resulting from such an arrangement would therefore be primarily in terms of financing cost, as a consequence of advancing loss compensation compared to the current situation.

The outcome of the inquiries in this area have led it to believe that the cost to European business and industry resulting from the absence of a fully-fledged EU-wide loss compensation are very substantial and that, therefore, there is a high likelihood of business decisions being distorted in a way that will make for a sub-optimal allocation of capital within the EU.

There is a clear preference for a system of cross-border loss compensation that allows all profits within the EU to be available for loss compensation. This goes further than the draft Directive, which limits such compensation to profits made by the parent company.

The current situation confronts potential direct investors within the EU with an imbalance in risk/reward profile because profits (immediately taxable) are treated differently from losses (not always immediately deductible, if at all). In the absence of cross-border relief, investments in a location with an existing tax base will tend to be favoured because of the protection against any downside risk. Such a bias will lead to sub-optimal decisions from an EU-wide economic point of view.

Cross-border loss compensation has first appeared on the EU agenda a long time ago already. Since than it has been in and out of discussion. The last discussion failed because the draft directive was too disadvantageous to the smaller Member States. Because the directive offered only the possibility of vertical loss compensation, the smaller Member States would be put at a serious disadvantage compared to the larger Member States. If losses can only be compensated with the profits made in the home market of the enterprise, then enterprises in smaller Member States will obviously have much less room for compensation.

This is not only a problem from a business point of view, but also from the (smaller) Member States' point of view. The adoption of the directive in this form would force businesses away from the smaller to the bigger Member States. In summary, a directive on cross-border loss compensation offering only the prospect of vertical compensation will never be acceptable. Therefore, a directive offering both vertical and horizontal compensation is needed. Obviously this will be a politically much more difficult solution.

Furthermore, the Member States will have to address the differences in carry-forward rules as (the lack of) the rules influence the possibilities for loss compensation. In the Member States that do not allow carry-forward of losses, loss compensation is an illusion to the extent that the losses are attributed to those Member States, because there will often not be enough profits to compensate the losses with. A further issue to address is the differing treatment of groups of companies. Enterprises that are located in Member States opening the possibility of taxing a group's consolidated result within that Member State are at an advantage compared to enterprises that cannot apply for consolidated taxation.

### *6.2 Carry-forward and carry-back*

Although this is in essence a national issue, it has a profound impact on the possibilities to develop a business throughout the EU. In the first place, it inevitably leads to distortion of competition within the EU where companies based in countries with more lenient rules for cross-border loss compensation will be put in a favourable competitive position compared to those who are not. Secondly, there is a negative impact on the competitiveness of multinationals with a European home-market where they compete with e.g. US-based companies. The latter operate from a tax-wise more integrated domestic market and full offset of losses within this market is a matter of fact. Finally, the current situation will lead to dis-economies as investment decisions will be influenced by the prospective tax treatment of possible losses resulting from the investment. Finally, the lack of a coherent approach to domestic rules for loss compensation among the Member States complicates the introduction of a facility for cross-border loss compensation. Awaiting progress on the issue of cross-border loss compensation the ERT and UNICE could envisage setting at least a minimum time for loss carry-forward and carry-back as a start in dealing with this obstacle to cross-border economic operations.

## 7. Cross-border flows of income

### *7.1 Withholding taxes ***

It is the ERT's and UNICE's firmly held view that the application of withholding taxes on inter-company financial flows is at odds with the concept of an internal market. Such taxes distort competition in favour of those who do not have to bear them, they hamper the free provision of financial services to some extent, and they may impede the transfer of technology within the EU.

A study among a group of European enterprises seems to confirm that Withholding taxes on inter-company payments of interest and royalties (IRWHT) have a high nuisance value for companies operating within the EU. The formalities for obtaining relief are sometimes cumbersome, a time-lag between levy in the payer's country and credit in the payee's country will lead to financing costs and, last but not least, the need to avoid non-creditable IRWHT forces companies into complex and/or sub-optimal structures. These negative aspects will be addressed in more detail below.

#### *7.1.1 Sub-optimal structures*

Generally, companies will be able to avoid actual double taxation from occurring but often this can only be achieved by arranging their operations in a way, which is sub-optimal from a business perspective. The need for such arrangements is more pressing to the extent that the IRWHT rates are higher and/or the creditability of IRWHT is more limited, either in time (no carry-forward) or in scope (single source credit system).

In reactions to inquiries within the group, several examples of such sub-optimal situations were mentioned.

- Sometimes companies had to "create" taxable income in order to secure creditability of IRWHT. In one example a company had to release reserves that it had been allowed to make out of untaxed profits and which could have been kept for much longer were it not that this would have resulted in losing the IRWHT credit.
- The application of IWHT clearly limits the scope for flexible intra-group financing arrangements within Europe. It sometimes effectively prohibits intra-group financing by way of on-lending where the tax on an on-lending spread is insufficient to cover the IWHT. In such cases financing will have to be re-routed within the group or done locally, which is likely to lead to higher costs for the local operations and, therefore, to lower (taxable) profits.
- In other cases, it turned out to be difficult or even impossible to include operations in EU countries applying an IWHT in European cash pooling arrangements without running the risk of non-creditable withholding tax.
- A limited capacity for offsetting RWHT might also lead to sub-optimal arrangements for the recovery of centrally incurred international (research) cost. Under these circumstances, companies might be inclined to apply cost-sharing rather than royalty agreements, where the latter would have been more appropriate. This is particularly relevant in relation to emerging markets where the countries concerned impose relatively high RWHT. The abolition of RWHT within the EU would help European-based multinationals to shape their recovery of international cost in an optimum way.

#### *7.1.2 Formalities*

Another aspect that adds to the nuisance value of IRWHT to European business and industry are the cumbersome formalities and sometimes time-consuming procedures that have to be complied with in order to obtain IRWHT exemption/ reduction or refund. The ERT and UNICE are aware that the European Commission is currently investigating whether these formalities could be harmonised and simplified. In preparation for this study, the Commission has asked European business organisations to provide it with information about problems and with suggestions for improvements. The ERT and UNICE assumes that the data made available to the Commission are sufficient evidence that the complaints by European business and industry are justified and that solutions need to be found.

Because of the study currently being made by the Commission, the group has not focused so much on this aspect of IRWHT. In their responses, some companies were nonetheless complaining about bureaucratic red tape in relation to IRWHT. Specific reference was made to the procedures for obtaining reduction of RWHT in Portugal and Spain. One company claimed that the work these procedures entail keep one employee occupied almost full-time.

#### *7.1.3 Financing cost*

In relation to IRWHT, financing cost may be incurred by business and industry due to the time lag between the payment of withholding tax and its reimbursement through a credit against the payee's domestic tax. In this respect, periods of 3 to 15 months were mentioned, depending on the date of payment of the interest or royalties concerned.

Financing cost will also be incurred in those situations where IRWHT relief has to be obtained through a refund of taxes withheld in excess of treaty rates. Here again, the periods mentioned differ significantly and vary between a few months and several years. Italy and Portugal were specifically referred to in respect of substantial delays.

### ***7.2 Tax credit methods: exemption and credit systems***

Further to the Commission’s observations, which are endorsed by the ERT and UNICE, an additional comment can be made. The credit method for the prevention of international double taxation is applied by countries adhering to the principle of Capital Export Neutrality (CEN). According to this principle a state should tax foreign source income of its residents in such a way that these residents are neither encouraged nor discouraged to invest abroad (home neutrality). Investment decisions should not be affected by taxation. Therefore, the credit method leads to an equal level of tax on both foreign source income and domestic income. This method is of course not neutral in so far as the tax level abroad is higher than the domestic level in which case no refund is given. Moreover, the companies from credit countries are at a competitive disadvantage vis-à-vis their competitors in the foreign market in case the foreign tax burden is lower, because they face higher tax costs even though they are competing in the same market.

According to the principle of Capital Import Neutrality (CIN), a state should exempt foreign income of its residents, since that income has already been taxed in the source state, and it is the prerogative of the source state to set the tax rate in its jurisdiction (source country entitlement). The effect and purpose of CIN is that any income generated within a particular tax jurisdiction should bear the same level of taxation, regardless of where the final recipient of that income is resident. Therefore, the countries adhering to this principle apply the exemption method (the income is not taken into consideration) to prevent double taxation of foreign source income. This method is not neutral in so far as it encourages investments in lower taxed jurisdictions.

### *7.3 Non-neutral dividend taxation ***

In Europe today the member countries use a number of different ways and principles to treat distributions from companies to shareholders. Some countries use the classical method, which results in economic double taxation of company income. Other countries use different ways to remove or reduce double taxation. Full or partial imputation, full or partial exemption or split rate company taxation methods are used – all causing different economic effects. Moreover, many of these methods, if applied, put international investment at a disadvantage. The reliefs that are granted to dividends on shares in domestic companies are generally not applied to dividends on foreign shares. It should, nevertheless, be possible to agree upon economically equal treatment of investments in domestic companies and companies of the other Member States of the European Union.

The main argument against applying the classical system with its double taxation of corporate profits is that double taxation puts a heavier tax burden on share capital than on loans and other kinds of savings. There is also a strong political reason to eliminate double taxation in order to stimulate the formation of risk capital in the EU in order to achieve higher growth and create more jobs at the same time.

The problems of discrimination built into the imputation systems can be summarised as follows:

1. Cross-border dividends. Dividends from foreign companies generally do not receive the same preferential treatment as dividends from domestic companies. Nor are foreign shareholders generally granted the same relief as domestic shareholders. In the few cases where relief is granted, it is a slow and burdensome procedure, which is not fit for large-scale cross-border ownership.
2. Under an imputation system, dividends from foreign subsidiaries can in general not be distributed free of additional burdens because of the systems created to guarantee that the distributed income has borne its fair share of corporate tax. Furthermore, in some states, dividends flowing to foreign parent companies are treated less favourably than dividends flowing to domestic parent companies.
3. Cross-border mergers. Foreign corporations in general cannot acquire corporations in a country applying an imputation system by way of exchanging the shares in the acquired company for their own shares without triggering an additional tax burden on future dividends for the acquired company's shareholders.

This gives rise to economic double taxation and makes investments in shares of companies in other Member States less favourable than investments in domestic shares. To a limited extent, the double taxation effect has been removed by home countries of the distributing company by way of granting a tax refund, equal to the imputation credit for domestic shareholders, to foreign shareholders in double taxation treaties. Most of these solutions, however, are not well suited for large-scale cross-border

European shareholding. What needs to be achieved as a minimum solution is that the effects of the tax treatment of dividends received from domestic companies and dividends from companies in other Member States are equal.

### *7.4 Domestic integration of personal and corporation taxes*

See under 7.3

## 8. Groups of companies

### *8.1 Headquarters costs ***

Inherent to the adaptation of a pan-European structure is the realignment of functions within the group. As the EU will be targeted as one market by product groups instead of country based organisations, functions such as marketing, R&D and treasury will not be performed in each separate country, but will be centralised either at the head office or in specific countries throughout Europe. Consequently, the costs of these functions will be allocated through a cost sharing mechanism. As the use of these mechanisms within to the pan-European organisation is still required for tax purposes, their impact on transfer-pricing will become too big for the Member States not to address this issue by agreeing on which mechanisms are acceptable for the purpose of allocating and recovering (centrally) incurred costs.

### *8.2 Treatment of mergers and acquisitions/cross-border business integration ***

Several respondents to previous UNICE and ERT inquiries complained about the fact that tax and company law obstacles prevent them from establishing integrated European-scale business units. In the absence of a European Company Statute that could provide an appropriate vehicle for such structures, an alternative way of achieving these is by converting existing operations in the EU Member States into branches of the European unit's head office. In practice, this turns out to be prohibitively costly in cases where companies have contemplated doing so.

The EU Directive on cross-border mergers offers only partial relief, as in various EU Member States it cannot be applied due to company law restrictions and, if applicable, it does not give protection against transfer taxes levied in a number of EU countries. The conversion of existing operations into branches may well endanger the future absorption of tax losses accumulated pre-conversion and it might also put in jeopardy the compensation of future losses since the branches will be excluded from local systems for group relief in the EU countries concerned. Furthermore, some EU countries impose a heavier tax burden on branches than on subsidiaries (e.g. Germany). Last but not least, foreign corporations in general cannot acquire corporations in a country applying an imputation system by way of exchanging the shares in the acquired company for their own shares without triggering an additional tax burden on future dividends for the acquired company’s shareholders.

The ERT and UNICE are convinced that in many more cases, without needing more detailed investigations, companies arrive at the conclusion that tax obstacles will make it impossible to achieve the optimum structure and that they will have to be satisfied with a half-way house. To the ERT and UNICE it seems to be a foregone conclusion that as long as tax systems continue to place artificial and unnecessary restrictions on the behaviour of companies in pursuit of pan-European business objectives, European business and industry will not be able to generate all the savings and other economic benefits linked to the full potential of the internal market.

In this respect, it is important to note that any improvement in the area of cross-border business integration is bound to be a revenue-raiser because the potential tax costs are by and large avoided in practice by not implementing optimum - and probably more profitable - business structures.

### *8.3 Directive: effective implementation*

As with the implementation of the EC Parent Subsidiary Directive, the Member States have not adopted a uniform interpretation of the various provisions of the Directive in drafting their national laws. The requirement in the Directive for the Member States to translate the terms of the Directive into their national laws provides substantial scope to member States in deciding how to implement these requirements in their national laws. The result is that the circumstances under which the benefits of the Directive will be applicable are not identical in all respects in any two Member States. Therefore, it does not accomplish the simplicity it was intended to promote to the fullest extent, becoming a cause for distortion to the proper functioning of the Single market.

Moreover, the Directive does not provide for relief on all taxes triggered by cross-border mergers. A recent study by two European multinationals shows that notwithstanding the benefits of the Directive, cross-border business integration can still be prohibitively expensive from a tax point of view. This study investigated the costs of converting existing operations in the Member States into a branch structure. A summary of this study is given in paragraph 8.2.

### *8.4 Cross-border consolidated profits taxation ****

Obviously, this would be the answer to a wide range of taxation obstacles that pan-European organisations currently face in their cross-border economic operations. The most pressing obstacles are transfer pricing, cross-border business integration, cross-border loss compensation and cross-border capital flows. However, as this requires a more comprehensive review, UNICE will make a contribution on this topic in a separate paper. The ERT and UNICE note that cross-border consolidated profits taxation is a necessary, though time-consuming project. Therefore, the necessary work in this area should not slow down the process of eliminating the obstacles mentioned that need to be removed in the shortest possible term. Moreover, cross-border consolidated profit taxation should be an optional system available to pan-European enterprises. Regardless of the introduction of such a system, SMEs will still need the elimination of the obstacles mentioned, as cross-border consolidated profit taxation is less beneficial to them. Therefore, the discussion on this issue should not impede the swift elimination of the still existing obstacles.

## 9. VAT and other indirect taxation

The ERT and UNICE note with some concern the general lack of progress of work at Council level, regarding both simplification of the current transitional VAT regime and design of a common definitive system. As a result, many of the deficiencies identified in the transitional regime remain, and can still represent a significant barrier to business operating across the EU, particularly for small and medium-sized enterprises.

The ERT and UNICE's long-term priority is the creation of a final VAT system, which would permit the effective functioning of the Single Market. However, an immediate goal is the simplification of the current system, thus adapting it to companies' needs. The ERT and UNICE are disappointed to note little progress by the Commission towards this in the last five years, yet recognises the existence of constraints at Council level. The Commission and the Council should act now to improve the current system, for example by implementing the recommendations of the SLIM VAT project, notably with regard to recovery of foreign VAT and easing of tax representation. The ERT and UNICE calls for a rationalisation of VAT rates, which would include a reduction in the number of rates, and a reduction in the number of exceptions.