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

3 April 2000

UNICE MEMORANDUM

ON CROSS-BORDER COMPANY TAXATION OBSTACLES IN THE SINGLE MARKET

Executive Summary

The overall business environment in the European Union has improved substantially in recent years following the creation of the Single Market and the process towards the establishment of Economic and Monetary Union. Economic and business restructuring and integration have intensified under the pressures of enhanced competition, globalisation and technological change. However, problems remain. Many obstacles still hinder cross-border business and investment activity within the EU, creating significant handicaps for the global competitiveness of European companies. This is increasingly evident in the area of cross-border company taxation where the only significant progress to remove such obstacles was achieved ten years ago, before the Single Market was set up.

This paper addresses the requirements with regard to cross-border company taxation measures. It is set in the framework of UNICE's overall position on the EU tax strategy which is guided by the need to reduce total tax burdens on business, preserving sound tax competition conditions and allowing reform of corporate tax structures adapted to the Single Market. The proposed measures to achieve these objectives do not require either full harmonisation of company taxation systems or tax rates in the EU.

However, in UNICE's view the continued existence of major tax obstacles to cross-border economic activity is incompatible with the notion of a single market and the four fundamental freedoms of the EU Treaty. The current EU tax agenda takes little or no account of real business needs for measures to remove such obstacles, given that its underlying objective is essentially to protect national revenue bases. Failure to address these problems will continue to generate inefficiencies in the operation of the Single Market, impose unnecessary costs on business and hold Member States back in their attempts to deliver higher growth and employment in the EU.

At present, enterprises which operate a pan-European business are still confronted with 15 different national tax jurisdictions in what is supposed to be a single territory for business purposes. Companies, especially SMEs, not only face costly and time-consuming compliance burdens in every Member State where they conduct their business, but they also have to bear the costs resulting from the lack of common EU-level solutions to cross-border company taxation problems. Despite many efforts by the European Commission, Member States have so far been unable to agree on measures to remove even the most urgent obstacles which relate, in particular, to cross-border loss compensation, cross-border business integration, inter-company payment of interest and royalties, transfer pricing issues and the

implementation of the Arbitration Convention. The advent of e-commerce will greatly increase the number of businesses adversely affected by these tax obstacles.

A number of short-term solutions to these problems have already been advocated by UNICE and are reiterated in this paper. These solutions represent the bare minimum needed to improve the operation of the Single Market. However, a longer-term tax strategy is also necessary to develop the Single Market further, taking account of business competitiveness requirements. Many companies have gone or are going through an overhaul of their business structures, aligning them as much as possible on the logic of the Single Market and the euro. Reorganisation of company taxation systems within the EU is not keeping pace with these developments. The urgent need for a more comprehensive pan-European solution to eliminate cross-border tax obstacles should become a priority for the EU.

Addressing these trends, UNICE intends this paper to be a catalyst for a debate on the introduction of an optional European system of company taxation aimed at enterprises, of all sizes, with business activities in different Member States. For UNICE, the essential component of such a system would be an EU-wide taxable base. If properly structured, EU-wide consolidation of taxable results would eliminate a large number of existing tax obstacles to cross-border economic activity and business integration. There are various possibilities to achieve this objective. UNICE proposes three options for a system of consolidation, including the concept of Home State Taxation and a phased approach for an eventual transition to Common Base Taxation. The optional nature of the systems and their limited scope would be compatible with subsidiarity and Member States' prerogatives to set tax rates. These necessary tax changes could be made without the stalled European Company Statute.

Regardless of which optional system might be adopted UNICE sees the development of such a system as highly desirable. It stresses the urgency of structural reform to improve cross-border company taxation conditions in the EU, facilitating the growth of trade and investment and enhancing European businesses' competitiveness and profitability, to the benefit of the economy at large. UNICE urges both the Commission and the Member States to study the options further and to engage in dialogue with the business community as soon as possible.

TABLE OF CONTENTS

I. Introduction 4

II. Why do we need a change of system? 4

II.1 Current system is not Single-Market-friendly 4

II.2 Short-term solutions 6

III. What should be done? 7

III.1 Longer-term strategy necessary 7

III.2 The way forward 9

III.3 Cross-border consolidation: three possible approaches 10

1. Home State Taxation (HST) *10*

2. Common Base Taxation *11*

3. Commercial accounts *12*

III.4 Other aspects 12

1. Which allocation key should be used? *12*

2. Related issues *13*

3. Timetable *13*

IV. Conclusion 13

Annex 1. Cross-border loss compensation *15*
Annex 2. Cross-border business integration *17*
Annex 3. Arbitration Convention *18*
Annex 4. Withholding tax on inter-company payments of royalties and interest *20*
Annex 5. UNICE papers 1988-1999 .... *21*

I. Introduction

Although the EU is one of the largest (single) markets in the world, this is far from true from the point of view of company taxation. Enterprises which operate a pan-European business are still confronted with 15 different national tax jurisdictions. Consequently, for tax purposes their businesses are carved up into 15 pieces in what is supposed to be a single territory for business purposes. Companies, especially SMEs, not only face costly and time-consuming compliance burdens in every Member State where they conduct their business, but they also have to bear the costs of the lack of alignment between the Member States' company tax systems.

Under the Santer Commission, a business panel was set up last year to conduct a study into the tax obstacles to cross-border business integration. In parallel, a panel of academics was set up to examine the differences in effective corporate taxation in the EU. It is UNICE's understanding that the intention is to expand the process beyond the overview to include a joint effort by the Commission and business to draft recommendations to eliminate these obstacles. As this discussion on tax obstacles seems to be well under way, UNICE invites the new Commission to advance the debate further and move towards consideration of an optional common system of company taxation adapted to business requirements in the Single Market.

This paper is intended as an initial contribution to a debate on the introduction of an optional European system of taxation aimed at enterprises, of all sizes, with business activities in different Member States. It starts, however, with an overview of the most urgent existing tax obstacles and makes recommendations for the way forward regarding the elimination of these impediments. Later chapters elaborate on the conditions and options for a more comprehensive system of company taxation aimed at pan-European enterprises.

It is UNICE's view that in the longer term a system is needed which would enable pan-European enterprises to be taxed on the basis of an EU-wide consolidated result. This would allow them to approach the EU as a single market for tax purposes and would greatly reduce the compliance and administrative burdens on both business and tax authorities. Moreover, to strengthen global competitiveness of European business and industry their domestic (tax) markets must be enlarged to put them on an equal footing with competitors from other parts of the world which benefit from large domestic markets which are integrated in tax terms.

UNICE agrees with the new Commission that full harmonisation of company taxation systems is both counter-productive and unnecessary. Therefore, UNICE wishes to offer in this paper the building blocks for an optional system that will not only allow European enterprises to approach the EU as a single market for tax purposes, but will also retain the necessary flexibility for governments to address differences in economic development and policy preferences. In UNICE's view the principle of subsidiarity, allowing the Member States to deal with national issues while the EU deals with cross-border situations, should remain the guiding principle.

II. Why do we need a change of system?

II.1 Current system is not Single-Market-friendly

For European taxation to be Single-Market-friendly, it should not create obstacles to cross-border economic activity within the European Union. Notwithstanding many efforts by the European Commission to put forward proposals to eliminate impediments to the proper functioning of the Single Market, even the most urgent ones have not yet been removed. Although the EU is one of the largest (single) markets in the world, this is far from true from a

tax and legal point of view. This paragraph gives a short overview of the major tax constraints European businesses face.

Cross-border loss compensation

There is no mechanism for cross-border loss compensation (i.e. the ability to offset losses across borders) within the Single Market. Therefore, the EU does not offer the full benefit of a single European domestic market to its enterprises. The lack of the ability to offset losses across Europe constitutes a serious hurdle for businesses. Companies' experience shows that the costs of this particular obstacle can amount to many millions of euros.

Cross-border business integration

Cross-border (or rather cross-tax jurisdiction) formation and operation of a pan-European business is sometimes still prohibitively expensive. The sum of one-off and on-going tax costs prevents businesses from adopting the most efficient structure so that they can benefit fully from the commercial advantages that a single market offers. The Merger Directive has been a step forward, but in many cases does not provide an efficient means to restructure a European organisation without incurring excessive tax costs. In addition, appropriate EU company law instruments have not yet been agreed. Such impediments are most pressing, as they primarily hinder existing European operations, thereby offering a distinct competitive advantage to non-EU enterprises which start a greenfield operation in the EU.

Inter-company payments of interest and royalties

Withholding taxes on inter-company payments of interest and royalties within the EU still force enterprises to adopt structures that are sub-optimal from a business point of view and, even with those in place, it is not always possible to avoid double taxation. Furthermore, enterprises are confronted with cumbersome formalities and time-consuming procedures in order to obtain exemptions or refunds. Moreover, depending on the time lag between payment and reimbursement of withholding taxes, considerable financing costs are imposed upon enterprises.

The Arbitration Convention and Transfer Pricing

Notwithstanding the big step forward brought about by the adoption of the Arbitration Convention, unresolved transfer pricing problems remain and there is also room for improvement in the Convention itself. For example, it appears that some Member States tend to interpret the Convention in a way which either lengthens the procedure considerably or even excludes the taxpayer from using it if he has first gone through the national appeal procedures. This seems to be at odds with the spirit of the Convention.

However, the problem does not lie with the Convention exclusively. One of the most pressing problems in the transfer pricing area is the constant increase in documentation and reporting requirements that companies have to comply with. Several Member States have introduced or are in the process of introducing new, more extensive requirements. This regulatory burden has become very costly for companies engaged in cross-border economic activities. There is a growing belief that the documentation requirements are disproportionate for a single market.

II.2 Short-term solutions

A number of short-term solutions have been put forward by both UNICE (see Annex 5 for an overview of UNICE publications) and the 1992 report of the Ruding Committee, each targeting one of the above-mentioned obstacles. UNICE notes that the time frame for action proposed by the Ruding Committee's report has long expired. This paragraph presents a brief overview of these short-term solutions. The Annexes to this paper give a more detailed outline of these solutions.

Cross-border loss compensation

The Commission made a proposal for a system of cross-border loss compensation in January 1990. In UNICE's view, the discussion on this proposal should be restarted along with the discussion on the proposal on loss carry-over. Although these proposals are open to improvement, they would still constitute a big step forward.

Cross-border business integration

The Merger Directive was adopted in 1990, but the transition from one structure to another is still difficult because the Directive does not address all the relevant issues. Among the problems encountered are transfer taxes due upon transfer of assets to a branch structure, the loss of pre-conversion losses that cannot be transferred to a new branch structure and the obligatory release of provisions which have up to that point reduced taxable profit. The first initiative to be undertaken should therefore be to enlarge the scope of the Merger Directive to include all taxes levied in the process of merging two or more companies. Furthermore, it would be helpful for business if the Commission could review the various interpretations that the Member States have given to the Merger Directive with a view to agreeing a common interpretation on which businesses can rely.

A further issue is the lack of symmetry between the Member States' tax systems in the case of cross-border transfers of earning capacity – often an integral part of European business restructuring. Up-front taxation of a capital gain in one Member State and no or slow depreciation of the goodwill transferred in another is commonplace and sometimes makes such transfers too costly to be effected despite their commercial desirability.

Inter-company interest and royalty payments

The proposal presented by the Commission for a Council Directive on a common system of taxation applicable to interest and royalty payments between associated companies in different Member States (COM(98) 67 final) is a major step forward in eliminating these withholding taxes. However, UNICE is concerned about the direction the Council discussions on the proposal seem to have taken. The scope of the Directive is reported to have been seriously reduced, rendering it much less effective. UNICE urges the Commission and the Member States to reconsider the changes to the Directive with a view to maximising its efficacy (see annex 4).

The Arbitration Convention and Transfer Pricing

Taxpayers need guaranteed access to the Convention as a means to resolve transfer-pricing disputes. At present, the different interpretations that Member States apply to the Convention can leave transfer pricing disputes unresolved at taxpayers' cost.

In addition to arbitration to resolve disputes, a joint effort by both business and tax authorities to minimise the routine administrative burden of transfer pricing is urgently needed. What are the most immediate needs of business? 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 practice so that the company can be sure that as long as it stays within the parameters of its practice, it will not be confronted with corrections. Such an ex-ante assessment should not, however, slavishly copy the US APA procedure, which is far too burdensome, costly and time-consuming. More refined and elegant EU solutions are required.

III. What should be done?

III.1 Longer-term strategy necessary

The short-term solutions mentioned above are the bare minimum needed to improve the Single Market for European business and industry. However, a longer-term strategy is necessary to develop the Single Market fully in tax terms. Companies have gone or are going through an overhaul of their business structures, aligning them as much as possible on the Single Market. Fiscal reorganisation of the EU is not keeping pace with these developments. A number of trends in European business have become clearly visible in recent years and will increasingly strengthen the need for a more comprehensive pan-European solution to eliminate tax obstacles. The most prominent trends are:

- Concentration of production
- Transition towards the use of one transfer price for the whole of Europe (euro pricing)
- Organisation of business functions along product or business group lines instead of territorially
- The growth of E-commerce

Concentration of production

Concentration of production is the most obvious and high-profile indicator of the realignment of business operations. Because of the considerable reduction in the number of production facilities, cross-border intra-group trade between the few remaining manufacturing units and associated marketing/sales organisations in other Member States will grow significantly. In itself, this growth in intra-group trade is already creating a larger risk because of the sheer volume and value of such trade. Whereas in the past exports to affiliated companies in other Member States were the exception rather than the rule, it is now common practice for manufacturing units to export most of their products to affiliates.

Euro-pricing

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 will become much more transparent. Consequently, 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 of which production facility the goods are sourced from. 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 belong to the same single European manufacturing unit. Though euro pricing makes a great deal of sense commercially and is fully in line with the concept of Europe as one domestic market, tax obstacles still pose major problems, for instance where losses arise in less efficient manufacturing plants.

Product and function lines

Not only manufacturing, but also other functions within groups of companies 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, the costs of these functions will have to be allocated through some sort of cost-sharing mechanism. As business integration in Europe proceeds at great 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 differing requirements set by the various tax administrations is becoming very real. UNICE feels that it is essential that the Member States address this issue by agreeing on mechanisms for allocating and recovering (centrally) incurred costs. These mechanisms should be easy to administer, efficient and result in cost always being deductible somewhere. Concentration of all sorts of business functions is indispensable to exploit the full cost-saving potential offered by the Single Market. Tax systems should therefore facilitate, rather than hinder this trend.

E-commerce

The growth of E-commerce will have a major impact on the way business is done in the EU. It is a brand-new business in itself, which will not be stopped at the Member States' borders and will be almost impossible to analyse and address along national lines. More importantly, E-commerce will speed up and reinforce all the trends identified above. As the importance and constraints of geographical distances fade, business functions will be europeanised to a much greater extent than before. Furthermore, E-commerce will increase price transparency and therewith the economic argument for euro pricing.

Failure of current EU tax agenda to address the real competitive issue

The current EU tax agenda does not reflect these trends. Its underlying objective is aimed at protection of national revenue tax bases, as illustrated by the 1997 Tax Package currently stalled in the Council. This one-sided preoccupation is not balanced by initiatives aimed at improving company taxation conditions in the EU, facilitating the growth of trade and investment and enabling business to compete on equal terms in the EU and world market places. To address the commercial reality all tax costs need to be taken into account; not just national corporate income taxes, but also the costs that are caused by a lack of co-ordination and common measures to deal with the friction and lack of symmetry between 15 different national tax jurisdictions in the EU.

III.2 The way forward

In UNICE's view, therefore, the Member States' focus should shift towards improving the tax environment for companies operating in the EU. This process should start with a discussion on an optional (i.e. companies would make a once and for all choice to be taxed by the specified regime) European system of taxation aimed at pan-European enterprises. For UNICE, the essential component of such a system would be an EU-wide consolidated taxable base. If properly structured, such EU-wide consolidation of taxable results would eliminate a large number of existing tax obstacles to cross-border economic activity and business integration, particularly for SMEs. Moreover, to the extent that such a system would remove the scope for special or discriminatory tax regimes, it may well be a more appropriate and successful means to eliminate "excessive" tax competition than the EU Code of Conduct Group's recommendations currently under discussion as part of the Helsinki tax package.

Transfer pricing would no longer pose problems, as the price at which goods are transferred between business units in various Member States would become irrelevant in tax terms. The same would apply to the allocation of costs incurred within the group structure. The difference between branches and subsidiaries would also lose its relevance for tax purposes. Cross-border loss compensation would automatically be achieved, as it is inherent in the consolidation of taxable results. Cross-border mergers and business integration would no longer be hampered by the need to recognise gains upon transferring assets or shares between Member States.

In the light of the (tax) history of countries such as the United States, Canada and Switzerland, the move towards a consolidated taxable base is a logical development. The integration of cross-border business activities in these countries made it increasingly difficult to draw boundaries in a single market solely for tax purposes and made such boundaries stand out as a major obstacle to economic activity. Therefore, these countries adopted systems which address these obstacles by having a common taxable base but which simultaneously maintain flexibility by leaving the decision on tax rates to the different jurisdictions. Whilst the situation of EU Member States is not directly comparable, as integration tendencies intensify in the EU it is time to expand the debate beyond the mere protection of national tax bases to the development of a tax system suitable for the Single Market.

UNICE believes that such a system should have the following characteristics:

- The system must be optional and not rolled out across Europe on a mandatory basis. Not all enterprises run pan-European operations which are so integrated that they need to switch to a European system.
- Some elements of flexibility and tax competition must be retained, enabling Member States to address the specific needs of their economies, while providing a necessary counterweight to the upward pressure on public expenditure.

In essence, the development of an optional European system will require a balancing act between competition, coordination and harmonisation, in line with the principle of subsidiarity. The adoption of an appropriate legal instrument for a European Company Statute (ECS), with an accompanying optional system of taxation, has been advocated by UNICE as a means to strike such a balance. However, progress on the ECS has been very slow and the prospects are uncertain. In view of the urgent need for action in the tax area, UNICE feels that the two need no longer necessarily be linked. Some progress in eliminating tax obstacles to pan-European companies can also be made without the ECS, though the ECS itself cannot be implemented without agreement of a suitable tax regime.

Within European business circles, the discussion on how to shape an effective and efficient system for taxing pan-European businesses has been gaining pace over the last year. Various ideas have been developed which merit further study. Apart from the issue of what taxable base should be used, there is also the important question of what key should be applied for allocating to the Member States either part of the consolidated base or part of the revenue generated.

In the remainder of this chapter, UNICE discusses three possible approaches in more detail. However, a more comprehensive study of the relative merits of these alternative systems will be required and UNICE urges the Commission and the Member States to initiate such a study as soon as possible, working in cooperation with company tax experts.

III.3 Cross-border consolidation: three possible approaches

1. Home State Taxation (HST)

This concept allows enterprises that are headquartered in and operate from a Member State to adopt the national tax system of that Member State and apply it to their activities in those Member States that have joined the system. Thus, the tax base for all operations of a group of companies within the system is calculated under the rules of a single tax system – those of the parent company's home state.

The tax base is then divided between the Member States according to a pre-agreed formula and subsequently taxed separately in each Member State in which the group conducts its activities. Each Member State applies its own tax rate to the fraction of the group's taxable profits allocated to the activities performed in that State.

Thus, for example, a Swedish company can use the Swedish tax system to calculate the profits of all its branches and subsidiaries, wherever they are established within the EU (if all Member States join the system) as if all activities are performed in Sweden. The profits calculated under Swedish rules are then divided between the company, its permanent establishments and subsidiaries and are taxed in those Member States in which they actively conduct their operations. Thus, they pay tax at each Member State's corporate income tax rate on the profits allocated to the enterprise's operations in that State.

However, only Member States with similar (not necessarily identical) taxable bases are supposed to be allowed to participate in the system. These states will agree on accepting each other's taxable base as a basis for the application of the tax rates in the individual states. After this agreement there will be no (or only a very limited) possibility of changing the taxable base in any of the states without the consent of the other states participating in the system. Therefore, there will be no or very little room for competition with regard to the taxable base. Obviously, competition with regard to the general rates is not ruled out in this system.

An open question is how to define the concept of 'similar' with regard to taxable base. Should 'similar' be measured according to the body of law in the participating states or should 'similar' refer to the outcome of those laws' application. Notwithstanding the political dimension of this discussion, UNICE would prefer similarity in outcomes as the guiding principle. Possibly the results of the Commission's study currently being undertaken into the effective tax rates in the EU could provide the appropriate instrument to assess the similarity in taxable bases between the Member States that could participate in a system of HST.

The main advantage of such a system is that it could be introduced fairly swiftly in the medium term. It is likely to be particularly helpful for SMEs which need only cope with their own, home state, tax rules.

2. Common Base Taxation

In 1988, the Commission published a draft proposal for a directive on the harmonisation of rules for determining the taxable profits of enterprises. This proposal intended to offer common European rules for rate assessment, but without consolidating profits throughout Europe. Expanding on this proposal which never made it beyond the initial stage, one could envisage a system of European taxation based on a consolidated result calculated according to European rules. The taxable base determined according to the European rules would then be allocated to the Member States according to a pre-agreed formula, leaving it to them to apply their tax rates to this base.

An even more far-reaching solution would be to define the rate as well as the taxable base. This, however, would probably be unacceptable to both business and Member States. Business would not accept a system that does not have a safety valve to counter rising rates and governments would not be eager to hand over one of the last macro-economic tools left to them. Moreover, given the diversity within Europe, a fixed general rate would give rise to inefficiencies. The rate might be too high in areas where economic conditions justify a lower than average rate and possibly too low in areas where such conditions would justify a higher than average rate. Moreover, a rate can only be set by a unanimous Council decision. Consequently, the introduction of a European rate would render the system highly inflexible.

Obviously, common base taxation could give rise to distortions within countries, as not all companies in a Member State would be subject to the same rules defining the taxable base. Consequently, differences in the effective burden of taxation within Member States might occur (as is the case under the HST system). This problem could be solved by granting Member States the choice of whether they want to apply their own rate (where the computation of the taxable base under the rules of common base taxation did not differ much from their regular computation) or to apply a special rate if the difference was too big. Also this freedom to set a special rate could make the transitional period easier for those Member States that wished to bring their own taxable base into line with the taxable base under the common base taxation. A major benefit of common base taxation would be that the tax systems of the Member States would show a natural tendency to converge once it was introduced.

UNICE believes that common base taxation should eventually be the target for an optional EU system of company taxation.

3. Commercial accounts

As an alternative to a consolidated European result based on newly developed rules, the taxable base could also be determined from the commercial accounts. However, in some countries the commercial accounts differ quite substantially from the fiscal accounts, making the transition from fiscal accounts-based taxation to commercial accounts-based taxation a large step with the potential to produce big winners and losers in different sectors and between individual firms.

A further difficulty is that accounting rules are a less precise tool for the computation of taxable income. Building a tax base on the group accounts would be even more difficult as the accounting principles at this level are more flexible. In view of these difficulties, whilst (generally accepted) accounting principles might never be the sole denominator to assess taxable profit, they are very well suited to serve as a platform from which to develop a pan-European taxable base.

III.4 Other aspects

Regardless of the alternative chosen, some other considerations need to be taken into account:

1. Which allocation key should be used?

a) Water's edge Formula Apportionment.
The allocation of the taxable base could be determined according to a pre-agreed formula such as for example property, payroll and sales. This formula can be refined to take into account the differences between enterprises and their activities. However, the formula must not become too complicated.

b) Gross Domestic Product
Allocation could be based on Gross Domestic Product (GDP). This is a fairly rough and ready method which is likely to give rise to major distortions since it does not take into account the size of an enterprise's business in a particular country. Moreover, in economic terms, this approach may prove to be pro-cyclical if applied without the proper adjustments.

c) Adjusted VAT base
A third possibility is the use of a VAT base, adjusted for intra-community transactions, exports to third countries and, possibly, depreciation. If and when a common definitive VAT system is agreed, only the latter adjustment would still be necessary since the former category would be included in the domestic VAT return as domestic sales.

d) Hybrid
Another idea is to base the final allocation on a mixture of A, B and C. Such a mix may prove to deliver the most even distribution, taking the downsides of A, B and C into account. A further refinement could be made concerning the different types of economic activity, a so-called sectoral approach.

UNICE would like to point out that reduction of complexity should be the guiding principle behind any drive towards an optional European system of company taxation. Notwithstanding the fact that it would in theory be possible to arrive at a perfect key, practicality should not be lost from sight. Therefore, UNICE feels that it is important to accept that no key can be absolutely perfect and simple at the same time.

2. Related issues

If the Member States are prepared to pursue any of the possible approaches further, there are also other issues of a more technical nature to consider but only an overview of these is given here:

- Applicable treaties;
- Non-EU income (positive and negative);
- Participations outside the EU; Regional incentives;
- Which enterprises can apply for European taxation;
- Controlled Foreign Company legislation;
- Finance income;
- Transition from one system to another.

UNICE is ready to discuss these issues in greater detail.

3. Timetable

UNICE acknowledges that an instant transition towards Common Base Taxation is not feasible in the immediate term. Therefore UNICE foresees a gradual phase-in starting with the adoption of the principle of Home State Taxation. This transitional period would start with an investigation into which countries could offer the option of Home State Taxation in the short to medium term. This research should start as soon as the panel of academics has concluded its report on the differences in effective corporate taxation in the EU.

Subsequently, the countries whose tax systems are similar enough to offer optional HST should start making arrangement for a transition to it within three years. Meanwhile, a second panel should study the tax systems of the remaining Member States to see which changes would be necessary for them to be able to offer HST in the next five years. Over a ten-year period, all Member States should have made optional HST available.

Finally, when all (or most) Member States have HST, the Commission should prepare the transition to optional Common Base Taxation. During the ten-year period that is reserved for the EU-wide provision of HST, the Member States, Commission and European business and industry should jointly develop the rules for the system of optional Common Base Taxation. Logically, Common Base Taxation would by then not be a major deviation from the Member States' tax systems as they will already have been aligned to a large extent in the transition to HST.

IV. Conclusion

In this paper, several possible approaches have been put forward for short and a longer-term solutions to cross-border company taxation problems in the Single Market. In UNICE's view these are by no means mutually exclusive. They rather represent different stages of evolution towards an optional European system of company taxation. In UNICE's view, optional Common Base Taxation should eventually be the target. Such a pan-European solution, eliminating the tax obstacles that prevent the Single Market from achieving its full potential is in the interests of all enterprises, especially SMEs, which have business and investment activities in many Member States.

No matter which approach is adopted, it is beyond doubt that taxation based on a consolidated taxable result would eliminate a large number of tax obstacles to cross-border economic activity and business

integration. As company taxation obstacles are one of the major impediments to the proper functioning of the Single Market, UNICE sees the development of such a system as highly desirable. It is clear that this is a long-term solution, but UNICE urges both the Commission and the Member States to engage in dialogue with the business community as soon as possible.

In the meantime action should be taken to implement a number of short-term solutions to some of the problems identified by UNICE as a matter of priority. For European business and industry this should lead to a more balanced EU tax agenda that properly addresses the needs of companies operating in the Single Market.

Annex 1.
Cross-border loss compensation

Recommendations:

- Reconsider directive on cross-border loss compensation
- Investigate possibilities for horizontal compensation
- Set minimum rules for loss carry-forward and carry-back

Background
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 but others do subject to specified conditions. 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 arise 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 more integrated domestic market in tax terms 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.

Cross-border loss compensation first appeared on the EU agenda a long time ago. Since then it has been in and out of discussion. The last discussion failed because the draft directive was too disadvantageous for the smaller Member States. Because the directive offered only the possibility of vertical loss compensation, the smaller Member States would have been put at a serious disadvantage compared with 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.

Furthermore, the Member States will have to address the differences in carry-forward rules as (the lack of) rules influences the possibilities for loss compensation. Although this is in essence a national issue, it has a profound impact on the possibilities of developing 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 with 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. That the latter operate from a more integrated domestic market in tax terms and full offset of losses within this market is a matter of fact.
- Thirdly, 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.

Pending progress on the broader issue of cross-border loss compensation, UNICE could envisage an agreed minimum period for loss carry-forward and carry-back within all member states as a start in dealing with this obstacle to cross-border economic operations.

A further issue to address is the differing treatment of groups of companies. Enterprises that are located in Member States having the possibility of taxing a group's consolidated result within that Member State are at an advantage compared with enterprises that cannot apply for consolidated taxation.

Annex 2.
Cross-border business integration

Recommendations:

- Enlarge the scope of the Merger Directive to include all taxes levied in the process of merging two or more companies.
- Reconsider the various interpretations that the Member States have given to the Merger Directive.

Background
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.

UNICE is convinced that in many more cases, without needing to make 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 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 available from utilisation of 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.

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 of 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.

Annex 3.
Arbitration Convention

Recommendations:

- 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.
- Change the wording of Article 5 so that transfer prices cannot be changed by tax authorities until all the tax administrations concerned have reached an agreement as to what the correct transfer price should be.
- Make clear that Article 7 may not be interpreted so as to prevent arbitration proceedings being commenced before the other state concerned has formally notified that it does not accept the correction.
- Delete paragraph three of article 7.

Background
The Arbitration Convention, which is strictly not a matter of EU law but an intergovernmental agreement, 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 is 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.

Definitions remain uncertain if more than two Member States are concerned. Furthermore, double taxation conventions rarely contain definitions, but mostly refer back to the national legislation of the states involved. Consequently, the application of the Convention may lead to different interpretations if different Member States are involved. As the correct application of the Convention is not within the jurisdiction of the European Court of Justice, these differences of interpretation may be hard to solve, and the solution reached, if any, will be different in every case.

UNICE acknowledges that the form of a multilateral intergovernmental agreement was chosen to offer an instrument of dispute resolution acceptable to the 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 UNICE understands the Member States' reluctance to hand over dispute resolution, UNICE recommends insertion of an article allowing recourse to 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. 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 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. This would have the advantage of giving Member States 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. 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. UNICE recommends deletion of this paragraph.

Annex 4.
Elimination of withholding tax on inter-company payments of royalties and interest

Recommendations

- Reduce holding period to one year as ownership for a full year should be sufficient to indicate a serious investment
- Reduce holding percentage to 10% since this level represents an important business commitment, indicating the type of relationship that would merit avoiding the consequences of withholding taxes
- Delete article 7 of the draft Directive as the question of 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

Background
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 the Commission has 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. It is concerned, however, that Member States may have subsequently narrowed the scope of the draft directive in the course of negotiations in the Council. Furthermore, UNICE feels that there are still some areas in which the draft Directive is open to improvement.

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.

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.

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.

Annex 5.
UNICE papers 1988-1999

16-10-1988	UNICE observations on the preliminary draft proposal for a Directive on the harmonisation of rules determining the taxable profits of undertakings.
16-1-1990	UNICE position paper on the consolidation of losses
26-9-1991	Company taxation: UNICE suggestions for further harmonisation
15-11-1991	UNICE position on a proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States (COM(90) 595 final).
3-6-1992	UNICE position on the recommendations for harmonisation in the area of company taxes as made by the Ruding Committee
23-12-1992	UNICE's reaction to the Commission Communication subsequent to the conclusions of the Ruding Committee indicating guidelines on company taxation linked to the further development of the Internal Market (SEC(92)1118 final).
7-11-1995	Letter to Commissioner Monti on business priorities for the completion of the single market in the area of company taxation.
8-7-1996	Lack of Community action in company taxation and its attendant costs for European business and industry
4-11-1998	Company taxation in the Single Market: a business perspective
17-9-1999	Joint UNICE/ERT contribution to the European Commission's panel of independent experts on company taxation on "Transfer pricing issues and the Arbitration Convention", and "the impact of tax arrangements on the optimal EU business strategy".