ADDRESS BY MR. RICHARD BURKE

MEMBER OF THE COMMISSION OF THE EUROPEAN COMMUNITIES

RESPONSIBLE FOR TAXATION,

TO THE

INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

CENTENARY CONFERENCE,

LONDON, 15 MAY, 1980.

Speech of Mr. Richard Burke, Commissioner, to the Institute of Chartered Accountants, London, 15 May 1980.

Introduction

I deeply appreciate the honour of addressing the Institute of Chartered Accountants of England and Wales on the occasion of its Centenary. I congratulate the Institute on reaching its Centenary and wish you every good luck for the future.

The EEC has only been going for just over twenty years. In that short time it has helped to transform the economies of Western Europe by removing barriers to trade and creating the conditions of a truly common market subject to the minimum of interference and distortion. What I propose to do, with your permission Mr. Chairman, is to show how the policies for which I bear particular responsibility, in the field of direct taxation, are contributing to this process.

You will forgive me if, at the outset, I briefly describe the constitutional position, as this will provide the necessary perspective to the comments I shall be making on individual tax measures. We in the Commission are responsible for making legislative proposals, usually in the form of directives. Once a proposal is made, it is sent to the European Parliament and to the Economic and Social Committee for their opinions. It is then up to the Council of Ministers, composed of Ministers from national governments, to decide whether or not to adopt the proposal.

Parent and subsidiary companies

In the field of direct taxation, most of our attention has been focussed on the corporate sector, as this is where the main economic activity, whether measured by turnover, employment or investment, takes place.

Our first company taxation proposals, in fact, date from 1969. In January of that year, the Commission proposed two measures to facilitate cross-frontier co-operation and integration : one measure laid down a common taxation system for parent and subsidiary companies, and the other a common system for taxing mergers etc., where the two companies concerned are resident in different Member States. Both measures were approved by Parliament and the Economic and Social Committee, but neither has yet been enacted. The power of decision, as I have said, rests with the Council.

Let me first of all deal with the parent and subsidiary proposal. It sets out by defining a corporation - and this holds good for all our company taxation proposals - as one which is subject to corporation tax (this will exclude, for instance, the Luxembourg holding company). It then defines a parent corporation as one holding at least 20% of the share capital of a company in another Member State. It goes on to provide that dividends passed from a subsidiary corporation to its paren parent shall not be subject to withholding tax and that such dividends should be exempt in the parent's hands. Thus international double taxation of inter-group dividends is avoided by the exemption method, which was the method prevailing among the original six Member States in 1969.

We recognise that this creates problems for the United Kingdom, Ireland and Denmark, who all apply the credit method for relieving double taxation and we have suggested a way out. The Commission suggestion, made in 1973 when the Council reviewed our proposal in the light of the Community's enlargement, was to permit the two systems to coexist on a temporary basis until the Community decided which common system to adopt. This suggestion was not, however, followed up because the proposal itself has remained blocked ever since 1973.

<u>Mergers.</u>

With the mergers proposal, the story is somewhat different. Let me begin by summarising its main provisions. The effect of the proposal is to defer the taxation that would otherwise take place when two or more companies from different Member States participate in a merger, division or contribution of assets. This deferment is conditional upon the consideration taking the form of shares in the acquiring company and upon the transfer of the assets and liabilities to that company taking place at their existing tax values. Provision is also made for the carry-forward under suitable safeguards of tax-free reserves and losses.

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Because a continental-style merger has the effect of turning the merged company into a permanent establishment of the merging company, our proposal also lays down rules for taxing permanent establishments : in particular, a Member State may not tax them more heavily than it taxes domestic companies which carry on the same activities.

The Council briefly reviewed the mergers proposal in 1973 on the occasion of the Community's enlargement, but matters did not stop there. Shortly afterwards, the Commission found itself deeply involved in work on the Statute for the European Company and on the Draft Convention on International Mergers, both of which impinged very directly on our proposal. Accordingly in February 1977, under the UK presidency, I am pleased to say, the Council launched an intensive programme of technical reappraisal. The momentum carried us through to the middle of 1978 when we emerged with an updated and operational text : the list of qualifying operations was for instance, extended to include the exchange of shares, which is more common over here than on the continent.

Having solved virtually all the technical problems, however, we came up against two major political obstacles. They both reflected the very real concern of two Member States that, once the tax deterrent to cross-frontier mergers was removed, there would be a massive migration of control and capital to other Member States. In one case, it was argued that the mergers directive would be used as an escape route from the onerous requirements of worker participation and in the other case, a classical system of company taxation would lose out heavily to the neighbouring system of full imputation. We in the Commission have pointed out to the countries concerned - I have personally taken the matter up with members of their governments - that their positions are mutually contradictory, but we have nonetheless offered to insert a safeguard clause in our proposal under which its provisions could be suspended where they were having unacceptable economic consequences. The offer has been rejected on the grounds that by the time the clause was invoked, the damage would have been done and that what is at stake is the national interest. We remain hopeful, however that our proposal which is, I repeat, in a state of instant readiness will eventually be adopted.

Company Taxation

I now come, Mr. Chairman, to the heart of the matter, namely the harmonization of corporation tax systems. In 1975 the Commission made a proposal to harmonize systems of company taxation and of withholding taxes on dividends. As this is such

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a fundamental measure, I should like to discuss in some depth the background to this proposal, its principal provisions and the present prospects for its adoption.

There can be no doubt that the achievement of a truly common market, to which the Treaty commits us, is impeded by the coexistence of nine (soon to be ten) different and divergent national systems of company taxation and withholding tax. They range from purely classical systems in Luxembourg and the Netherlands through partial imputation systems in Belgium, Denmark, France, Ireland, the United Kingdom and Italy, to a full imputation system, combined with differential rates of corporation tax on distributed and undistributed profits, in the Federal Republic of Germany. Such differences necessarily interfere with the free movement of capital, itself a fundamental aim of the Treaty, and with international dividend flows : an investor faced with the choice between dividends which suffer full double taxation under the classical system and dividends on which he will get full or partial relief from double taxation under an imputation system will be induced to opt for the latter, other things being equal. The same inducements will apply in the case of dividends distributed by a subsidiary company to its parent and by the parent company to its shareholders. An enterprise seeking to set up a subsidiary company will clearly be influenced in its location decision by these tax distortions. Differences of tax system are thus seen as helping to preserve the fragmentation of the European capital market and as diminishing the value of lifting physical controls on capital movements, as the United Kingdom has recently done.

Differences in systems also distort conditions of competition between enterprises whose distributed profits bear full liability and those whose distributed profits bear little or no liability. We must therefore strive to achieve a greater measure of tax neutrality.

Finally I would draw your attention to the possibilities of tax fraud in those Member States, which do not apply a withholding tax on dividends and which do not have the means of ascertaining the identity of the persons receiving dividends.

There are then cogent economic reasons for harmonizing the Member States' systems of company taxation and withholding taxes on dividends. The political reasons are no less compelling. There is the Council resolution of 22 March 1971 affirming harmonisation to be an essential part of economic and monetary union. There is also the fact that the present differences in taxation are so great that, as demonstrated

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earlier, they can and do affect business decisions on where in the Community to locate a subsidiary company or plant, often to the detriment of other Community policies, especially in such sectors as regional policy and transfer of resources.

Nor should we forget, Mr. Chairman, that the harmonization of corporation tax systems is crucially important to our other harmonization proposals in the field of the direct taxation of enterprises. This is especially true of the proposal for a mergers directive. One of the major obstacles to its adoption is the argument, that I have already quoted, that removing the tax barriers to mergers while company taxation systems remain unharmonized will simply accentuate the trend for mergers to take place in the countries which grant the most favorable treatment to distributed profits.

How then does our proposal tackle the deficiencies in the present situation ? First of all, it lays down a common imputation system under which partial relief is given for the corporation tax paid on a company's profits in the form of a tax credit attached to the dividend distributed out of those profits. This is, of course, the system you have in the United Kingdom, but with this important difference : all shareholders wherever resident in the Community, receive the same rate of tax credit on the company's dividends, that rate being determined and its cost being borne, as a general rule by the Member State of the distributing company.

Secondly, we propose common bands for the rates of corporation tax and tax credit . The normal rate of corporation tax is to be between 45% and 55% of profits ; however Member States are permitted, under certain conditions, to set rates outside these bands for specific policy reasons. The tax credit rate is more firmly fixed, between 45% and 55% of the normal rate corporation tax on the grossed up distribution.

Thirdly, we provide for a compensatory tax to be levied on companies which distribute dividends out of profits that have not suffered corporation tax. The compensatory tax is equal to the tax credit attached to those dividends, and by this method the tax credit emanating from a subsidiary company or a permanent establishment can be transmitted to the shareholder of the parent company or head office company situated in another Member State. Our proposal is, I believe, unique in providing this facility. I should add that the compensatory tax provisions

would not apply to the United Kingdom, where every distribution of dividends gives rise to an advance payment of corporation tax which is equal to the tax credit and which is not repayable.

The fourth main feature of our proposal is a withholding tax of 25% on dividends. There are two exceptions; no withholding tax is to be imposed on dividends distributed by a subsidiary to its parent corporation resident in the Community, it need not be imposed where the dividends are distributed to resident shareholders whose particulars are known to the tax authorities. In other words, the United Kingdom could choose not to apply withholding tax to UK residents, since all such shareholdings will be registered, but would have to apply withholding tax to all other dividends except those paid to parent corporations resident in the other eight Member States.

Now where have we got with our proposal? After four years of wrangling, the European Parliament has still not delivered a formal opinion as required by the Rome Treaty. Their interim report of 2 May 1979 calls for the deferment of common rate bands and for priority to be given to harmonizing the tax base, pending further consideration of the proposal. We, for our part, have made it clear to Parliament why we cannot follow their line of reasoning.

The call to defer harmonization of the rate bands reflects the concern, expressed in Parliament, that our proposal as it stands would restrict the power of national governments to vary the rates of corporation tax and tax credit in furthering of specific domestic policy objectives. This fear is, in my opinion grossly exaggerated. If you look at the recent fiscal history of the Member States, you will find very few instances where they have juggled with the rates of corporation tax in order to grant incentives in furtherance of investment and other policies. Much greater use has been made of the tax base for this purpose : I need only cite the rules governing depreciation and the valuation of stock. It should also be borne in mind that the bands are by no means rigid : our proposal does permit Member States, as I have already indicated, to set rates outside these bands for specific policy reasons. But to leave the rate bands entirely open would mean abandoning the imputation system and all semblance of harmonization of corporation tax systems. The situation would remain exactly as it is now, with all the negative and damaging effects on the common market that I have described.

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As regards the tax base, it is not feasible for us to follow the line advocated by Parliament, since we consider that harmonization of the corporation tax systems must come first. The harmonization of the tax base is no alternative to the harmonization of the company taxation systems, because it would leave untouched these distortions in capital movements which come about precisely because the systems are unharmonized. Even if we could achieve complete harmonization of the tax base and complete uniformity of corporation tax rates tomorrow, we should not have achieved equalization of the tax burdens unless we had also harmonized the company taxation systems.

To demonstrate the point, let us assume that all Member States have an imputation system of company taxation, a common tax base and a single corporation tax rate, of say 50 %. However, each Member State is left free to decide what tax credit (between 0 % and 100 %) to grant in respect of dividends distributed by its own companies but must grant the same rate of tax credit to its own residents, no matter what Member State the distributing company is in. I know this does not correspond to the system we have proposed but it will serve to illustrate the point I wish to make.

Now let us assume that the Federal Republic of Germany gives full imputation of the corporation tax on distributed profits - a tax credit rate of 100 % while the Netherlands, on the other hand, gives no tax credit - a tax credit rate of 0 %. German companies with German shareholders would need to distribute only relatively small cash dividends, because the total yield to the shareholders would be doubled by the tax credit. Dutch companies with Dutch shareholders would have to distribute much more. A German shareholder in a Dutch company would get the best of both worlds, because he would receive both the high Dutch dividend and the high German tax credit. (I wonder, incidentally, who would pay for this tax credit. Would Germany pay, when the profits distributed had not been taxes in Germany? Or would the Netherlands pay a tax credit to German shareholders although it paid no tax credit to Dutch shareholders? Neither seems very likely!) Furthermore, to the extent that German companies distributed less than Dutch companies they would have the competitive advantage of retaining more profits for investment in productive resources.

The consequences of such a situation are that Dutch shares would be worth more to Germans than to Dutchmen; and that German companies would have more funds to invest. It is thus apparent that putting harmonization of the tax base before that of the systems, so far from bringing about neutrality, actually creates considerable distortions both in capital movements and in competition. The greater the advance towards economic and monetary union, the worse would be the effect of these distortions.

It may be objected that the example I have given is too extreme. But the point I was making could equally well be made of any pair of Member States with different national tax credit rates. The effect of harmonizing the tax base first is to make existing differences sharper. Indeed, under any arrangement under which the rate of corporation tax is harmonized, while the systems of company taxation are left unharmonized - and I must stress that leaving a high degree of freedom in the setting of tax credit rates means leaving the systems unharmonized - the effect of giving part or all of the corporation tax back to shareholders as a tax credit in some countries, while doing so to a much less extent, or not at all, in others, inevitably becomes even more pronounced. That is why it has been necessary for us to propose upper and lower limits not only for the rates of corporation tax but also for the rates of tax credit.

Q.E.D., Mr. Chairman. If we were to harmonize the tax base and the rate of corporation tax before harmonizing the systems, we should create distortions instead of eliminating them. If, on the other hand, we harmonize the systems first, we eliminate or reduce certain distortions without creating others. Now harmonizing the systems and bringing about a certain convergence in the corporation tax rates in the way we propose by no means removes all distortions. But the distortions resulting from differences in the tax base and from the absence of a uniform corporation tax rate do not immediately affect the distribution policies of companies and hence the return to the shareholder. They are therefore of only indirect importance in relation to movements of capital, which must be of great concern to us in the context of closer monetary and economic integration.

Though we may all agree that it is desirable to harmonize the basis on which taxable profits are computed in the different Member States, it is no good thinking that this is something which can be, or even ought to be, achieved rapidly in a single short-term action. For as long as economic policy is in the hands of Member States - and this must be so as long as there is no Community body to which it is entrusted - it is natural and inevitable that the Member States continue to use adjustments to the tax base as a means to achieve these economic policy objectives. I am thinking here, above all, of course, of these special reliefs, accelerated depreciation measures and so forth, which are generally thought of as incentives. It would hardly be

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reasonable to leave economic management to the Member States and at the same time deprive them of one of the main instruments for carrying it out.

However, in view of the positions taken up in Parliament, we are preparing to put more emphasis in our future work on harmonizing the tax base. Our aim will be to establish a closer connection between harmonizing the corporation tax base and harmonizing the corporation tax system. As the problems involved in harmonizing the tax base cannot be solved overnight we would propose to lay down a transitional period during which we would define the common rules for determining the taxable profits of enterprises. We do not underestimate the magnitude of this task but it should be possible, in a reasonable time span, to evolve solutions for the main components of the tax base.

One of those components, and an important one, is the treatment of inflation /_a subject to which you, Mr. Chairman, have personally made a notable contribution_/. This is an area where it is of vital importance to adopt a harmonised solution and so avoid distortions among Member States. In dealing with inflation as with the whole range of problems inherent in the tax base, we must also have regard to the accounting rules applicable in the Community and in particular, those of the fourth company law directive. I am well aware of the valuable assistance rendered by the European accountancy profession in formulating these rules and we shall in due course be calling upon your expertise, organised at European level, to help us tackle the formidable problems of harmonizing the tax base.

Once solutions have been devised, we envisage a formal link between the two sets of provisions - those harmonizing company taxation systems and those harmonizing the tax base - whereby they will be introduced and implemented in parallel. At the end of the transitional period, in other words, each Member State will apply a common system of company taxation and withholding tax on dividends to the profits of companies determined according to common rules.

A further area of concern is the protection of Member States, especially the smaller ones, against any adverse effects our proposal might have on their public finances or economy. To the extent, for instance, that Luxembourg is a net exporter of dividends, it will incur budgetary losses in financing the tax credits granted elsewhere in the Community to shareholders of Luxembourg companies. In the case of Ireland, there may be serious difficulties in having to impose withholding tax on dividends paid to shareholders in the United Kingdom. We are ready to look at these problems and devise equitable solutions

Collective Investment Institutions

Having dealt extensively with our company taxation proposal, I should now like to devote a few words to the companion proposal on collective investment institutions. Its effect is simply to put the indirect investor, in an investment trust or unit trust for instance, on an equal footing with the direct shareholder as regards entitlement to tax credit on the dividends received and then redistributed by the collective investment institution.

Accordingly our proposal, made in 1978, lays down common rules permitting the tax credit and the right to set off withholding tax to be transmitted to the final recipient of the dividend. Dividends redistributed by the collective investment institution are liable to a 25 % withholding tax subject to a set off in respect of the withholding tax previously charged on those dividends: the participant is entitled to have the withholding tax set off or repaid. Furthermore where the participant is resident in the same Member State as the collective investment institution and his particulars are known to the tax authorities, that Member State may refrain from charging withholding tax on dividends which have not suffered withholding tax and may actually repay to the collective investment institution the withholding tax on dividends which have. This is an extremely complicated subject, Mr. Chairman I believe that the Commission has, in its proposal, devised some ingenious solutions, but the fate of the proposal as a whole rests of course, on that of the main company taxation proposal and this is where we must concentrate our energies.

European Monetary System

May I conclude this survey of our company taxation proposals, Mr. Chairman, by relating them to the prospect of closer economic integration held out by the European monetary system.

During its first 15 months EMS has brought about an important element of stability in the exchange rates of Member States. This satisfactory development has been achieved in spite of considerable unrest concerning the US dollar. There can be no doubt that without EMS the currency exchanges in Europe would have been in a state of turmoil instead of the relative

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calm we have experienced. While not being unduly optimistic I dare to express the view that EMS will also in future exert a strong stabilizing influence on the exchange rates of Member States. The monetary authorities will then find themselves in a situation where they will be far less dependent on the maintenance of capital restrictions for the purpose of their exchange rate policies, than they were during the 60's and the 70's. In other words I expect EMS to fulfill the necessary precondition for a step by step abolition of exchange controls. Also the possibility of a gradual introduction of the European Currency Unit, the ECU, for the purposes of private transactions across the Community borders may come to play an important role in furthering the integration of Community capital markets. I believe the next few years will see a rapid development in this monetary field which will have a direct bearing on the fiscal problem in front of us. It will become abundantly clear that we must move ahead and harmonize our corporation tax systems and their rules on tax credits in order to avoid a situation in which progress towards monetary integration in the Community leads to increased fiscal distortions. Time may not be on our side, as monetary progress could be achieved more rapidly than is generally expected and the gradual adjustment of Member States' present corporation tax regulations towards the future Community system must of necessity be a time consuming process.

Mutual assistance

Let me now turn, Mr. Chairman, to a topic which exercises the minds of tax authorities, tax practitioners and tax payers alike: I refer to international tax avoidance and evasion. It is now over two years since the Council adopted, on a proposal from the Commission, the directive on mutual assistance between the tax authorities of the Member States: it has been in force since January 1979. This directive was a major break through in two respects: it was the very first Council directive to deal with direct taxation, and it set up the most advanced system of exchanging tax information on an international scale. Not only is information to be supplied on request: Member States may also take the initiative in supplying information which falls within agreed categories of cases or which points to the possibility of tax abuse. Article 10 provides for the Commission and the Member States to keep the operation of the directive especially as regards transfer pricing under

constant review and we are just about to conduct the first such review in Brussels.

I must also report two recent, encouraging developments. The directive was enlarged, last year, to cover value added tax, and we are proposing to enter into negotiations with four Scandinavian countries - Finland, Iceland, Norway, Sweden - who have formally requested to be associated with the Community system of mutual assistance. I have no doubt that their association will prove to be of mutual benefit.

Arbitration procedure

The systematic exchange of information now taking place under our directive should bring to light more cases of transfer pricing and other devices for switching profits from one Member State to another. We are well aware this can have undesirable side effects in the form of the double taxation of those profits, when they are added back in one Member State's computation but not deducted in the other Member State dealing with the associated enterprise. Under existing double taxation conventions, the two Member States concerned must endeavour to eliminate this type of double taxation by agreement, but they are not compelled to do so. Our proposal made in November 1976, fills this gap by providing that, where the two Member States fail to eliminate this kind of double taxation the case shall be referred to an independent commission whose decision shall be binding on all parties. This is the first time that such an arbitration procedure has ever been proposed, and the international business community rightly attaches great importance to it.

It is only fair to tell you, however, that the Member States are dragging their feet. They maintain that, by and large, the bilateral arrangements are perfectly satisfactory and that, to the extent that an arbitration procedure is necessary, it should be embodied in a multilateral convention under Article 220 of the Rome Treaty, not in a directive under Article 100. In June 1978, Coreper requested the Council Working Party on Financial Questions to examine simultaneously the Commission's proposal and the text of a draft convention prepared by one of the Member States.

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Two years later, we are no further forward: despite repeated and urgent representations from the Commission, the proposal remains on the table and not a single meeting has been held. The Working Party has signally failed to perform any work! It is to be deplored that the Council seems unconcerned by the risk of overtaxation. If the Institute shares my sentiments, Mr. Chairman, perhaps they could mobilise their professional influence in the appropriate corridors of power ...

Frontier Workers

Finally, Mr. Chairman, I come to our most recent proposal, only six months old, for harmonizing the income tax provisions affecting persons who exercise their right of free movement in the Community. At present, such persons can find themselves penalised by the income tax treatment they receive as non-resident employees or as persons with financial commitments abroad. The Commission has accordingly made a proposal to remove these disadvantages. The proposal has three main provisions:

firstly that frontier workers should be taxed in the Member State of residence, with credit being given for any tax withheld at source by the Member State of employment;

secondly that other non-resident workers should be taxed in the Member State of employment on terms no less favourable than those applied to resident workers;

thirdly that income tax relief for payments such as insurance premiums and pension contributions should no longer be conditional upon the payee being resident in the Member State granting the relief; payments made anywhere in the Community are to be treated alike.

It is still a little early to gauge the reaction of Parliament, the Economic and Social Committee and the Council, but we feel the proposal is a useful contribution to making life fairer and simpler for the worker and also for the institutions providing insurance, pension and other services across Community frontiers.

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Conclusion

That, Mr. Chairman, completes my review of the Commission's activities in the field of direct taxation. It is, I know, an ambitious programme, but we are not harmonizing just for the sake of harmonization. Our proposals make sense because a common market means free capital movements, freedom of movement for workers and equal tax charges for enterprises competing with each other for customers and investors. It means other things as well, but these are the conditions most sensitive to the direct tax factor. We see it as our task to remove the restrictions, distortions and inequalities created by the differences in national tax systems. This does not require uniformity throughout the Community, but a significant degree of convergence. We look to the accountancy profession to make its contribution, by constructive criticism of the Commission's proposals and by practical assistance to business as it adapts to the process of tax convergence in the European Community.