Legislative Initiative in the Field of Direct Taxation in the EC

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1 Introduction

The launching of the internal market in 1993 and the introduction of the Euro in 1999 as the single currency of the majority of the Member states of the European Community (EC) have a profound impact on matters relating to direct taxation, especially those relating to the cross border savings income taxation and cross border taxation of interest and royalty payments made between companies. The introduction of the euro has successfully removed the distortions related to exchange rate risks within the euroland and simultaneously shed more light on the remaining tax distortions within this monetary zone. There is thus a growing need and urgency to make progress towards tax reform in the EC, particularly in the field of corporate taxation.

The aim of this article is to highlight the past legislative developments relating to the harmonisation or approximation of direct taxation in the EC and the current efforts to streamline matters relating to cross border taxation of interest and royalty payments made between companies. The European Court of Justice (ECJ) have also contributed enormously to minimise the distortions in the internal market caused by the lack of a uniform system of direct taxation but the scope of this article will be limited to the legislative initiatives in this sector.[1]

2 Legal Basis for Harmonisation of Direct Taxation

There is no specific provision in the Treaty of Rome, which provides for harmonisation of direct taxation.[2] The subsequent Treaty amendments such as

1 On the ECJ contribution, *see e.g.*, Lantremange, Gaelle, *Freedom of Establishment in the Direct Tax Jurisprudence of the European Court*, EC Tax Journal, (2002) Volume 6, at 187.

2 Mohamed, Sideek, *National tax laws reign supreme over capital freedom in the EU*, European Financial Services Law 1995, Volume 2, at 180-186.

the Single European Act, the Maastricht Treaty on European Union, the Amsterdam Treaty and the Nice Treaty, do not explicitly deal with this issue. The EC Treaties do not provide a mechanism to move towards tax co-ordination or harmonisation among the Member states. Rather than making progress towards converging the tax systems of the Member states, Article 58(1) of the EC Treaty explicitly confers supremacy on national tax laws over Community freedom to move capital across borders.

There is however certain Treaty provisions which may be indirectly invoked for the purpose of harmonisation of direct taxation.[3] Article 94 of the EC Treaty directs the Council to adopt measures by way of unanimous voting to take appropriate measures to approximate the ‘law, regulation or administrative action in Member states which have as their object the establishment or functioning of the internal market’. As an exception to the unanimity-voting rule in Article 94, Article 95(1) provides for co-decision procedure to adopt laws, which have as their objective the establishment of the internal market.[4]

The invocation of Article 95(1) EC to harmonise the EC tax system could be justified on the basis of the Treaty objective to ensure harmonious development of its internal market. The difference in national laws on the taxation of capital income is liable to distort the smooth flow of capital within the EC and thereby offend the Treaty objective to develop a dynamic and stable internal market. It may be argued that such laws should be approximated to ensure the proper functioning of the internal market. However Article 95(2) excludes the application of co-decision procedure to fiscal matters. The effect of this qualification is that unanimity among Member states will continue to be an essential factor in order to legislate in the field of direct taxation.

3 Past Initiatives Towards Tax Harmonisation

Even though the EC Treaties do not provide a proper legal basis for tax harmonisation, certain efforts were made by the Community to achieve this goal. It is useful briefly to examine those past initiatives to highlight the difficulties currently confronted by the EC in reaching a compromise on this politically sensitive issue. There is no guarantee that the current efforts to reform direct taxation of cross-border capital income would succeed. A brief reflection on the past experience towards tax harmonisation would thus be a useful exercise.

Since the founding of the EC in 1958, company taxation has received particular attention as an important element first for the establishment and then the completion of the internal market. The impact of corporation tax on competitiveness was examined on several occasions by different working parties to discuss tax bases and instances of favourable tax treatment. The Neumark report of 1962 and the Tempel report of 1970 provided for a limited degree of harmonisation of the corporate tax system, base and also rates. These reports

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3 Art 220 EC for example declares that double taxation should be avoided within the Community.

4 Art 251 EC provides for co-decision procedure to adopt a directive.

were later withdrawn due to lack of political support for any comprehensive corporate tax reforms at the EC level.

The last comprehensive study on company taxation was in 1990 where the European Commission asked a committee of independent experts chaired by former Dutch Finance Minister Ruding to examine whether differences in corporation tax caused distortions in the single market, particularly as regards investment decisions and competition, and to suggest ways of overcoming this problem. The Ruding report makes a detail analysis on the relation between company tax systems and the functioning of the internal market.

The Ruding report declared that the differences in taxation between Member states could potentially influence companies' investment decisions and creates distortions of competition. It also made specific recommendations designed to eliminate double taxation of cross-border income flows and harmonise three components of corporation tax, namely the rates, the assessment basis and the administrative collection system. The committee also recommended the elimination of double taxation dealing with abolition of charges, regulation of transfer pricing, treatment of losses abroad and completion of the network of bilateral tax agreements. The report also highlighted the need to ensure effective taxation and prevent tax evasion but little progress was made to implement these recommendations.

3.1 Legislative Action on Corporate Tax Reforms

There is however some measures adopted to minimise distortions to the proper functioning of the internal market due to the absence of a harmonised system of direct taxation within the EC. In 1990 the EC adopted two directives and a Convention to remove some of the tax obstacles to cross border cooperation and activity.

3.2 Merger Directive

The Merger Directive 90/434/EEC[5] was designed to cut down tax measures that might hamper business reorganisation. Capital gains taxes and transfer taxes on cross border restructuring operations are extremely high within the EC. Such transactions under national tax laws normally incur heavy tax costs if the transaction involves assets leaving the jurisdiction. Some Member states impose a corporate level tax on any capital gains realised on a transfer or exchange of shares or on the liquidation of a company.

The directive applies to mergers, divisions, and transfers of assets and exchanges of shares in which companies from two or more Member states are involved. The directive provides for a common system of taxation for cross-border restructuring operations. It seeks to remove tax barriers against cross border linkages of companies. The directive provides for the deferral of corporate tax on cross border structuring operations.

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5 1990 OJ L225/1.

The scope of application of this directive is however too narrow to eliminate all tax barriers to the free movement of companies within the EC. The Commission put forward a proposal for a Council Directive amending Directive 90/434/EEC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member states[6]. The aim of the amendment is to extend the scope of application to all enterprises subject to corporation tax, irrespective of their legal form.

3.3 Parent-Subsidiary Directive

There are various disadvantages suffered by companies in different Member states within a parent-subsidiary relationship because of inconsistencies in treatment by national tax systems. The aim of the Parent-Subsidiary Directive 90/435/EEC[7] is to eliminate some of the disadvantages such as double taxation on cross border dividend payments between parent and subsidiary companies. It seeks to abolish double taxation of profit distributed between parent companies in one Member state and their subsidiaries located in another Member state.

The scope of the directive is however limited. It is subject to national safeguards to prevent fraud or abuse[8]. It applies only to companies of a form listed in the Directive. Each company must be resident for both national law purposes and double tax convention purposes within a Member state. The effectiveness of the directive is further reduced by the fact that it does not cover all companies subject to corporation tax. It applies only where the parent has a 25 per cent interest in the subsidiary. It does not cover all types of tax charge such as transfer taxes that can arise upon a restructuring. The directive imposes limits on cross border loss relief, which may lead to double taxation.

3.4 Arbitration Convention

The Arbitration Convention 90/436[9] provides for a dispute resolution procedure in the area of transfer pricing. The Member states concluded this Convention based on Article 293 of the EC Treaty, as a means to prevent double taxation in connection with the adjustment of profits between associated enterprises from different Member states.

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6 COM(93) 293 final CNS0915 - OJ C 225, 20.08.1993.

7 1990 OJ L225/6.

8 Article 1 para 2.

9 1990 OJ C225/10.

4 Current EC Legislative Initiatives to Reform the Corporate Tax System

There are new developments within the EC, which call for a renewed assessment of its strategy in the field of company taxation. The overall economic framework has changed since the early nineties. The liberalisation of the internal market has facilitated multinational companies to operate across the borders. There had been a wave of international mergers and acquisitions particularly in the industrial and financial sectors. The introduction of the euro has not only minimised the transaction costs of the companies but also provide them easy and cheaper access to a wider and deeper financial liquidity. The cross border activities of EC companies have been further facilitated by the emergence of electronic commerce. As a result of these far reaching developments within the EC, multinational companies now view the whole internal market as their home market.

The major obstacle for the companies to operate in an efficient and effective manner is the lack of progress made to eliminate the obstacles relating to cross border corporate taxation. The EC companies are confronted with 15 different company tax systems within a single economic zone. These tax differences faced by companies located in different countries but competing in the same market affect their international competitiveness. The existence of a multiplicity of company tax systems within a single market causes losses of economic efficiency, higher compliance costs and contributes to lack of transparency. The current efforts to reform the direct taxation system in the EC should be viewed in this background.

4.1 The Tax Package of 1 December 1997

In order to ensure that the EC companies could effectively exploit the benefits of the internal market facilitated by the introduction of the euro and other factors, the EC decided to adopt pragmatic measures to modernise its corporate tax system. The EC's pragmatic approach was formalised in a Commission communication on a package of measures to combat harmful tax competition in the EC.[10] The Ecofin Council approved the tax package proposed by the Commission on 1 December 1997.

The aim of unveiling this tax package was to ensure that taxation policies were better geared towards the EC goal of completing the internal market. The tax package aims to prevent excessive losses of tax revenue and to encourage tax structures to develop in a more employment friendly way. The communication does not seek to have overall direct tax harmonisation. It however requires some coordination of the Member states corporate tax systems to ensure the smooth functioning of the internal market.

The tax package consists of a code of conduct for business taxation; measures to remove distortions in the taxation of income from savings and measures to

10 A package to tackle harmful tax competition in the EU, (COM (97) at 564.

abolish withholding tax on cross-border payments of interest and royalties between companies of different Member states.

4.2 Code of Conduct for Business Taxation

The Code of Conduct for business taxation is not a legally binding instrument but it clearly does have political force. In terms of this Code, Member states agreed to roll back existing tax measures that constitute harmful tax competition, which may affect the location of business activity within the EC.[11] The Member states also committed themselves to refrain from introducing any new harmful tax measures. They also agreed to re-examine their existing laws and amend such laws if necessary. The Member states also agreed to inform each other of existing and proposed tax measures, which may fall within the scope of the Code.

The Code was however specifically designed to detect only such measures, which may unduly affect the location of business activity in the EC by being targeted merely at non residents and providing them with a more favourable tax treatment than which is generally available in the Member state concerned. The Ecofin agreed all such measures must be dismantled by 1 January 2003 and the benefits must run out by the end of 2005. In order to ensure the effective implementation of the Code, the Commission shall report to the Council annually on its implementation.[12] A Code of Conduct Group (Business Taxation) was also established by the Ecofin to assess the tax measures that may fall within the scope of the Code.[13]

4.3 Taxation of Cross Border Savings Income

The other measure envisaged in the Tax package is to adopt a directive on the taxation of cross border savings income.[14] It provides for a co-existence model where majority of the Member states agreed in principle to exchange information on matters relating to cross border taxation of savings income. The Member states which are opposed to the information system agreed to impose a minimum withholding taxation on such savings income.

There are certain conditions, which should be satisfied for the adoption of the proposed Savings Directive. The Commission has to negotiate equivalent agreements on an information system with a number of important non-EC financial centres.[15] The Member states agreed to adopt this directive in

[11] These tax measures were identified in a report of the *Primorolo Group* to the Commission, which identified 66 harmful tax measures. On the Primorolo report, *see* Easson, Alex, *State Aid and the Primorolo List*, The EC Tax Journal, volume 5/2 (2001) at 109.

[12] *See e.g.* the first annual report, Brussels, 25.11.1998, COM (1998) 595 final.

[13] 9 March 1998, 98/C99/01; OJ of 01.04.1998 No. C99 at 1.

[14] *See* Mohamed, Sideek, *A critical assessment of the proposed directive on taxation of cross-border savings income*, The EC Tax Journal, Volume 6 (2002) at 45-68.

[15] These include Switzerland, the US, Liechtenstein, Monaco, San Merino.

accordance with the principle of subsidiarity set out in Article 5 of the EC Treaty.[16] They agreed to reach a consensus on the scope of the directive by the end of 2002 but failed to meet the deadline.

5 Taxation of Cross-border Payment of Interest and Royalties

The third element contained in the tax package is to adopt measures to introduce a common system of taxation applicable to interest and royalties made between associated companies of different Member states. In order to achieve this objective the Commission presented a proposal for a directive on a common system of taxation applicable to interest and royalties made between associated companies of different Member states.[17]

6 Essential Features of the Proposed Directive

The proposal for a directive on a common system of taxation of payments of cross border interest and royalties between associated companies is relatively a short legal instrument, which contains altogether twelve articles. Article 1 declares that Member states shall exempt interest and royalties from liability to any taxes where such income had already been subject to taxation in another Member state. This provision however will not apply in situations, which do not represent cross border payments. If for instance the beneficial owner of the capital income is resident in the same Member state where the company pays out the interest and royalties, the directive shall not apply to such transactions.

The proposed directive defines interest income from debt-claims such as income from bonds or debentures, including premiums and prizes attaching to such bonds or debentures. It defines royalties to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, scientific work, or software. The cross border payments of interests and royalties, which are considered to be so by virtue of a double taxation convention between the Member state where the interest or royalties arise and the Member state of the beneficial owner or in the absence of a convention, by virtue of the tax legislation of the Member state where the interest or royalties arise, are covered by the proposed directive.

The company is defined largely in line with the definition set out in the EC Treaty. A company should fulfil three criteria to benefit under the proposed directive. It shall be formed in accordance with the law of a Member state and have its registered office, central administration or principal place of business within the Community. The activities of the company shall present an effective and continuous link with the economy of that Member state. Such a company should also be considered to be resident in that Member state according to its tax laws. It should not be considered to be resident for tax purposes outside the

[16] Recital 12 of the Savings Directive.

[17] COM (1998) 67 final of 04.03.1998, OJ of 22.04.1998, No 123 at 9.

Community within the meaning of a double taxation convention concluded with a third country.

Under the proposed directive, a company is treated as an associated company of a second company if at least the first company has directly or indirectly a minimum holding of 25 per cent in the capital of the second company or the second company has a minimum holding of 25 per cent in the capital of the first company or a third company has a minimum holding of 25 per cent in the capital of the first and second company. The Member states are however given the option to apply the directive to companies where the level of the holding concerned is less that 25 per cent. It can also replace the criterion of a minimum holding in capital with that of a minimum holding of voting rights. A Member state may withdraw the benefit of the directive from companies of that Member state in circumstances where these conditions have not been maintained for an uninterrupted period of a minimum of two years.

The proposed directive defines a beneficial owner of payments of interest or royalties to mean a company of a Member state or a permanent establishment, which holds those payments for its own benefit and not as an agent, trustee or nominee for some other person. A permanent establishment shall be a fixed place of business situated in a Member state through which the business of a company of another Member state is wholly or partly carried on.

The Member states shall retain their competence to adopt appropriate measures to combat fraud or abuse. They may withdraw the benefit of this directive in the case of any transaction, which has as its principal objective tax evasion or tax avoidance.[18] The proposal contained an anti abuse clause, denying the benefits of the proposed directive where the recipient of interest and royalties payments is subject to taxation at a rate below the normal company tax rate in its country of residence.[19]. This provision was later abandoned due to opposition from some of the Member states.

6.1 Tax Models Proposed for the Future

The Commission submitted to the Council a communication identifying four potential models for providing companies with the necessary consolidated tax base for their EC wide operations.[20] These models are either based on a mutual recognition approach or rely on a limited form of harmonisation. Each of the models prescribed in this communication, which are briefly highlighted below, has its specific advantages and disadvantages. It also raises complex technical and political questions for its adoption and effective implementation in the EC.

One of the models identified in the communication is based on Home State Taxation. According to this model, a multinational group can opt for computing

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[18] Article 6.

[19] Article 7.

[20] Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, *Towards an Internal Market without tax obstacles, A strategy for providing companies with a consolidated tax base for their EU-wide activities* COM (2001) 582 final.

its consolidated tax base according to the rules of the Member state where its headquarters are based. The home state rules would apply to consolidated profits of entire enterprises. The tax rates according to this model would be set in each Member state. The profits of the companies would be allocated and paid locally.

The other model known as the Common Consolidated Base Taxation, would enable a multinational company to opt for computing its consolidated tax base according to a completely new set of restructures of EC wide rules. The tax rates according to this model would be set in each Member state. The profits and tax would be allocated to each Member state.

The third model known as the European Corporate Income tax model prescribes that company tax shall be levied at the EC level and revenues would go at least partly to the EC budget. A single tax code would apply across the EC. A new tax authority shall administer this model. This tax will be compulsory for all companies.

The fourth model proposed by the Commission is known as the Compulsory Harmonisation of Existing Tax Bases model. According to this model, all companies in the EC would compute their consolidated tax base according to harmonised rules. All Member states would apply the same rules and this tax will be compulsory for all companies.

7 Concluding Remarks

The absence of a harmonised system of direct taxation within the EC will not contribute to attain the Treaty objective to ensure the proper function of the internal market. The requirement for unanimity voting is one of the reasons for the Council for not agreeing on a more comprehensive piece of legislation to deal with direct taxation of cross-border capital income.

There are wide differences between Member states in the real level of company taxation. Germany and France has the highest tax burdens while Ireland, Sweden and Finland are at the lower range of the ranking.[21] As the EC law stands today, decisions on levels of tax rates remain within the exclusive competence of the Member states.

In the absence of an effective system of EC tax coordination, there is a great risk of harmful tax competition among the Member states. Such tax competition could dramatically erode the tax base and tax sovereignty of the Member states. The aim of the Tax package is to ensure that Member states do not resort to tax competition in a manner, which could distort the proper functioning of the internal market.

The Parent-Subsidiary and Merger Directives as well as the Arbitration Convention have played a major role in removing some of the tax obstacles for groups of companies within the EC. These legal instruments have however proved to be insufficient to keep pace with the growing integration in the internal market. Their scope of application should be extended to cover a wide range of companies, taxes and transactions. The provisions of the Arbitration

21 According to the European Commission figures, as at 2001, these countries had 39.35, 36.43, 10, 28 and 29 per cent corporation taxes respectively.

Convention should be made subject to interpretation by the ECJ, preferably by turning it into an instrument of Community law.

These legal instruments should be amended to extend their scope of application to all entities subject to company tax and especially the companies, which will be run under the European Company Statute[22] The full benefits of establishing a European Company will only be achieved if existing companies can form such an entity without incurring additional set up costs and avoid some of the existing tax obstacles of operating in more than one Member state.

The proposed directive on taxation of cross border interest and royalties seek to solve some of the tax obstacles faced by companies operating across the EC borders. The fate of the adoption of the proposed directive on cross border taxation of interest and royalties however depends largely on the adoption of the savings directive. The interest and royalties directive will be adopted only after the adoption of the savings directive. There is thus an element of uncertainty as to whether and when this directive will be adopted.

The EC should address the underlying problem of dealing with up to 15 different tax systems. It is necessary to provide the multinational companies with a consolidated corporate tax base for their EC wide activities through a single framework of company taxation. The initiative of the Commission setting out a strategy for providing companies with a consolidated tax base for their EC-wide activities is a step in the right direction. As in the past, it will certainly attract stiff opposition from Member states, which are not willing to part with their national tax competence. Such objections could be overcome if there are sufficient number of Member states, which are committed to adopt the Commission strategy to introduce a common tax base for the EC companies. The Treaty of Nice highlighted the possibility for enhanced cooperation by a group of Member states if agreement by all 15 Member states is not possible.

[22] Council Regulation (EC) No 2157/2000 of 8 October 2001 on the Statute for a European company (SE), OJ 2001 L294/1, 10.11.2001.