



STUDIES

*CORPORATION TAX
AND
INDIVIDUAL INCOME TAX
in the European Communities*

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by Prof. Dr. A.J. van den Tempel

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FOREWORD

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Tax harmonization involves the important and urgent task of aligning the structures of corporation tax in the Community, and consequently the question of the taxation of undistributed versus that of distributed corporate profits. The present study looks into the main aspects of this exceedingly difficult subject. It has been carried out by Professor A.J. van den Tempel at the request of the Commission of the European Communities.

The terms of reference for the study were:

- (i) To examine the case for mitigation of economic double taxation of dividends;
- (ii) To give a comparative account of the economic, financial and social implications, as regards relations between member countries and relations between the Community and non-member countries, of different methods of doing so;
- (iii) To examine the disadvantages for the Community having a variety of corporation tax structures in the various member countries, and to suggest ways and means of mitigating these disadvantages until such time as a harmonized system of corporation tax enters into force.

Professor van den Tempel deals mainly with the systems current in the Community, i.e. the classic system (Netherlands, Luxembourg), the tax credit system (France, Belgium) and the split-rate system (Germany). But he also considers other systems such as that of complete avoidance of economic double taxation of dividends, that of "tax transparency" for joint stock companies, and the system involving deduction of a primary dividend from corporate profits.

The author shows how the various systems work in a closed and an open economy and examines the implications of applying one or the other system. He concentrates in particular on a projection of the different national systems into Community level and the effects they would have within the Community and in the Community's relations with non-member countries.

In the final section Professor van den Tempel outlines ideas on a harmonized system for the Community and arrives at the conclusion that the classic system of corporation tax would best meet the Community's needs.

The Commission wishes to express its gratitude to Professor van den Tempel for this important work.

Responsibility for the conclusions expressed in the study is, of course, solely the author's.

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CORPORATION TAX AND INDIVIDUAL INCOME TAX IN THE EUROPEAN COMMUNITIES

I— Interpretation of the mandate

1. Since World War II much attention has been given in Western Europe by the legislative bodies and in the scientific literature to the question of how the taxation of the profit of entities and the individual income tax on natural persons are to be related to one another. Naturally, this aspect of the tax structure is no more than a segment of the whole of the problems of a social and financial-economic nature which are evoked by taxation, or which are connected with it. A separate treatment, however, of the problem of the relation of corporation tax and individual income tax is useful, in order to judge the various structures which are possible by their qualities and to compare them with each other. Of the many possible systems, three particular systems are most widely used in practice and are compared with each other:

A. The classic system

The corporation tax and the synthetic (affecting the entire income) individual income tax of natural persons, are independent. The rate of the corporation tax is the same for the retained and for the distributed profit. For the individual income tax, the dividends received by the shareholders are taxed in the same way as any other income. This system exists now in Luxemburg, the Netherlands and in the United Kingdom. Formerly, it existed in the Federal German Republic and in France.

B. The system of the double rate

In order to reduce the economic double taxation on dividends a lower rate of corporation tax exists for the distributed profit of the share company than for its other profit. Then the dividend is taxed just as any other income for the purposes of the individual income tax. The relief to mitigate economic double taxation has therefore been performed at the company level. This system exists in the Federal German Republic: the two rates of the *Körperschaftsteuer* for the public share company (*Kapitalmarktbezogene Gesellschaft*) are now 51% and 15%.

C. The credit system

The rate of the corporation tax is the same for the retained and the distributed profit. In order to reduce the economic double taxation of dividends, part of the

corporation tax on distributed profit is credited against the individual income tax. The relief to mitigate economic double taxation on dividends has been applied here at the shareholder level. This system exists in France. The rate of the *impôt sur les sociétés* is 50%; half of the tax charged on the distributed profit, is credited. In Belgium this system forms the main structure: however, elements of other systems have also been included in the legislation.

2. The following concise chronicle of events in Western Europe which concern the subject discussed, shows that attention has mainly been paid to the three systems A, B and C mentioned above and furthermore, it cannot be said that there has been a clear development in the direction of one of them.

- 1953 Germany switches from the classic system to the system of the double rate.
- 1960 The Dutch Government makes a proposal to Parliament to switch from the classic system to the system of the double rate.
- 1962 The Fiscal and Financial Committee advises, in its report issued to the European Commission, the adoption of the system of the double rate in the E.E.C.
- 1962 Belgium introduces, with the transition from the schedular system (separate taxes for categories of income) to a synthetic individual income tax and corporation tax, a credit system combined with an element of the system of the double rate.
- 1965 The United Kingdom abolishes the credit system which had been in existence for a long time and switches to the classic system.
- 1965 France switches from the classic system to the credit system.
- 1965 The Dutch government withdraws the proposal of 1960 and announces a proposal for the introduction of a credit system.
- 1967 The Wissenschaftliche Beirat of the German Bundesministerium der Finanzen advises a switch to the system of full credit of the corporation tax on the distributed profit.
- 1968 The Dutch Government abandons the intention announced in 1965 and proposes, for the time being, to maintain the classic system.
- 1968 The Italian Government decides to propose the replacement of the existing schedular tax system by the classic system.

Luxemburg forms a centre of silence in the middle of these changes. After having studied the various systems, the Government of Luxemburg takes the view that, pending developments in the E.E.C., maintenance of the classic system is to be preferred.

3. In the discussion of the details of the three main types of systems, this study closely follows the characteristics of those systems which are now met with in five of the E.E.C. countries and in the United Kingdom. The strongly diverging Italian tax structure is not considered; it will, if the intentions of the Italian Government are carried through, be abolished and be replaced by a system which approaches the systems in the other countries mentioned.

The systems A, B and C display great similarity. In the first place, they all include a synthetic, progressive individual income tax which affects the income of natural persons, including dividends. Also in respect of the corporation tax, they show many important points of resemblance:

- i) the corporation tax is an independent tax on the profit of entities;
- ii) the corporation tax is imposed on the entire profit of share companies; and
- iii) the corporation tax is at any rate partly a "real corporation tax", in the sense that it is imposed without trying to prevent "economic double taxation".

It is true that in Belgium, Germany and France the economic double taxation is moderated, but this moderation does not go further than that about half of the burden of the corporation tax on the distributed part of the profit is taken away.

4. In chapter IV three other systems are summarily discussed, each of them with respect to one of the items i), ii) and iii) mentioned in section 3 diverging from the systems A, B and C. The systems discussed in chapter IV are the following:

- (a) the system of complete avoidance of economic double taxation on dividends (compare section 3 under iii);
- (b) the system of "transparence fiscale" of the share company, in which a corporation tax in the usual sense is lacking (compare section 3 under i);
- (c) the system of deduction of a primary dividend of the profit (compare section 3 under ii).

5. As remarked in section 3, none of the three systems A, B and C provides for a complete avoidance of economic double taxation on dividends. That these systems receive most attention, can also be ascribed to a practical consideration; for it is improbable that the E.E.C. countries and the United Kingdom will proceed to the abolition of a "real corporation tax". On this subject

one can speak of a clear development. The two countries which quite recently did not have a real corporation tax, have both decided to introduce it; the United Kingdom introduced a partly real corporation tax in 1937 and a complete real corporation tax in 1965, whilst Belgium introduced a partly real corporation tax in 1962.

These developments mean an abandonment of the idea that the share company and its shareholders can be considered as being identical. Modern industrial development has meant that notably the public share company, of which the shares are quoted on the stock exchange, when seen from an economic and social point of view has an existence of its own, independent of that of its shareholders. This impersonal entity aims at its own maintenance and growth, with a view to the object to be achieved by it. Its interests are to be found in the sphere of production and are not the same as the interest of the shareholders. The idea that the share company is a form of contractual co-operation, by means of which the joint shareholders run an enterprise, is obsolete. It is the share company which has the status of entrepreneur and which competes both with its congeners and with the enterprises of natural persons. Its income cannot exclusively be seen, as would be convenient in the absence of a real corporation tax, as partly already and partly not yet distributed dividend.

6. The foregoing is applicable to the big public share company. In many cases a share company does not display all the characteristics of this type and the typical private company does not comply with the characteristic given at all. In the fiscal field the private company presents special problems which are not, or to a much lesser degree, to be found with respect to the public share company. That special fiscal problem exists everywhere, irrespective of the fact of whether the national legislation does or does not recognize separate legal forms for the private company, may it be true that, if these exist, the taxation law will often take them into account.

The special fiscal problem of the private company proceeds from the special relation between the entity and its shareholders. The (majority-) shareholders at the same time control the share company; the relations between the shareholders still have to some extent the character of relations between partners. The consequence of this is, on the one hand, that the shareholders experience the corporation tax as a burden which affects them personally. The economic double taxation is for them a psychological reality the more so, because a comparison with the entrepreneur operating as a sole proprietor is obvious. On the other hand it is certain that the "economic double taxation" in fact means an additional burden, surpassing the one they would experience in the case of a direct attribution of the profit.

In the determination of the size of the distributions and of the remuneration of the management, the personal interests of the shareholders in the private share company and the interests of the share company have equal attention. Those interests can be conflicting. They can also run parallel. Thus, retention of profit is the most important and sometimes the only source or means for self-maintenance and expansion of the share company, in absence of admission to the capital market. The retention of profit, however, means at the same time a tax saving for the shareholder personally. The complicated problem of the fiscal regime of the private share company has many facets. This study confines itself to bringing up a few points related to the tax structure. So the items mentioned above are discussed in section 46 and sections 48-49; one single aspect of an international nature is discussed in section 87.

For the rest, the public share company stands in the foreground. In the international movement of capital it occupies the most prominent place and it is especially this type or company for which a harmonized system for the countries of the European Communities has to be found. The accomplishment of such a harmonized system does not exclude special fiscal provisions for the private share company. Reference may be made here to special rates existing in the Federal German Republic, to option rules existing in various countries (section 49 and section 116) and to provisions counteracting unjustified fiscal advantages.

7. The diverging consequences of the taxes existing in the various countries do not only proceed, notably also as to their effect on the international movement of capital, from the differences in tax structure.

Differences in the manner of determining the tax base (profit, income) and in the level of the rates can also be of importance.

In this study the problem of the computation of the taxable profit and that of the limits of the income concept are not considered. Differences between the legislations on these items which are considered in another connection in the European Communities,¹⁾ are not discussed here. The question of on which level the burden of direct taxation in general and the burden in the corporate sector in particular has to be, also has to remain out of consideration. In the judgment of the actual situation, both have to be taken into account. This study only aims at a comparison of the nature and the consequences of the structural differences in the relation of corporation tax and individual income tax. The structures can all be applied to different levels of burden (rates and determination of the object). Within the framework of European integration in the fiscal field, this problem indeed

has an independent significance. A structural harmonization can, as long as the countries have not yet effected a binding agreement with regard to the level of the rates and the determination of the tax base, remove numerous problems or reduce their significance.

8. In Chapters II and III of this study therefore proceed from the alternative application of the systems in one and the same level of burden. Another starting-point could also have been the drawback that the consequences which differences in the level of the taxes on corporate profits and on dividends might have via the government budget—e.g. in the form of higher indirect taxes or higher government expenditure—and the influences which those differences could exercise on international economic relations would have to be taken into consideration. The gross burden of the taxes in the sector discussed here could no longer—as happens hereafter—be accepted as standard for the net burden. Thus lower indirect taxes may, via lower prices and wages, affect the profitability of the enterprises. The *ceteris paribus* assumption which has been made in this study in the comparison of the effect of the systems has been accepted as a working-method, extends—as the above shows already—also to the entire burden of taxation and its influence on the economic data.

9. If therefore, for a judgment of the systems, a comparison at an identical level in the corporate sector is the best starting-point, the difference in the structure of the systems does not make it easy to eliminate the factor of a difference in level. As a measure of whether the level of the burden in the various systems is equal, the most usable criterion would seem to be the joint yield of the tax on the profit of the share company and of the tax on the dividends of the shareholder. This approach has the advantage that in the judgment of the relative merits of the systems the aspect of the tax proceeds can be disregarded.

A comparison on this basis, as much as it may seem to be the most usable, can only be approximate. Reference is made to the remarks in section 16. Thus the influence of the systems on the size of profit distributions is not known. Changes in the circumstances can be an influence on the distribution quota in the share companies and thus, according to the rates of the corporation tax and the individual income tax, have diverging consequences for the tax proceeds. Notwithstanding these difficulties, an attempt has been made hereinafter, in the form of a few schematic examples (see those in section 19 et seq.), to indicate which order of size the differences between the rates of the various systems must have in order for them to be comparable.

¹⁾ Report Working group IV on the basis for the computation of profits in the Member States.

10. The following have been considered to be beyond the framework of the mandate for this report:

- i) taxation of the share company by other standards than its profit, such as taxes imposed on the capital paid-in at the creation of the enterprise or in capital increases (a draft-directive in respect of these taxes has been submitted by the European Commission to the Council of Ministers in December 1964) and periodic net wealth taxes;
- ii) taxes which affect enterprises irrespective of their legal form, such as the *Gewerbesteuer* in the Federal German Republic;
- iii) the taxation of entities other than the share company, an important group of which are the co-operatives, whose special aspects of an organizational and socio-economic nature deserve special attention in each system; and
- iv) the taxation of capital gains, also as far as the rationale lies in the retention of profit by private share companies.

11. Furthermore, numerous particulars in the national laws in respect of the taxation of profits and dividends which are not characteristic for the type of system applied, have been left aside; such as special régimes for certain categories of enterprises and legal conceptions existing in certain countries (e.g. the *Organlehre*, the principle of the worldwide profit or the consolidated profit of concerns, etc.). It is presumed that the degree of implementation of the legal provisions is always the same. It is also assumed that the systems have been established for a considerable time, and the consequences which may arise, when switching from one system to another, during the period of adaptation to the new régime are in principle disregarded. Some of these are mentioned in the notes to section 31 and section 42.

12. The study has been aimed at an analysis of the consequences of the application of the different systems. The term "economic double taxation" has been used for the sake of convenience, notwithstanding that a value-judgement is connected with it. 'Double taxation' is in itself a term which is based on a formal criterion and which has nothing to do with the desirability or the undesirability of the phenomenon. The nature and the size of the consequences which manifest themselves in a certain method of taxation are decisive. Theories and principles are only raised in this study as far as this can clear up the argument. In the analysis of the machinery and the effects in Chapters II-IV, in general an attempt has been made—certainly not always with success—to omit value-judgements, dependent as they are on the objects to be achieved and on the actual circumstances under which taxation must operate. An exception, however, are those value-judgments which—even when internationally binding standards do not exist—find

support in aims almost universally accepted as worth seeking, such as the principle of non-discrimination, or, in relation to the European Communities in particular, can be considered to find support in the provisions of the Treaty of Rome.

II—The effects of the systems A, B and C in a closed national economic system

13. In this chapter the effects of the systems A, B and C in a closed economy are examined with a view to judging the efficiency of the relief of the economic double taxation of dividends. The international aspects of the systems are not considered here. The crossing of the border by investments and participations in enterprises causes complications, owing to the fact that the taxation on both sides of the border has an influence on the financial result. Those complications are dealt with in Chapter III. In the present Chapter first the mechanism of the systems and then the economic, social and fiscal-technical aspects in the domestic sphere are discussed. "Domestic" refers to the territory of the national State, but also to the Common Market when a stage has been reached in which the harmonization of the direct taxes will have made big progress.

1. The mechanism of the systems

14. The discussion is based on perfect models which have been chosen in such a way, that they are mutually comparable (see sections 7-9). A perfect model of a credit system is that employed in France. Both the rate of the French corporation tax (50%) and the part which comes into consideration for crediting against the individual income tax of the shareholders (half, i.e. 25 percentage points of the corporation) has hereafter been chosen as the starting-point. The Belgian legislation also has the credit system as its main structure. Elements of the system of a double rate and of the system of deduction of a primary dividend (this latter as a temporary constituent), however, have been added to it. Consequently the effects of those systems will manifest themselves simultaneously, strengthening or weakening each other, each according to the provision which has been made for them. Much as it may be accepted that in the Belgian situation and with the Belgian fiscal tradition this synthesis has its own merits, as a starting-point it is not usable because of the complexity of its effects.

15. The chosen model of a system of a double rate has a strong resemblance to the system for the public share company existing in the Federal German Republic. The high rate prevailing for the non-distributed profit, is equated with that of the French corporation tax. The low rate for distributed profit has been chosen in such a way that, in accordance with the situation in France, an integration degree of 50% is achieved, which means that in

the case of complete distribution of the available profit the burden of the corporation tax is reduced to half of the full rate, i.e. to 25% of the profit. The German rates of 51% and 15% have therefore been replaced by rates of 50% and 16 2/3%. When distributing 75% of the profit, the corporation tax at these rates amounts to 16 2/3% of 75 plus 50% of 25, i.e. an effective 25%. This conformity in the result of the system with a double rate and that of the system of credit is to be found with the chosen rates in each dividend quota (see sections 19 *et seq.*).

16. In the "classic system" the choice of a rate which makes the system comparable with the former two models in the sense of the factors indicated in section 9, is more difficult. It is assumed that with a rate of the corporation tax of 40% roughly the same tax yield is achieved as under the chosen models for systems B and C. The chosen rate of 40% resembles that in Luxemburg; it is a little lower than the existing rate for the corporation tax in the United Kingdom (42 1/2%) and rather considerably lower than the rate of the Dutch corporation tax (46%).

17. A few examples are given below to demonstrate the effects of the systems when applied alternatively, under *ceteris paribus* assumptions ignoring secondary consequences. The examples are only intended to illustrate the principal characteristics.

In example I it has been assumed that, on an average, half of the profit, after imposition of the corporation tax, is distributed to natural persons. In the credit system, the shareholder not only receives the dividend, but also the "avoir fiscal" connected with the distribution, which embodies the right to the crediting of corporation tax and which, for the purposes of the individual income tax, is added to the dividend.

The individual income tax imposed on the dividends in the hands of the shareholders has been fixed at an average of 33 1/3%. This assumption, which as far as Germany and France are concerned, will probably not be very different from the actual percentage, has as a result that in system C the average individual income tax to be paid is just equal to the credit. Natural persons owing a smaller percentage of individual income tax than the percentage of the credit, have the difference refunded in France, but in Belgium there is no refund.

18. In the examples given below, the complication caused by the existence of a dividend tax has been omitted. The dividend tax mainly has significance in the domestic sphere—unlike the international cases (see Chapter III)—from a point of view of collection and control. A dividend tax can occur in all tax structures discussed here, though it is less likely in system C, which indeed already contains as it were an advance levy on the individual income tax in the form of half of the

corporation tax. In France therefore, a dividend tax on dividends accruing to those who have a right to credit of corporation tax, viz. residents, is lacking (dividend tax is retained however on dividends accruing to non-residents). In system A and system B a dividend tax is usual; as a rule it has, however, no influence on the tax amount finally to be paid by domestic shareholders, because it is credited against the individual income tax (or, if the dividend is received by a share company, against the corporation tax).

19. Example I

Assumptions: 50% distribution of the profit after taxation;
33 1/3% individual income tax.

	A. Classic	B. Double rate	C. Credit
a. Profit before taxation	100	100	100
b. Corporation tax	40	50 -10 ¹⁾	40
c. Profit after corporation tax	60	60	60
d. Retained profit	30	30	30
e. Distribution	30	30	20 ²⁾
f. Individual income tax	10	10	33 1/3 of 30 ²⁾ =10 tax credit 10
g. Dividend after taxation	20	20	20
Appropriation of profit:	A	B	C
h. Retained profit	30	30	30
i. Dividend after taxation	20	20	20
j. Corporation tax	40	40	50
k. Individual income tax	10	10	—
l. Tax	50	50	50
Total	100	100	100

¹⁾ The corporation tax is reduced by one third of the distribution of 30, because the rate of tax on the distribution is 16 2/3%, therefore 33 1/3% lower than the normal rate.
²⁾ Including the "avoir fiscal" to the amount of half the distribution, the dividend amounts to 30.

Should the average individual income tax imposed on the dividend amount to 40% instead of 33 1/3%, then the individual income tax (line f and line k) in all three systems is 2 units greater and the dividend after taxation 2 units less.

The appropriation of profit in the three systems will then be:

retained profit	30
dividend after taxation	18
tax	52

20. The nature of the system can have an influence on the dividend quota, as will be discussed in sections 37 *et seq.* In the following examples II and III it is assumed that the dividend quota under system A is lower than under the systems B and C. In order to facilitate the comparison with example I, in example II for the systems

B and C a dividend quota identical with that of example I is assumed and the same has been done for system A in example III.

The assumption of an equal burden in the corporate sector in all systems has been maintained in example II, by proceeding from a higher rate of the corporation tax in system A than in example I. In the examples the point that the percentage of the individual income tax on the dividend in case of an alteration in the size of the distributions, will change a little—*ceteris paribus*—in consequence of the progression of the rate has been ignored.

21. Example II

Assumptions: in system B and C, 50% distribution of the profit after taxation;
in system A, 43.6% distribution of the profit after taxation;
33 1/3% individual income tax.

	A. Classic	B. Double rate	C. Classic
a. Profit before taxation	100	50 100	100
b. Corporation tax	41.5	-10 40	50
c. Profit after corporation tax	58.5	60	50
d. Retained profit	33	30	30
e. Distribution	25.5	30	20
f. Individual income tax	8.5	10	— 33 1/3% of 30=10 tax credit 10
g. Dividend after taxation	17	20	20
Appropriation of profit:			
h. Retained profit	33	30	30
i. Dividend after taxation	17	20	20
j. Corporation tax	41.5	40	50
k. Individual income tax	8.5	10	—
l. Tax	50	50	50

The notes under example I are also applicable here.

22. Example III

Assumptions: in system B and C, 58% distribution of the profit after taxation;
in system A, 50% distribution of the profit after taxation;
33 1/3% individual income tax.

	A. Classic	B. Double rate	C. Credit
a. Profit before taxation	100	50 100	100
b. Corporation tax	40	-12 38	50
c. Profit after corporation tax	60	62	50
d. Retained profit	30	26	26
e. Distribution	30	36	24
f. Individual income tax	10	12	— 33 1/3% of 35=12 tax credit 12
g. Dividend after taxation	20	24	24
Appropriation of profit:			
h. Retained profit	30	26	26
i. Dividend after taxation	20	24	24
j. Corporation tax	40	38	50
k. Individual income tax	40	12	—
l. Tax	50	50	50

The notes under example I are *mutatis mutandis* also applicable here.

23. Both in system B and in system C the tax relief is intended to moderate the “economic double taxation”. The difference between both systems is sometimes indicated in such a way that system B allows the relief in the scope of the corporation tax and system C does the same in the scope of the individual income tax. This characterization contains indications as to the difference in the effects to be expected, e.g. in the psychological aspect. As to the consequences to be expected, and the additional regulations to be made in view thereof in the domestic application and in the application in international cases (Chapter III), the difference between the systems is, however, better expressed as follows:

- (a) in system B the relief is already granted at the point of distribution by the share company, without waiting to see if the dividend will be taxed (again);
- (b) in system C the relief is only granted when it appears that the dividend is taxed (again).

24. As is evident from section 23, system B has in the first instance the effect that each recipient of a dividend benefits from the reduced rate. In accordance with the scope of the system, this effect has to be avoided when there is no economic double taxation, on account of the fact that the second phase of imposition is absent. This is the case when the dividend is received tax free by some other share company.¹⁾

25. The rules concerning the tax free receipt of dividends in the domestic sphere—the other cases will be discussed in chapter III—can go more or less far independently of the tax structure. They go farthest in Belgium and the United Kingdom, where dividends received on shares in a domestic share company remain untaxed in the hands of the receiving share company (*non bis in idem* in the corporate sphere). In Germany, France, Luxemburg and the Netherlands the exemption remains restricted to dividends—possibly reduced by the expenses, whether or not determined “à forfait”, attached to the participation—received in a parent—subsidiary relationship (participation exemption, “Schachtel-privileg”).²⁾ In order to have a right to the “Schachtel-privileg”, the participation in the capital of the subsidiary company must exceed a certain minimum which in the countries mentioned has been determined in different ways.

26. A withdrawal of the relief in system B for those dividend amounts which have not been redistributed

¹⁾ Apart from the possibility that fiscal consequences are connected with the non-distribution of this profit, which can be the case with investment companies, if they only enjoy freedom from tax on the condition of redistribution of the dividends received to investors.

²⁾ It is not yet known what regulation the tax reform being prepared in Italy will contain.

by the receiving share company can, if only participation dividends are exempted, remain restricted to those dividends. The other dividends in the receiving share company are again subject to corporation tax; the relief from double economic taxation has therefore not been granted erroneously. Under the wide *non bis in idem* rule which exists in Belgium and the United Kingdom, system B would mean that for all domestic dividends which are not passed on, a supplementary tax would be imposed.

For technical reasons the supplementary taxation, even if it remains restricted to participation dividends, cannot take place at the level of the distributing share company. For the latter is mostly not acquainted with the size of the holding of the shareholders and their fiscal place of establishment; particularly so when, as in the E.E.C.-countries with the exception of Italy, bearer shares are recognized. In Germany therefore, the additional collection of the tax (Nachsteuer) takes place at the level of the parent company.

In order to provide completely equal fiscal treatment of financing from the business profit of a share company and that received from (exempted) domestic (subsidiary-) dividends, the Nachsteuer must comprise the full *écart* between the two rates of system B (in the foreign cases the situation is different, see Chapter III). Accordingly also the German legislation.

27. In section 23 system C has been characterized as a system for the moderation of economic double taxation, whereby the relief is only granted when it appears that the dividend is taxed (again). If in the terminology the parallel with system B is carried further, then it can be stated that system C also provides for two rates, though this does not yet find expression in the imposition of the corporation tax. Part of the corporation tax is withdrawn by crediting this part when it is certain that the dividend is affected by individual income tax (or, if received by a share company, by corporation tax).¹⁾ In the other cases this part of the corporation tax is maintained. This is therefore also the case when a parent company does not pass on participation dividends which, in that company, are free of tax. The corporation tax which is not credited, plays here the part which in system B falls to the “Nachsteuer” in the receiving share company.

It is clear that in this respect system C, more accurately than system B, fits in with the purport of both systems: the restriction of the taxation on dividends, if double taxation indeed occurs. This concordance of purport and design leads to simplicity in the legal provisions. There is less chance of the occurrence of leaks through which low-taxed dividend can flow out without having paid the

¹⁾ In France the credit cannot lead to refund in this case.

second toll which justifies the lower imposition at the previous stage.

28. The simplicity of design of system C is, however, distorted by the circumstance that a dividend can also be distributed from profit which has not been subject to the first toll. Not all profits of domestic share companies are affected by the corporation tax; furthermore taxed profit is not always subject to the normal rate. A consistent application of the system leads, as happens in France, to no right to credit being attached to a dividend accruing from exempted profit elements. The technical complications resulting from this will be discussed in section 71.

2. Shifting of tax

29. Formerly it was usually assumed that the problem of shifting did not play a part in taxes on income and profit. Those taxes were considered to simply reduce by the amount imposed the net-surplus, which was their object, so that the burden of taxation fell where it should be, in accordance with the wishes of the legislator. It was taken for granted that taxes of this kind had no influence on the prices which were established between the taxpayer and others: buyers or suppliers of goods, labour or capital. The certainty of those assumptions has among other things been affected by the insight that the object of individual income tax and corporation tax, both for entrepreneurs and non-entrepreneurs, is not always a surplus in the economic sense, but that it contains elements which can be considered as sacrifices made. The tax on such elements of income or profit can in principle be eligible for shifting, just as any normal indirect tax. Besides, a broadening of the theory by the addition of macro-economic views has led to the insight that, under certain circumstances, pure surplus taxes can also be shifted by the nominal taxpayer. Neither theoretical analysis, nor the empirical investigation carried out especially in recent years, can, however, indicate with certainty under which circumstances and to which degree, shifting of tax takes place. Indeed the investigation has led to the knowledge, that it is fairly certain that certain factors stimulate or counteract shifting, but a quantitative determination of the influence of these factors separately, and of their combination in a real situation, has for the time being not proved to be possible.

In the actual practice of tax and budgetary policy, usually no allowance is made for the shifting of corporation tax and individual income tax. So the yield of a rate increase of the corporation tax is usually estimated without taking into account the possibility that the tax increase enlarges the profit before taxation in the manner of higher selling prices or lower cost, and affects the scope for distributions to a lesser extent than is to be

expected if only the direct effect of the increase is taken into consideration.

30. In this study phenomenon of the shifting of tax to its full extent is not under discussion. The question of the shifting has only to be considered within the restricted framework of a comparison of different structures of corporation taxes and individual income tax, whereby a starting-point is that these solutions have a practically identical budgetary result. An examination of the differences between those structures could produce indications which make it probable that in one system there is more shifting of tax than in another.

31. When comparing the systems by the examples given in section 19 *et seq.*, the first striking feature is that, compared with the systems A and B, in the credit system C tax is imposed to a greater extent on the share company and to a lesser extent on the shareholder. A comparison with the system of a double rate indicates that this characteristic becomes more striking when the distribution quota increases (example III). Now, it is generally accepted that the proportionate tax on profit,—in any case as far as it is imposed on what from a business economic point of view is to be considered as expenses—in branches of industry where the corporate form prevails, is more suitable for shifting than the individual income tax. This train of thought could lead to the conclusion that in the credit system there is more shifting than in the other systems, even if the shareholder gets a credit on account of that corporation tax. But it is equally justifiable to assume that the part of the corporation tax to be credited has no other consequences than a dividend tax which is also paid by the company, but for the account of the shareholders.¹⁾

32. With a higher distribution quota (example III), system B shows the reverse position from that shown under system C. Compared with the classic system, the corporation tax imposed is slightly lower also in the case of a rather higher distribution quota. It is not excluded that—assuming that the shifting possibilities in respect of corporation tax are greater than with regard to individual income tax—higher distributions under the system of the double rate lead to a decrease of the shifting of tax and consequently to a somewhat lower profit before tax. It is true that in system B which taxes the distributed profit lightly at the level of the company, a relatively high dividend tax fits in as (provisional) additional tax.

¹⁾ In this connection it is to be noted that with the introduction of the credit system in France, the dividend tax on dividends accruing to residents has also been abolished. At the same time, the tax relief accompanying the alteration of the tax structure became evident to the shareholder at the moment of his assessment to individual income tax. See also the note to section 42.

As a rule, however, it is assumed that a reverse tendency does not proceed from that tax. It is true, however, that the individual income tax makes the delay in collection slighter than might be deduced from examples II and III.

33. Furthermore there is the question of whether there is a difference in shifting between corporation tax imposed on retained profit and that which, without being eligible for a credit against individual income tax, is imposed on the distributed profit. Attribution of the tax to those two profit appropriations, produces characteristic differences between the systems. It can be derived from the example I that the amount of corporation tax which must be paid is:

	Corporation tax under system:		
	A	B	C
in order to retain 30	20	30	30
in order to distribute 30 ¹⁾	20	10 ²⁾	10 ³⁾

1) In system C the "avoir fiscal" is reckoned to belong to the dividend.
 2) 16 2/3% of 30 and 50% of 10 tax.
 3) On a profit of 40, 20 corporation tax is imposed, 10 of which is definite; the other 10 is an advance levy (see note 1)) and is here considered as individual income tax (see, however, section 31).

As regards other retention and distribution quotas it should be stated that, over and above the amount necessary for the appropriation indicated above, the following percentage of it must be available for permanent of taxes ("tax quota"):

	"tax quota" in		
	system A	system B	system C
on retentions	66 2/3%	100%	100%
on distributions	66 2/3%	33 1/3%	33 1/3%

34. To prove that the corporation tax imposed on the profit appropriated for distribution is shifted to a greater extent than the tax on the retained profit, it is sometimes argued that for the share company, especially in view of the acquisition of fresh capital, a certain level of distributions to its shareholders is necessary. The minimum of necessary distributions would be for the share company practically equal to a business expense. The level of those distributions does not necessarily have to be equal to the yield of other forms of investment which compete with shares on the capital market, since other aspects than the yield have influence on the demand for investment objects. But, in fact, a certain equilibrium between the yield levels will arise. The share company which distributes relatively little does not come up to the expectations of the market. In order to reach this level, a share company, compared with other forms of investment the yield of which is not affected by corpo-

ration tax, has to bear an extra burden. This burden, to be paid from the profit, would give rise to a shifting of tax through prices.

35. An essential part of this argument is the influence on the suppliers of capital, on the one hand of the yield and on the other hand of the other factors which are of significance for those suppliers. The retention of profit also belongs to the other factors. The size of this, just as the size of the distributions, can be influenced by the "tax quota" which, as much as the "tax quota" on the distributions, varies in the systems discussed, but in an opposite sense. This means that for the conclusion to be drawn from the trend of thought discussed here it is essential to know whether the distribution of profit to a considerably greater extent than retention of profit, contributes to the standing of a share company on the capital market. Various signs indicate that the yield, which in the past was certainly of paramount importance, loses more and more its primary significance. The bigger or more experienced investor attaches value to an ample retention of profit which just occurs commonly in the case of fast-growing and industries which foresee further profit possibilities. In addition to this, the greater part of the privately owned shares, belongs to investors in the high income groups. For them retention of profit has the attraction that increase in value of the share in case of realization remains untaxed or is taxed at comparatively low rates. Retention of profit represents for these investors a tax saving. "Growth shares" also owe their increasing popularity to this factor.

36. Also if one comes to the conclusion that it cannot be stated with some certainty that one of the systems discussed leads to shifting of tax more than the other, the question remains of whether the corporation tax cannot influence the course of the flow of capital, in the sense that the corporation tax forms a bar which weakens the strenght of the flow to the corporate sector. In all three systems discussed this influence can occur, if the corporate sector, in proportion to the other sectors, is excessively taxed. The reverse effect can also happen, in that case a "run for the corporate form" will be the consequence. The determination of the correct level of the burden is, however, beyond the scope of the subject discussed here (see section 7).

3. The influence on the dividend quota

37. In favour of systems B and C it is argued that they stimulate an increase of distributions at the cost of retained profit. The "tax quota" (see section 33) is lower on dividends than on retained profit. In system B this effect will be expressed in a higher declared dividend, and in system C in a higher dividend amount available, after taxation, for the shareholder. The alteration in

the proportion, after taxation, between the distributed and the retained profit, leads according to this trend of thought to an expansion of the capital market. The selective judgement of the demand on that market by the suppliers of capital would improve the allocation of the national resources, whilst the self-financing to which the managers have a tendency, would be moderated by the fiscal stimulus. In the past similar arguments have been adduced for a differentiation in the taxation of retention and distribution, e.g. in the form of an undistributed profits tax.

38. The stimulus to distribution becomes a stimulus to immediate distribution if the mitigation of the economic double taxation is only granted in respect of profit distributions for the year in which the profit has arisen.

Such a restriction of the tax reduction with respect to the distribution of annual profit is for technical reasons (section 69) desirable in system B (even preferable is a restriction to the maximal annual profit-after-corporation tax which in the chosen types of system B and C amounts to 75% of the profit). In system C such a limitation in time is necessary in as far as it must be prevented that profit arising under previous tax régimes benefits as it were retroactively by the new régime; administrative considerations in addition explain the restriction in force in France of the credit to dividend coming from the taxable profit of the last five years. In that case also, however, unlike in system B, there remains scope for a policy of dividend-equalization.

39. The counterpart of the systems B and C are those tax measures which stimulate the retention of profit by connecting a higher "tax quota" to distributions than to retained profits. The ordinary form of this is a tax on the share company in respect of distributed profit, as existed in the Netherlands until 1940 and the profits tax which existed in the United Kingdom from 1947 until 1958. As arguments for such a tax it can be said that the size of the national savings is increased by it (compare section 45), that the financial stability of enterprises becomes greater and that a free scope is given to expanding industries and branches of industry which by their greater profitability can permit themselves as a rule a lower dividend quota.

40. As to influence of system A on the distribution quota it can be stated that, seen from the point of view of the enterprise, this system works neutrally. The "tax quota" is the same for retention and for distribution (section 33). In favour of such an equal régime for both appropriations of profit it can be argued—apart from the macro-economic effects of an increase of the dividend quota to be treated later—that the judgment as to the appropriation of profit can best be left to the enterprise itself; for it is the enterprise which has the best knowledge of the dividend policy to be conducted, taking

into account the liquidity now and in the future and the necessity of new investments for the maintenance or the improvement of the market position. The enterprise bears also the responsibility for decisions to proceed to an enduring increase of charges, which indeed occurs when self-financing is renounced, irrespective of whether equity capital or loan capital is attracted for replacement.

Also the interests of the employees are concerned in the maintenance, growth and prosperity of the business. The interests of the shareholders need not suffer; their interest, notably on a long term, is mostly also served by retention of profit (see section 35). These arguments plead for an omission of fiscal influence on these decisions.

41. It may be assumed that the effects of systems B and C in favour of a higher distribution quota in the public share company will remain restricted to a certain, as a rule not very wide, margin. The lower limit of that margin is formed by the distribution which, in the light of the dividend policy conducted so far and in view of future issues, would be necessary in any case. An upper limit is set on that margin by the necessary self-financing of modernization and expansion investments. If the investment plans exceed the investment capacity, the margin will be lacking and the dividend will be restricted to the unavoidable minimum. Also, in the case of increasing profit this margin can remain small; good profitability prospects encourage the tendency towards expansion. On the other hand it sometimes happens that enterprises, notwithstanding satisfactory profits, show little inclination to expansion, for whatever reasons. Here the stimulus has in principle a wider field of activity. Also the low "tax quota" on the dividend will bring weak enterprises sooner to a position to maintain their dividend.

42. However much a certain influence of the systems B and C on the dividend quota in the public share company may be assumed, that influence cannot be quantified. Empirical investigation also cannot give sufficient indications as to the size of the effect, because numerous factors other than fiscal ones have an—presumably much more important—influence on the dividend quota. In the Federal German Republic system B existed from 1955 to 1958 with an *écart* of 15% between both rates. This does not seem to have had a tangible effect on the distribution quota. Probably a smaller stimulus cannot bring about a change in the distribution of profit which is preferred for other reasons. The experience in the Federal German Republic since 1958, when the now existing *écart* of 36% between both rates was introduced, also does not give a clear picture. In France (switch in 1965 from system A to C) and in the United Kingdom (switch in 1965 from system C to A) transitory

effects probably also still play a part at present.¹⁾ Besides, in both cases the judgement is impeded by the fact that the alteration of the system was associated with a change in the level of the burden.

43. A bigger dividend quota under systems B and C accrues for the greater part to the shareholders. In Example III, as compared with Example I (sections 19 *et seq.*) a reduction of the retained profit by 4 has been assumed; with the rates of that example the dividend after taxation received in total by the shareholders also increases by 4. These two quantities will diverge if the individual income tax payable by the shareholder is higher or lower than the *rate-écart* in system B or the credit in system C. But also in that case the amount by which the retained profit decreases, will reappear, at least for the greater part, in the available income (after taxation) of the shareholders.

44. The extra dividend which is placed at the disposal of the family households, will be spent for the greater part on consumption. The dividends coming into the hands of entities will partly be passed on and therefore also, though to a smaller extent, be used for consumption purposes. Assuming that the marginal consumption for the extra dividend is put at two thirds, one third remains available for the capital market. From the side of the share companies on the other hand, there is a smaller supply and a greater demand. The total size of the savings will be smaller, the consumption—and the yield of the consumption taxes—greater than would have been the case without the stimulus to distribution.

45. Such a shifting from enterprise savings to consumption can be considered to be desirable from a point of view of socio-economic considerations of a general nature. Should, however, in view of the level of the economic growth, a reduction of the size of the savings in itself not be considered to be desirable, then the effect

is favourable if it is compensated from the fact that the allocation of the extra supply on the capital market rises in quality above that which would have been obtained with retention. This is not probable. The selective effects of the capital market are already reduced by the fact that they are not accessible to all enterprises or not on equal terms. Besides, the effectiveness of the effects of the price mechanism on the capital market are affected by the circumstance that the information of the market parties, also in favourable cases, rests on a most uncertain basis, viz. on expectations in respect of future profitability. The remark may be true that the survival of the fittest is something other than the survival of the fittest, it is only possible to grow fast through self-financing, if one can maintain a high profitability. The giving of some scope to enterprises showing vitality by their profitability, does not need to give a worse result than the judgement by the capital market. It is therefore not likely that an improvement of the appropriation of the supplementary amount offered is achieved on the capital market to such a degree that it is counterbalanced by the shrinking of the size of the savings at the disposal of the enterprises by a multiple of that amount.

46. The private share company shows special characteristics (section 6), which make it necessary to supplement the considerations in the foregoing sections. On the one hand the effect of the dividend declaration on the outside world does not play a part. On the other hand the decisions on the dividend policy are strongly influenced by the consequences for the individual income tax of the shareholders. Usually they come in a higher tariff class than has been assumed in the examples of sections 19 *et seq.* The consequent tendency to retention of profit occurring in private share companies has therefore many times led to special provisions to ensure the interests of the Revenue. The size of the distributions will depend on the point at which the need of the shareholders for money for private use weighs more heavily than the fiscal sacrifice on distribution. Systems B and C shift, compared with system A, the burden from distribution of profit to retention of profit.

Higher withdrawals continue to demand a fiscal sacrifice, because in these cases the individual income tax will usually surpass the mitigation of the corporation tax. It is nevertheless to be assumed that the size of the withdrawals under these systems will be higher than under system A; probably, however, not much higher. In the private share company as a rule the ceiling of the distribution is low this company often having no choice other than retention of profit, because self-financing forms practically the only source of capital for modernization and expansion. The fiscal charges of this self-financing under systems B and C are higher as compared with system A, in consequence of the higher rate on retained profits. Self-financing becomes more expensive and the fiscal position more unfavourable than that of share

¹⁾ In the period of introduction or abolition system C shows a considerable difference in effects as compared with the systems A and B. In system C the taxation in the first phase, at the level of the share company, in the form of corporation tax or *précompte*, is heavier than in the two other systems. It is true that part of that tax is refunded (credited) in the second phase, but this only happens after some time and to taxpayers other than the company. Thus when switching from system A or system B to system C, if the level of the burden remains equal, the enterprises have to face higher tax obligations than would have been the case under the old system. To avoid this, the tax reform will at the same time have to introduce a tax reduction. An example is the tax reform in France in 1965, whereby the rate of the corporation tax was not increased with the introduction of the right to a credit. The inclination of the enterprises to maintain the old dividend percentage can lead to the position where the tax reduction at first entirely accrues to the shareholders (apart from the supplementary payment of individual income tax by those shareholders). A reaction can follow in the following years in the form of dividends lagging behind with increasing profits. The budgetary and monetary effects are naturally also governed by the presence of a dividend tax and the régime of advance payments (compare the note to section 31).

companies which can afford more distributions. The private share company does not have access to the more ample means available on the capital market.

4. The tax structure and the legal form of enterprises

47. In this section a problem of fiscal neutrality is discussed, viz., the question of how to avoid the situation where the enterprise with the legal form of a share company is fiscally at an advantage or a disadvantage as compared with the sole proprietorship. The problem has two aspects: to have the smaller-scale business and the medium-sized business choose their legal form at will; and the aspect of the competition between the large-scale business in corporate form on the one hand and the sole proprietorship on the other hand.

48. None of the systems discussed is neutral in respect of the legal form of the enterprise. The individual income tax is in all systems progressive and the corporation tax proportionate. When the income of the individual entrepreneur increases, the difference between the marginal burden of the individual income tax and the rate of the corporation tax becomes increasingly significant. In the total of circumstances which make the corporate form more advantageous than the direct conduct of the enterprise, the size of the profit (and of the other income of the individual entrepreneur) is an important factor, but numerous other circumstances are also of importance, such as the amount of the deductible compensation of the management and the necessity of distributions by the share company which again are subject to the individual income tax. For the comparison of the systems it will be sufficient to note that systems B and C are more neutral than system A, in so far as both the prospect of fiscal advantage and the prospect of fiscal disadvantage in consequence of the transformation of the business into a share company become smaller. The advantage is smaller, because the rate of the corporation tax on retained profit is higher in systems B and C than in system A, and the distance to the top-rate of the individual income tax smaller. The disadvantage is smaller, because the economic double taxation on distributed profit is moderated in systems B and C. In private share companies the first mentioned aspect will presumably be much more important than the second. The conclusion must be then, that the switch to the corporate form under the systems B and C has generally less fiscal significance than under system A, but will mostly also be less attractive than under the last mentioned system. Just as in section 46, it also appears here that the fiscal position of the private share company under systems B and C is a little more unfavourable than under system A.

49. In all systems, provisions are conceivable in order to prevent the situation where for small-scale or medium-sized business the corporate-form, which is desirable or even necessary for private law and/or business economic reasons, causes too heavy fiscal burdens. The chance of an extra burden is reduced if the joint shareholders can opt for a régime holding the possibility of fiscal transparency with respect to the share company, and that the shareholders are taxed as if they were directly the owners of the enterprise and as if they enjoyed as income a share of the profit proportionate to their holding. If that possibility of opting for fiscal transparency (see Chapter IV under b) exists, it may be assumed with substantial reason that, if no use is made of the option, in any case for the majority-shareholders, the "economic double taxation" whether or not mitigated does not mean an extra burden compared with individual income tax on the whole profit. For the reasons mentioned in section 48 such a right to option has presumably more significance under systems B and C than under system A. In a certain way some other method to detach the taxation from the legal form of the enterprise can be considered as a counterpart of the fiscal transparency method. This method implies a uniform taxation on the profit of enterprises, irrespective of their legal form. Withdrawals from sole proprietorships are regarded as a dividend for this form of taxation. One of the principal objections against such a business tax is that it affects the fundamental idea of the synthetic individual income tax.

50. The second aspect, mentioned in section 47, is that of the competition between the large-scale business in corporate form on the one hand and sole proprietorships on the other hand. Here the attention is drawn above all to the tax rate for the retained profit, because that part of the profit is directly of significance to the expansion capacity of the share company. In this respect, systems B and C contribute more to a balanced tax régime than system A.

5. The choice of the means of financing

51. In this section, just as in the foregoing, a neutrality problem is being discussed. Interest on loan capital is deductible in computing the taxable profit, interest on the equity capital (or on the paid-in capital) is not. This difference in fiscal treatment could be a stimulus to the use of financing by loan capital, instead of financing with equity capital, to a greater extent than is justified from a business economic, and than is desirable from a social economic, point of view. Some people are of the opinion that by emphasizing the fact that there is economic double taxation on dividends the essential drawback of the existing corporation taxes has not been indicated correctly. That essential drawback would, in this argument, rather be the difference in fiscal treatment just mentioned of the financing cost in the business economic

sense. The adequate solution is sought for by them through providing a deduction for a primary dividend which usually, on considerations of principle or of practice, is fixed at a certain percentage of the paid-in capital. This line of thought is discussed in Chapter IV under c. Here, however, the significance of systems A, B and C for the choice of the means of financing is under consideration.

52. Systems B and C do not imply an exemption of dividends, but a mitigation of burden. That mitigation is applicable to the whole dividend, irrespective of the fact of whether this comprises a primary capital reward or surplus profit resulting from "rents". Both systems moderate along the whole line the fiscal differences between interest on debentures and dividends. In order to be able to pay 6% dividend, with the rates of the examples, 10% profit before taxation is needed under system A, and under systems B and C only 8% because the "tax quota" (section 33) under those systems amounts to one third. From a theoretical viewpoint, the idea of a more neutral attitude of the Fisc in respect of the choice between the use of equity capital or loan capital is attractive. Whether the effect in a concrete situation must be considered as favourable or unfavourable is dependent on whether the total of the factors which determine the method of financing, prove to lead to a degree of financing with loan capital which evokes drawbacks.

53. Also, in this respect the fiscal factor is only one amongst many. Thus there is a restraining influence on the issuing of loan capital through the fear of charges enduring when the profitability of the enterprise decreases. Furthermore the return required by the suppliers of capital can be higher on loan capital than on the issue of shares; for the remuneration of the investor is not only to be found in the dividend, but also in the increase in value of the share by retention of profit. The significance of that increase in value for the private investor is the greater, because as a rule it is not taxed at all, or is taxed at a low rate. In this respect the issue of convertible debentures is a compromise between the desires of demanders and suppliers; seen from a general economic point of view it has its good side in that, from time to time, in periods of high stock exchange prices, the debts of business decrease, so that there is less danger of a constantly accumulating burden of debt.

54. The many non-fiscal factors which influence the capital market, such as the size and direction of the supply by institutional investors, cannot be discussed here. However, it may be mentioned that the gradual decrease in value of money will have opposite effects on the demand for and the supply of capital. Fear of inflation will have the result that the suppliers of capital demand a higher interest on debentures and will mean

that they will prefer to invest their money in shares. On the other hand, the possibility of inflation reduces the resistance in the share company to the incurring of debts by the prospect of a decrease of the real burden.

6. Unnecessary business expenses

55. One of the disadvantages of high tax rates on income and profit is that there is a tendency of proceeding sooner to expenses which are not justified from a purely business point of view, but which satisfy the personal wishes of entrepreneurs (-shareholders). Examples of this are expensive office fittings, fixtures and furniture and "Bewirtung" of guests of the enterprise (excessive entertaining). The possibilities of deduction of such expenses exist particularly in enterprises, because the tax administration, under the law or in practice, does not enter into the conduct of the business and the proof that business considerations have not been decisive, is difficult to furnish. The provisions of the law existing here and there which counteract deduction of such expenses, only have a limited significance and present difficulties of implementation. Assuming that these expenses in the first place make the retained profit lower, systems B and C have the drawback that, with an equal level of tax burden, they have a higher rate for that profit than system A.

7. Anti-cyclical application

56. The two possible classic uses of the corporation tax for the mitigation of cyclical disturbances are rate alterations and alterations in the determination of the tax base by granting additional depreciation, investment allowances, etc. The last mentioned stimuli will work a little stronger under the high retention rate of systems B and C than under system A. Systems B and C add a third possibility. This consists in the alteration of the *écart* between both rates of system B, and the alteration of the size of the credit in system C. An application in system C could fit in the whole of a policy to influence private consumption. An application in system B would in the first instance have an influence on the available means of a great part of business. The effect however—contrary to such instruments as additional depreciations and investment allowances—would not extend to enterprises of natural persons and, unlike it is the case with these instruments, not particularly be aimed at investments in business assets which are of special importance to the cyclical development. A serious drawback of alterations in the rate *écart* for anti-cyclical purposes is in both systems the time lag between the decision of the government and the effect on the enterprises and on the shareholders.

57. The average dividend quota is presumably in all cyclical phases under the systems B and C a little higher than under system A. The individual income tax

can therefore in the systems B and C, in consequence of its level and the progression, exercise certain effects as “build-in stabiliser”.

Those effects are, however, affected by the mitigation for the avoidance of economic double taxation on distributed profit. That mitigation encourages distribution, for the very reason that it eliminates for a great part the tax effect. If one assumes that in a period of boom, with increasing money incomes, the individual income tax, on average due on the dividend, amounts to 40%, then the extra dividend (compared with the situation under system A) is not taxed by more than 6 2/3%, i.e., the difference between individual income tax and the amount of the mitigation. If the individual income tax, on an average paid on the dividend, is lower than the amount of the mitigation of the economic double taxation, then the tax receipts are lower to the extent that the dividend quota is higher. In a period of recession opposite effects are to be noticed. In both situations the differences in this respect between the systems are of little practical importance.

8. Improvement of the distribution of property

58. From a point of view of social policy, an interesting question is whether the systems discussed also differ in so far that one system more than the other contributes to an increase of the holding of shares by the lower classes. In the first instance one would think that a mitigation of economic double taxation is particularly of benefit to those who have a low income and who therefore only have to pay a small percentage of the return to the Fisc.

As to this subject it is especially necessary to hold on to a comparison between the systems on the basis of an equal level of burden in the corporate sector. If the introduction of systems B or C means a budgetary sacrifice, then, as far as no signs of shifting occur, an increase of the available private income resulting from it accrues to the groups of people with a medium-sized or high income; for among the working classes the holding of shares is practically non-existent. The cases in which a low income and the holding of shares go together, can partly be explained by inheritance, gifts to children, etc. A correct comparison of the merits of the systems is only possible with an equal level of burden, which means that opposite to a mitigation of the burden on the distributed profit stands an increase of the burden on the retained profit. Does that alteration make the holding of shares more attractive for people with a low income?

59. It must be emphasized that not a single effect is to be expected if the dividend quota remains equal to that under system A. If the dividend under the three systems is the same, then the result for the taxpayer with a low income is also the same. More of the dividend (in system C, including the “avoir fiscal”) remains after

the imposition of individual income tax, to the extent that the taxpayer is subject to a lower progressive tax rate, but this is true of all three systems.

60. If the dividend quota under systems B and C is higher than under system A—which may be assumed (see sections 37 *et seq.*)—then, if one considers the income disposable for spending or saving, the taxpayer with a low income profits more by it than the shareholder who is subject to a high progressive scale. This applies to all increases of income. Contrary to this, the retained profit of the company is lower (examples II and III). Retention of profit has—in general, and seen on a longer term—the tendency to increase the value of the share. That increase of value is not taxed, or is taxed at a proportionate rate, so that the net advantage is independent of the income. A higher dividend quota seems therefore, in general, to be more advantageous—or less disadvantageous—for the groups with a low income than for those with a high income. In the short term, an increase of the dividend quota does not need to have an influence on the price of the shares. The profitability of the enterprise does not change for the time being and for the shareholders with a medium-sized or high income—who have the greater part of the shares in their hands—an increase of the distributions, when the profit remains the same, will in general give no ground for a higher valuation of the share. Should, in the case of an increase in dividend at the cost of the retained profit, the prices rise then the increase of the rate of return is lost to that extent.

61. Let us, notwithstanding the great degree of uncertainty on numerous points, assume that under systems B and C the holding of shares becomes more attractive for the “small investor”. This can manifest itself in two ways. There can be a certain shifting of the holding of savings accounts and bonds in the direction of the holding of shares (whereby the risk can be spread by buying shares in investment funds). Here lie chances, when money continues to decrease in value, of a better maintenance of the real value of the holding. This is, however, hardly a matter which influences the distribution of property. This influence will only make itself felt if the greater attraction of shares would lead to more savings from income. This possibility must be considered to be small.

Even apart from the fact that the inclination to save is determined to a very considerable degree by other factors than the prospect of a higher income from the return, it is not to be assumed that a somewhat higher return on a small holding of shares will alter the spending habits in the case of a low income. The continuing increase of the real income of the workers, junior office employees and suchlike will make little difference. For the general increase of prosperity evokes among the

least prosperous people a strong urge to increased consumption.

62. Systems B and C have in identical cases the same definite tax consequences. The difference between both systems is that in system C the small investor, who has to pay little or no individual income tax, only after the assessment for the individual income tax receives the remaining net dividend amount, whereas in system B the whole dividend is received at once from the share company. If however, as is usual, an advance levy in the form of a dividend tax is added to system B, then the same effects are achieved: a delay in the availability of part of the dividend and the avoidance of an "additional collection" of individual income tax.

9. Socio-psychological effects

63. The diverging, mutually sometimes opposite effects of a certain tax structure, cannot be overviewed by the taxpayer. Certain aspects, however, sometimes stand out so distinctly, that they have an influence on the confidence with which, however much difference of opinion there may be as to the desirable distribution of the burden, still, in any case in principle, as far as possible equal treatment of identical cases is respected, which includes a not too different treatment of socially closely related categories of cases. Unequal fiscal treatment, or the suspicion of it, can evoke strong emotions. An example of such a judgment of the fiscal position of practically identical cases is the inclination of the middle class trader to compare the marginal burden of the individual income tax paid by him—which restricts his possibilities for renewal and expansion—with the tax on the retained profit to be paid by the share company competing with him (section 50).

64. Differing opinions are held on the question of whether, in general, shareholders regard the double burden of the corporation tax existing side-by-side with the individual income tax on dividends as being unjustifiable. It seems reasonable to assume that shareholders of private companies feel this way. To a certain extent, the ground for this can be removed by the opening of the option mentioned in section 50. The normal investor is in a different situation; he is not personally involved in the imposition of the corporation tax. He compares the pros and cons of the various forms of investment which accrue to his account: a savings account, life insurance, bonds, shares and immovables. What prior burden, in the form of corporation tax or other taxes, the yield from these investments have undergone is not known to him as a rule. He will also not be very interested, since the prior burden has already been discounted in the expected profitability and the development of the value of the investment. Only changes in the prior burden during his holding—which

can happen in any system—are of importance to him. The switch from a system containing economic double taxation to a system which partly takes away that double taxation—or vice versa—will be particularly taken into account by him in connection with the question of whether the value of his holding is affected. If the prior burden, roughly, remains the same then it is improbable that the alteration of the structure of the system seriously affects his senses of justice as an investor.

65. There can be some doubt as to the answer to the question of whether the nonshareholder will take a similar view and will find in none of the systems discussed here an infringement of the principle of fiscal equality. This is especially the case with system C, on account of the fact that on the dividend received in cash little or no tax need to be paid (or tax is even refunded), which can give rise to the thought that there is a fiscal privilege for this form of return on property as opposed to other forms of income. The significance of this psychological factor will vary according to the national fiscal tradition—e.g. whether or not the principle "non bis in idem" is established—and the information which is given to the taxpayers on the significance and the consequences of the system of taxation.

10. Technical tax points of view

66. In the choice between diverging tax structures the technical tax points of view are of great importance. A complicated structure can impede the extent to which the law and its implementation are understandable and thus have influence on the degree in which taxation, as it has been prescribed in the law, is in fact put into force. Drawbacks of that nature can effect the distribution of burdens aimed at and have consequences for the conditions of competition. Furthermore they increase the collection costs for the government and the "indirect costs" consisting of the costs and the nuisance which the fulfilment of his obligations implies for the taxpayer and the supervision of that compliance by the government.

67. Systems B and C are by their nature more complicated than system A. They are similar to the last mentioned system in as far as they contain a real corporation tax which is also imposed in case of a complete distribution of the profit. They differ from system A by the fact that in addition they contain a regulation to reduce the tax in the case of distribution of the profit. That regulation gives rise to complications. The reduction should only be granted if this is in agreement with the purport of the system, viz. *if indeed there is a question of double taxation, and therefore not in cases in which the corporation tax is not (or not fully) imposed, or no individual income tax is to be paid.* The technical elaboration of this point differs in connection with the difference in the structure of the systems pointed out in section 23.

68. In system B the technique of the law and the implementation are entirely in the sphere of the corporation tax and of the tax at source to be retained on dividends paid by the share company. The imposition of the individual income tax is beside the point. The application of the lower rate is governed by the definition of the concept of distribution entitling to taxation at the lower rate (“berücksichtigungsfähige Ausschüttung”). These should be excluded from this definition the distributions which under the national law, do not give cause for the imposition of individual income tax. In the Federal German Republic this includes a bonus share distributed to shareholders, with the exception of the bonus share from the annual profit (stock-dividend).

That which falls under the concept of “berücksichtigungsfähige Ausschüttung”, can accrue to persons other than natural persons. The corrections necessary when dividend accrue to share companies have already been discussed in sections 24 *et seq.* If the dividend is enjoyed by entities which are not liable to taxation, such as cultural, ecclesiastical and charitable institutions and associations, then problems of implementation impede retracting the lower rate.

69. It should furthermore be provided whether a distribution of dividends from the profits of previous years does or does not entitle to taxation at the lower rate, which is notably of importance if the share company conducts a policy of dividend equalization. An affirmative answer to that question leads to numerous complications, such as reopening assessments of previous years. Exclusion of past profit (and of exempted profit) can partly be achieved by a limitation of the privileged distributions to an amount of the taxed profit of the last year. Such is the provision in the German law. More accurate works a limitation to the after tax profit of the last year, i.e. after deduction of the corporation tax due (the “available profit”). Those limitations cannot prevent difficulties from arising, if the law provides for a carrying back of losses. In that case, the amount of the taxed profit is being reduced retroactively, which leads to an additional imposition of corporation tax and which can have an effect on the “Nachsteuer” (section 26).

In the foregoing, it must also be taken into consideration that the profit for tax purposes can differ from the commercial profit, which forms the starting point for the appropriation of profit by the share company.

Special tax régimes for certain categories of entities may require an adaptation of the provisions mentioned above to those régimes. The technical complications that are to be found in system B are not small. They affect, however, a relatively small number of taxpayers.

70. In system C the moderation of the economic double taxation is applied, when the dividend passes the second

toll. The connection with the concept of taxable income—or taxable profit for share companies—is thus achieved automatically. If bonus shares are not affected by the individual income tax, the full corporation tax continues to burden them. There is also no question of credit if the dividend is received by entities which are not liable to corporation tax, such as cultural, ecclesiastical and charitable institutions.

71. The dividend can find its source in profit which is not taxed at all, or not taxed at the normal rate. The legislator can consider this not to be a sufficient reason to refuse the normal credit in case of distribution. Such is the provision in Belgium. With a high rate of tax the drawbacks increase. The French law maintains the requirement that the dividend must accrue from profit taxed at the rate of 50% (in which case by presumption of law the dividend may be deemed to accrue first of all from the fully taxed profit). How far this is the case would have to be determined every time when a dividend distribution takes place, assuming that for the share company the assessment has been definite. Dividends with diverging credit rights, however, would constitute serious complications, both for the determination of prices on the stock-exchange and for the individual income tax return for the shareholder. This complication can be removed by imposing an additional advance levy on distributions accruing from profit not fully taxed. Thus in France (the country which provided the C rate of the examples in sections 19 *et seq.*), 1/3 of the dividend distributed from profit which has remained untaxed has to be withheld and paid as a *précompte* to the tax administration, i.e., 50% of the 2/3 which the shareholder receives in hands. The computation of the individual income tax of the shareholder can thus always proceed from an integral credit. Dividends accruing from participation dividends received tax free, fall under the *précompte*. However, as concerns participation dividends from French subsidiary companies, the credit connected with it can be applied against the *précompte*. A further equality when imposing individual income tax on dividends can be achieved, as happens in France, by instructing domestic institutions acting as intermediaries in the payment of foreign dividends to residents, to withhold 1/3 of the dividend as advance levy (“*retenu à la source*”). The difficulties with the imposition of the individual income tax are thus reduced.

Nevertheless, the necessity of “grossing up” the dividend (increasing the amount received by the “avoir fiscal”, which is equal to the credit and declaring the total as income) remains a complication, which has the more significance, because the credit right must be realized by a great number of persons who have little skill in the field of accountancy. That consideration makes it desirable not to impose a dividend tax in addition; and in this system there is not so much reason for a dividend tax.

72. Furthermore it is for administrative reasons alone necessary to grant the reduction only if the recent profit is distributed. Such a restriction does not need to go as far as under system B. A limitation of the credit right to dividends from the profit of the last five years – in accordance with the French legislation – would seem sufficient.

73. Additional considerations may furthermore lead, as is the case in Germany and France, to excluding distributions not provided for in the corporate charter from the relief.

III. International aspects of the systems A, B and C

74. From the structure of the systems (section 1) follows the nature of the consequences which can occur in the application to cases with an international element. In system A the taxation of the entity takes place independently of the taxation of the shareholder. The former does not affect the latter. Thus the application is domestic and the same prevails in the application to profits and dividends crossing borders. So in the imposition of the corporation tax it does not matter whether the shareholders are residents or non-residents and it is of no influence on the taxation of the shareholders – provided double taxation is avoided by a unilateral measure or by a tax treaty – whether the profit from which their dividend accrues is made by a domestic or by a foreign share company. In systems B and C the legislator has brought the taxation on the profit and the taxation on the dividends in relation with each other, in order to moderate the economic double taxation. The relief in one phase finds its reasons in the full taxation in the other phase. In system B the corporation tax on distributions is reduced in view of the individual income tax on the dividends. In system C the individual income tax is relieved by considering an element of the corporation tax as an advance levy. If the whole process takes place within national territory, then the legislator has in principle complete control. If one of the two phases takes place abroad, then the question arises what consequences must be attached to it for the other phase.

75. In certain cases, as will appear below, those consequences are expressed in “border adjustments”, in impositions or refunds of tax in respect of dividends crossing borders. In the systems B and C border adjustments of that nature cannot be avoided, if one does not wish to tax cases involving a foreign element considerably lighter or heavier than similar domestic cases.

Border adjustments in respect of dividends also take place, irrespective of the tax structure, on account of the international demarcation of the taxing rights of the countries, but they do not need to accrue from this. A balanced demarcation of the taxing rights of the countries, in the way that international double taxation

on dividends is avoided, is possible without border adjustments. It has become usual, however, as will be discussed in the next section, to grant to the source country of the dividends a certain right of taxing.

In systems B and C consequently several types of border adjustments concur, a conjuncture of which hampers a clear understanding. The two problems can indeed be theoretically distinguished within these systems, but they cannot be separately regulated.

76. The international consultation on the problem of the avoidance of international double taxation in the Fiscal Committee of the Organization for Economic Co-operation and Development has led in 1963 to the drawing up of the model convention. The provisions laid down in it give the most representative expression of the concepts in respect of the demarcation of taxing rights at present prevailing in Europe. The OECD model convention of 1963 has been recommended by the Council of the OECD as a guide in the conclusion of bilateral treaties; it has been accepted by the Member States of the European Communities as a basis for the discussions on a multilateral convention, and the same applies to the Member States of the European Free Trade Area. The provisions of the OECD model convention give in general a consistent solution of the problem of the avoidance of international double taxation on profit and dividends. The imperfections,¹⁾ which are to be found on certain points, as well as the remedies against them, stand apart from the tax structure and are therefore not discussed here. For each category of income the model convention determines the limits to which the taxation on the income in the source country can extend. Profit of a share company is taxed in the country where the share company is established, provided that the profit which can be attributed to a permanent establishment in the other Member-State can be taxed by the last mentioned State. The taxation of dividends is – unless the shares belong to a permanent establishment in the other State – left to the country of residence of the shareholder, except that a limited imposition in the source State can be agreed upon. Against the unlimited imposition on profit and the limited imposition on dividend in the source State, stands the obligation of the other State of granting an exemption or a credit for the tax paid abroad.

These provisions of the model convention can by themselves be applied in the relation between countries with system A. For the conventions with or between countries with another system a definite solution could,

¹⁾ Reference is particularly made to the Proposal by the Council for a directive, concerning common taxation applicable to parent corporations and subsidiaries established in different Member States submitted by the European Commission to the Council (15 January 1969).

in 1963, still not be found, so that a further study of the Fiscal Committee of the OECD has been decided upon. That study has not yet been completed.

77. In the expositions following hereafter, in order not to complicate the argument, attention will not be drawn every time to the possibility of an imposition on dividends in one country and a credit in the other country. In a number of cases, however, such an imposition plays a part in the effects of the systems and attention should be drawn to that element.

System A

78. As can be seen from the above, the drawing up of rules for the application of system A in accordance with its purport to cases with an international element, gives rise to little difficulties. In the system itself, as it has been described in section 74, demarcation of the taxing rights has been already provided for. In the avoidance of international double taxation, the practice of the treaty, in accordance with the OECD convention, is based on the principle of reciprocity. The provisions of the model convention stand apart from the level of the corporation tax and of the level of the individual income tax in the countries from which the income is coming and to which it flows. This independence from national alterations in the tax rates gives durability to the treaties based on those provisions and is advantageous to the uniformity of the treaty law.

Reference table for systems B and C

79. In the following considerations the various categories of cases in which one or more foreign elements occur should be carefully distinguished.

In view of this the table below has been included, to which reference is made each time that this should be necessary for the sake of clarity.

The following elements of a foreign nature determine the classification of the table:

- the profit has been made abroad (Table under II)
- the share company is established abroad (Table under I (2) and II (2))
- the shareholder is a non-resident (Table under I (1) b; I (2) b and II (1) b).

In order to provide a better survey the cases have also been included in which a foreign element is lacking (Table under I (1) a). The cases in which the domestic element is entirely lacking have not been included, because then there is no point for taxation to be based upon.

Among the shareholders, the parent companies of concerns occupy a special place for tax purposes. The shareholders, therefore, are each time distinguished as being:
a. parent companies, i.e., share companies which on account of unilateral provisions or by treaty enjoy

exemption from corporation tax for the dividends on the participation in the subsidiary company (“Schachtelprivileg”), in respect of the size of their holding of shares in other companies (subsidiary companies), or have a right to indirect credit (see section 90);

- b. investors, i.e., the other shareholders, natural persons or share companies which with respect to the dividends are liable to the individual income tax or the corporation tax on the same terms as for other income (apart from the credit for possible withholding taxes).

Naturally a share company can be liable to taxation in more than one capacity and fall under more than one regime. Complicated situations, such as the attribution of dividends to the profit of a permanent establishment, have been left aside.

I. Domestic profit

- (1) made by a domestic share company, of which the shares are in the hands of:
 - a.1. a domestic parent company (chapter II)
 - a.2. resident investors (chapter II)
 - b.1. a parent company abroad
 - b.2. non-resident investors
- (2) made by a permanent establishment of a share company abroad, of which the shares are in the hands of:
 - a.1. a domestic parent company
 - a.2. resident investors
 - b.1. a parent company abroad
 - b.2. non-resident investors

II. Foreign profit

- (1) made by a permanent establishment of a domestic share company, of which the shares are in the hands of:
 - a.1. a domestic parent company
 - a.2. resident investors
 - b.1. a parent company abroad
 - b.2. non-resident investors
 - (2) made by a share company abroad, of which the shares are in the hands of:
 - a.1. a domestic parent company
 - a.2. resident investors
-

System B

80. Before proceeding to an examination of the various categories of cases, it is desirable to make a few general remarks on the nature of system B and on the standpoint which can arise from that nature in respect of the extension of the reduction of the corporation tax to distributions from foreign profit and to distributions to non-residents.

81. It is characteristic of system B that the moderation of the economic double taxation on dividends takes place in the sphere of the corporation tax.

As far as the corporation tax affects domestic profit, there is no problem: distribution is followed by reduction.

Is there also a reason for the reduction of the corporation tax when there is a distribution of profit of foreign origin?

An affirmative answer is quite natural, if the profit of foreign origin is liable without restriction to the domestic corporation tax. This answer can also be given, if credit against tax is granted for the foreign tax, and also if that credit, in respect of dividends from subsidiary companies, extends to an indirect credit for the corporation tax abroad.

But what must be the answer, if the foreign income, unilaterally or by treaty, is exempted from the domestic corporation tax? Is there sufficient reason for the granting of the reduction if profit is distributed which is affected by corporation tax abroad?

The nature of system B produces arguments for a negative answer. If returns abroad are exempted from corporation tax, they cannot qualify for the moderation of that tax. A fiscal rule of that kind should form a part of the tax regime of the country which as the source country is entitled to tax the profit. A reduction of the corporation tax finds indeed a natural limitation in the amount of that tax, and the reduction fitting to the system could not even be fully effectuated if the profit of the domestic share company mainly consists of exempted dividends from subsidiary companies, as can be the case with parent companies of international concerns. On the other hand, the point of view that the phase of the corporation tax has been terminated with the imposition abroad, also entails that the fact that (exempted) foreign participation dividends are not passed on to the parent's own shareholders does not give rise to the imposition of *Nachsteuer* in the hands of the domestic parent company. This is also the provision in the German legislation.

82. Still, also if the negative standpoint is taken in respect of distributions accruing from exempted foreign profit, an increase of the reduction of the corporation tax can in fact occur by the presence of that profit. The presence of that profit will mostly be expressed in the size of the distributions. If the distributions are proportionally attributed to the profit elements, the reduction will not increase. This will be different if the law provides that the dividend is considered in the first place to accrue from the taxed profit. Such a presumption of law, that in fact the reduction is also applicable to part of the distributed foreign profit, exists in the Federal German Republic. An analogous rule in respect of the credit right in system C exists in France.

The effects of the priority regulation described here in the application of the distributions are not prevented, but indeed they are somewhat limited, if the stipulation is made that the amount of the privileged dividends cannot exceed the "available profit", i.e., the taxable profit decreased by the corporation tax (see section 69).

83. A second characteristic feature of system B is that the relief is already granted with the distribution by the share company, without waiting to see if the dividend is taxed (again) (see section 23).

If a country employing system B does not take measures which withdraw the reduction of the corporation tax in the case where the dividend is enjoyed by non-residents, these automatically also benefit from the moderation of the economic double taxation.

The question of whether for that country there is occasion to take such "compensating" measures, can be answered differently according to the view which is adopted as to the mitigation of the economic double taxation. Both a narrow and a broad conception are possible. In the narrow conception the purport attributed to system B is only to moderate the economic double taxation if not only the corporation tax, but also the other component of the imposition, viz. individual income tax—or in share company with just a few shares: corporation tax—belongs to the own tax system. In that conception the reduction of the corporation tax is a correction of the total domestic tax burden on distributed corporate profits which are considered to be too high, and there is no reason for such a correction as far as the shareholders live or are established abroad and consequently a component of the imposition belongs to a foreign tax system.

84. There are, however, impediments to this narrow conception in the imposition of the corporation tax. A limitation of the reduction of the corporation tax on account of the presence of non-resident shareholders would not only affect the non-resident shareholders, but all shareholders and this to the same extent. To the share company the burden of the corporation tax is an indivisible factor. Furthermore the share company would be taxed more heavily—by enjoying less reduction—because its capital is entirely or partly in foreign hands, which can be considered to be in contravention of the standpoint embodied in the non-discrimination clause of article 24, paragraph 5, of the OECD model convention of 1963¹⁾ and in corresponding provisions in bilateral treaties. Should the country with system B "take back" the reduction of the corporation tax in case of the holding of shares by non-residents, by measures which do not affect the distributing share company itself, e.g. by the imposition of a dividend tax on dividends flowing abroad, which has the object of compensating entirely or partly for the reduction of the corpora-

¹⁾ "Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of that first-mentioned State are or may be subjected." (For non-discrimination in respect of permanent establishments, see section 93).

tion tax—and which is defended on that account in negotiations on a tax treaty—then this would, in the letter of the agreement, not be in contravention of the clause of the OECD convention mentioned, but it would be difficult to reconcile with its intent. Those who prefer the narrow application of the reduction will also not follow the difficult, from a technical and juridical point of view, road of first granting and then taking back the reduction. The French form of system C (section 104) achieves in a more simple way the effect desired in that conception.

85. Therefore, the broad conception which maintains that the presence of non-resident shareholders in itself does not impede the granting of the reduction fits in system B. Here, however, the reservation should be made that the broad conception should not lead to consequences which mean a deviation from the purpose and the contents of the system, as this applied in domestic relations. The requirement of non-discrimination may be considered not to oblige the acceptance of such consequences. Domestically, reduction of the corporation tax is only granted if the requirement has been satisfied that it can be established that the profit has left the share company and, if received by a parent company, it has been passed on by that company to investors. The establishment of the fact that the profit has left the share company causes difficulties in the case of domestic establishments of a non-resident company (see sections 93-94). The establishment that the profit has left a concern causes difficulties with domestic subsidiary companies of non-resident concerns (see sections 88-92). The danger existing in the last mentioned case that an excessive distribution of profit will be decided upon for fiscal reasons, can also present itself in a share company which is controlled by a non-resident majority shareholder (-natural person) (section 87).

A non-resident, natural person or share company, owns just a few shares in a share company established in the country employing system B.

86. In these cases, in general, a second phase of taxation takes place in the country of the shareholder. The broad conception, which lets the non-resident shareholder share in the relief of the economic double taxation, as a rule therefore does not present difficulties when compared with the position of the resident shareholder. Therefore there is no reason for special compensating impositions. These certainly cannot rest on the argument that the country employing system B, in its capacity of source country, indeed imposes very little tax on the profit, when it limits itself to the low rate of tax on distribution, increased by the dividend tax of 15% usual in treaties. This argument of a budgetary nature—which only affects the shareholders if the other country refuses to credit a possible additional imposi-

tion—it not convincing, because with an equal burden of the corporation tax the difference between system B and system A is such that under system B the distributions are more lightly taxed, but in contrast to that the retained profit is more heavily taxed than under system A.

A non-resident natural person is majority-shareholder in a domestic share company

87. In this case the shareholder can influence the distribution policy of the share company in such a way that maximum advantage is taken of the low rate of tax on distribution of system B. He will be able to proceed to this with fiscal advantage if he is a resident of a country which taxes income in general or foreign dividends in particular at very low rates or not at all. The relief of burden which thus can be achieved also depends on the dividend tax in one country and the credit of it in the other country. In such cases the question can be raised whether system B, in which the rates of the corporation tax and those of the individual income tax have been adjusted to each other, does not become disordered in its effects. The consequences will be the more noticeable, if the shareholder provides for the financing of the enterprise by bringing in again in the form of capital the means withdrawn. To the budgetary loss for the country in which the enterprise is established are added then drawbacks in respect of the unequal competition position. As a remedy against such a use of the system one could think of a supervision of the degree of distribution, by means of similar processes as are sometimes applied in the opposite situation, viz. against private share companies which, for the avoidance of the imposition of individual income tax, do not proceed to a distribution of profit.

Experience shows that it is difficult to apply standards in order to be able to judge what extent of distribution is reasonable and that there can be good reasons for unusual conduct. One could also think of an additional imposition in the form of the maintenance of a high dividend tax in the relations with the countries whose tax system is the cause of the drawbacks. Such a regulation, however, would have a very blunt effect, because it would also apply to normal distributions and in the case of small shareholders. Besides, differentiation in the dividend tax increases the chance of tax avoidance by following a detour which is fiscally cheaper.

A share company abroad has a participation in a share company of the country which applies system B (parent company—subsidiary company relation).

88. In the country of the parent company the “Schachtelprivileg” can apply to the dividends on the participation. No obligation of distribution is connected with

the "Schachtelprivileg". Judged from the ratio of the system, the relief surpasses its purpose as to that part of the dividend which is retained by the parent company abroad and thus remains at the disposal of the concern. Should it concern a domestic parent company, a "Nachsteuer" would follow. If, however, the parent company has distributed the dividend received to its shareholders, and if these are investors, then the relief has been granted rightly. It cannot be expected that the other country is prepared to co-operate in obtaining verifiable data as to the extent to which the dividend from the subsidiary company may be considered to have contributed to the dividend of the parent company, and to what extent the dividend has been received by investors. In order to restrict the difference in burden as compared with the domestic cases of self financing, a compensating imposition will be desirable which, without any distinction, is applied to all outgoing participation dividends. The size of such a compensating imposition will have to be smaller than that of the "Nachsteuer", but it will only be able to be determined "à forfait". Inherent in this is a great degree of approximation; it is only certain that it must amount to a considerable part of the *écart* between the rates. In the Federal German Republic the rate of the "Kapitalertragsteuer" amounts to 25%, at a *rate-écart* of 36%. This dividend tax lies on the correct level if the concern does not pass on to the investors approximately 70% of the dividend from the subsidiary company. This percentage is higher than the normal retention quota of the total profit after taxation of international concerns. On the other hand there may be cases analogous to those described in the previous section. Concerns abroad—behind which domestic interests can also lie—have the opportunity to gain fiscal advantage by distributing more than would be the case on the basis of other policy considerations, and then to transfer the moneys received in the form of capital to the subsidiary company. Furthermore the country which applies system B will have to try by treaty negotiations to maintain as much as possible its own tax on participation dividends, as it functions as a partial "Nachsteuer". It will have to try to press forward that demand which is counter to the usual treaty regulations for participation dividends, and it will have to defend the point that its system, chosen for domestic reasons, justifies a deviation from the principle of reciprocity. In general this will best succeed within the framework of an exchange of concessions.

89. On the part of negotiation partners which apply the "Schachtelprivileg" the most understanding may be expected, because, by the very recognition of a "Schachtelprivileg" for participation dividends abroad, they show that they consider the phase of the corporation tax as a matter of the country of the subsidiary company. Naturally the agreed "Nachsteuer" does not come into consideration for a credit in the country of the parent company.

90. Less understanding can be expected from negotiation partners which apply the system of credit against tax. In the parent company the dividends are taxed as profit, with credit for foreign dividend tax and, if indirect credit is also granted, for the foreign corporation tax which is attributable to the dividend. Assuming that the level of the corporation tax does not deviate much from the level of the tax on retained profit in the country of the subsidiary company, the drawbacks of a too light burden mentioned above do not, or practically do not, exist. (This is the more so, if the negotiation partner also applies system B and therefore imposes heavier tax to the extent that the parent company passes on less dividend to its shareholders; such a country, however, will keep in mind the negotiations with third parties). On account of these considerations the "credit countries" will mostly be inclined to hold on to reciprocal application of the usually low treaty percentages for the tax on outgoing dividends. The most striking case is here again (compare section 87) the use of the withdrawn dividends for the financing of the enterprise in the country applying system B. For that case a special provision has been included in the German-American tax treaty which permits the maintenance of the German dividend tax at 25% if in the year of distribution in the Federal German Republic more than 7 1/2% of the dividend has been brought in again in the share company. The application remains restricted to the amount of the sum brought in, as far as it is covered by the dividend in the year preceding that when the amount is brought in, and in the two following years (article 6, section 5 of the treaty, as amended in 1965).

91. A further drawback of the additional taxation on outgoing participation dividends in the form of a higher dividend tax is that in the matter of the participation concept it makes the differences particularly striking. A splitting up of a shareholding, by apportionment to two or more companies belonging to the concern in such a manner that the treaty limit for participations is no longer reached, but still that in the country of the parent company, makes it possible to avoid the additional taxation of the country with system B, without the exemption in the other country lost.

92. If distributions not provided for in the corporate charter do not fall under the low distribution rate, such as is the case in the Federal German Republic, and then also at home do not give cause for the imposition of "Nachsteuer" in the hands of a parent company, they should, if accruing to a parent company abroad, also not be considered for a "Nachsteuer" in the form of a higher dividend tax. A distribution not provided for in the corporate charter can, for example, take place if the tax on the profit of the subsidiary company is based on a deviation from the price which had been agreed upon between the subsidiary company and the parent company. For these cases an exception will have to

be included with the same contents as that which has been laid down in the Final protocol to article 6, paragraph 11, of the German-Swiss tax treaty.

A permanent establishment in the country applying system B of a foreign share company

93. Also in the case of transfer abroad of the profit, the profit remains in the same enterprise. No more than with participation dividends can the application of system B proceed according to plan. Part of the facts relevant to that application—viz. the extent to which the profit of the permanent establishment can be considered to have been distributed otherwise than to a parent company—is hidden from the observation of the tax authorities in the country applying system B. Again a rough solution “à forfait” is the only way out. The German legislation excluded the profit of a permanent establishment of a foreign enterprise from the double rate. The tax rate for the whole profit has been fixed at 49%, i.e. 2% lower than the rate for retained profit of share companies established in the Federal German Republic. The presence of profit destined to be distributed in the other country, and to be taxed in the hands of the shareholder, is always taken into account to a small extent, even if the profit in fact serves the purpose of self-financing; but on the other hand, also in that case only to a very small extent, if the profit for a greater part flows to the shareholders. Fiscal neutrality in respect of the legal form of the enterprise cannot be spoken of. In the Dutch draft bill of 1960 (see section 2) no moderation at all of the high rate had even been provided for in this case. This omission certainly does not seem to be compatible with the non-discrimination provision laid down in article 22, paragraph 4 of the OECD model convention¹⁾ and in many bilateral tax treaties.

“Indirect taxes”

94. Both in the case of the participation dividends and in the case of permanent establishments, resident investors can find themselves among these finally entitled to the profit of the enterprise abroad. Through international mergers these cases will increase in number and in significance. In the narrow conception (section 83) there is then also an economic double taxation, viz. a conjunction of the burden of the domestic corporation tax and of the domestic individual income tax. A moderation of that burden for the resident shareholders which goes further than the agreed settlement, in the manner of section 88 and section 93, is, however, for the reasons mentioned above, not to be realized. In the French legislation also the “indirect” resident shareholders are not entitled to a credit; the credit is only

applicable to those distributions to French residents which are made by share companies established in France.

95. The conclusion from the foregoing considerations is that system B, because of its starting point of relief being given already at the point of the imposition of the corporation tax, proves to be a rigid system, if it must be applied to cases with an international element. Practical considerations, and sometimes also juridical points of view, prescribe the course to be followed. The conclusions which have been reached in the items discussed agree with the form which system B has obtained in the Federal German Republic.

An important principle is that the economic double taxation is only moderated when the profit taxed within the country is distributed, except for the mitigation by the presumption of law mentioned in section 82; and furthermore that both resident and non-resident shareholders share in the mitigation. The application of the mitigation therefore extends to all cases mentioned under heading I of the Table (section 79).

These principles can be realized in accordance with the application at home in respect of non-resident investors (natural persons or entities) who own just a few shares in domestic share companies. For the rest such a realization, for numerous reasons, is not, or only in an imperfect way, possible:

- the taxation of domestic share companies which are subsidiary companies of a company abroad, must be supplemented “à forfait” by a tax on outgoing dividends, which cannot be adapted to the circumstances of the individual case, which are relevant in accordance with the purport of the system;
- the incorporation in a tax treaty of such an additional imposition on participation dividends, if necessary deviating from the principle of reciprocity, meets with resistance, notably on the part of those countries which do not have a “Schachtelprivileg” for foreign participation dividends and which apply the method of credit against tax in order to avoid international double taxation on participation dividends.

The tax regime in these two categories of cases stimulates investment in the country applying system B. The withdrawal of the profit, necessary for the sake of the fiscal advantage, can be followed by reimportation of the funds in the form of capital. These stimuli emanating from the system are particularly effective when the dividend in the country to which it flows is taxed at low rate, or has been exempted as a participation dividend.

By the establishment of holding companies and similar structures, the interested party can contribute to the creation of such a situation.

¹⁾ “All other elements of capital of a resident of a Contracting State shall be taxable only in that State”.

- differences between the participation concept, unilaterally or by virtue of a treaty in force in the country applying system B, on the one hand, and the participation concept which is applied unilaterally by some other country, on the other hand, can lead to outgoing dividends being exempt from the additional imposition, even though they have been exempted in the other country as participation dividends;
- in respect of domestic permanent establishments of companies abroad, the application of the double rate must be renounced and an agreed uniform rate be accepted, which does not allow for the appropriation of the profit in the individual case. This regime differs from that for subsidiary companies of companies abroad. System B is therefore not neutral in respect of the legal form for investments from abroad;
- a non-resident who controls a domestic share company and who in his home country pays little or no individual income tax on the dividends, can, by maximum distribution of the profit, enjoy more fiscal advantage than is in accordance with the purport of the system. This stimulates tax flight.

System C

96. In system C the mitigation to reduce the economic double taxation on dividends is only granted if the dividend is taxed (again) (section 23). The taxation in the first phase, on the profit of the share company, happens uniformly. That phase therefore is not prejudiced with regard to the application to cases with an international element. Consequently there are in system C more possibilities in respect of that application than in system B. The postulates which control the choice between the possibilities can be expressed in the most simple way in the regime for investment dividends:

- C I: Equality for resident and non-resident investors.
The mitigation to reduce the economic double taxation is not only granted to resident investors in domestic shares, but also to non-resident investors in domestic shares.
- C II. Equality for investments at home and abroad.
The mitigation to resident investors is not only given in respect of dividends on domestic shares, but also in respect of dividends on foreign shares.
- C III. Rejection of mitigation for cases with an international element. The relief accrues exclusively to resident investors in respect of dividends from domestic enterprises.

The regime for investment shares is characteristic for the three variants of system C, and, therefore, hereafter the three cases are discussed as variants of that regime. That denomination, however, is not quite exact, as will appear in the discussion of the rules fitting to each of

them for the other categories of cases, such as participation dividends and profit of permanent establishments.

C I. Equality for resident and non-resident investors

97. If, in the application of system C to international cases, the starting-point is accepted that the relief to mitigate the economic double taxation on dividends should also benefit non-resident investors, then the country employing system C should refund part of the tax which it has imposed as the source country. The refund to non-resident investors will have to correspond to the credit which in the case of resident investors is granted against the individual income tax due by them. This starting-point is in accordance with that which in the discussion of system B has been indicated as the broad conception.

98. Better than is the case in system B it can be guaranteed that the dividend, on which the relief is granted, is actually subject to a (second) taxation in the home country of the investor. For the refund to the non-resident investor the condition can in fact be made that a certificate of his home country is submitted. This contributes to the equality of treatment of the non-resident investor and the resident investor, who only enjoys the credit if tax is imposed on him. Also, if the other country is prepared to co-operate, the refund can be effected by credit against the tax in the home country, be it naturally for account of the country employing system C.

99. With the figures for the rate and the credit chosen in chapter II, which are the same as those which now exist in France, the refund amounts to 50% of the dividend declared by the share company. It does not matter if the country employing system C I levies a précompte (section 71) on the dividend paid from untaxed profit. Should this be the case, then the refund correctly also cancels the précompte.

The refund can be reduced by the dividend tax imposed unilaterally or reduced by virtue of the treaty on outgoing dividends. With a withholding rate of 15% on outgoing dividends in the source country, the refund would be 27 1/2% of the dividend:

dividend	100
“avoir fiscal” (=credit)	50
	—
dividend tax 15% of 150 is 22.5	150
refund 50 – 22.5 = 27.5	

In his home country, if this country credits the dividend tax of 22.5 imposed by the country employing system C, the non-resident shareholder will have to declare a dividend of 150. This dividend amount is the same as that which has to be declared by the resident shareholder in his home country.

100. No more than in system B can the broad conception be accepted in system C I without the reservation that consequences, which constitute a deviation from the purport and the contents of the system as it is applied at home, have to be prevented. This reservation leads also in system C to special regulations for categories of interested parties other than investors. Thus a refund corresponding to the domestic credit would not be correct, if the shareholder of the domestic share company, is a foreign parent company. In this case it is not certain that the dividend received is passed on and that a second round of taxation follows. Just as in system B, as has been described before, the equality of treatment of domestic and foreign cases can only be realized globally. Also in the system C I discussed here, there is no other solution than a refund "a forfait" of part of the apparent corporation tax, an approximate method which does not exclude a fiscal advantage of foreign concerns as compared with domestic enterprises. An imposition of 25% "Kapitalertragsteuer" under system B (section 88) would run parallel to a refund under system C, equal to 12 1/2% of the dividend. Also in respect of the domestic permanent establishments of foreign enterprises, no other solution can be thought of than the one described in system B, viz. a simple reduction of the rate of the corporation tax (section 93). With such a lower rate for permanent establishments, the claim to a refund has been settled. There is no rule for indirect interests (section 94).

101. As is apparent from the above, this way of treating the cases with an international element means that system C is bent towards system B, as this is applied in the Federal German Republic. The problems and considerations which are determinative for the choice each time of the most acceptable regulation, are essentially the same as those which came up in the discussion of system B. For a number of those which, for brevity's sake, have not been repeated here, reference is made to what was said earlier, which *mutatis mutandis* is applicable to this variant of system C. From a technical point of view, however, the two systems continue to differ. In system B part of the corporation tax is cancelled at once, whilst in system C a refund of credit is necessary. Only in respect of the taxation of domestic permanent establishments of foreign enterprises are the systems B and C also technically equivalent.

C II. Equality for domestic and foreign shares

102. This variant of system C fundamentally deviates from the previous one. It implies that with respect to dividends received by residents in the second phase of taxation the same reduction of economic double taxation is applicable, irrespective of whether the dividends are of domestic or of foreign origin. That reduction is expressed in a lower taxation of dividends, reflected in a credit, than of other forms of income. The reason is to

be found in the previous phase of taxation at the level of the share company which made the profit. The startingpoint entails that it is of no importance whether the share company is established at home or abroad. Neither does it matter whether the corporation tax imposed has been the domestic or a foreign tax. The country with system C II moderates its taxation as the home country of the shareholder and not, as in the previous variant, as source country of the profit of the share company.

With the equalization of the foreign corporation tax, as the reason for granting a mitigation in the second phase of taxation, with the domestic corporation tax, matches an equalization in the first phase. This means that the domestic corporation tax is fully maintained in respect of non-resident shareholders and in respect of profit from a domestic permanent establishment of a foreign enterprise. The cases of domestic profit (Table section 79 under I) do not produce problems in this respect, even though they contain an international element.

The corporation tax is entirely, in the domestic and the foreign sphere, a real corporation tax, corresponding to type A. Here also lies the explanation why system B, in which the corporation tax at once decreases when profit is distributed, cannot be extended in this way to cases with an international element.

103. In system C II the problems are to be found in its application to the income accruing from foreign profit (Table section 79 under II). Just as at home, the whole profit of share companies is not taxed abroad. In the domestic sphere this fact can already be a reason to connect the credit only to distributions from profit which has been taxed according to the normal rate of the domestic corporation tax (section 71). If the first phase of taxation takes place abroad, there is the more reason not to grant the credit until the nature and size of taxation in that phase have been examined. Naturally there will be many cases in which there will be no difficulty; the profit of industrial and commercial enterprises will mostly have been subject to normal taxation. Foreign dividends, however, can also accrue from untaxed, or unusually low taxed profit, although, judged by domestic standards, they would not be entitled to such a regime. This situation in a certain way forms the counterpart of the one discussed in section 87. The attachment of a credit to dividends from such profit would disturb the proper functioning of the system. Flight from taxation can be the consequence. Interest, royalties, etc. can be transformed abroad into dividends which would be entitled to the regime for dividends.

For a judgment of the taxation which has taken place abroad sometimes—as is the case with international concerns and international investment companies, in many parts of the world—the necessary data are lacking, both to the tax administration and to the investor. The variant C II can therefore not be applied in an acceptable way.

C III. No moderation of economic double taxation in cases with an international element

104. In the French legislation neither the trend of thought discussed under I nor that discussed under II, has been followed. The right to the credit has been exclusively connected to: dividends accruing from profit taxed in France (section 105), provided that they accrue to a French resident (natural person or share company (section 106), and are distributed by a share company established in France (section 107)).

105. The first restriction excludes distributions from foreign profit from the moderation of economic double taxation. This applies both to profit made by a foreign permanent establishment of a domestic share company (Table section 79 under II (1)) and to participation dividends received by a domestic share company from its foreign subsidiary company (Table under II (2)). Both categories of income are not taxed in the hands of the domestic share company; the French "impôt sur les sociétés" follows the principle of territoriality and includes in the profit "uniquement des bénéfices réalisés dans les entreprises exploitées en France", be it that there is a possibility to opt for taxation according to "world-wide profit".

The question of the relation between foreign profit and the moderation of economic double taxation has already been discussed with respect to system B (section 81). There it appeared that, if foreign profit is exempted, there is good reason not to connect to the distribution a right to moderation of the domestic tax. The taking of that stand-point on the other hand, as was mentioned there, entails that in system B in the case of non-distribution of the profit the "Nachsteuer" is not imposed. The phase of the corporation tax is completed with the imposition abroad. The same idea, transferred into the structure and terms of system C, means there that the foreign profit not only remains exempted in the hands of the French share company from the first half of the French corporation tax (the "real" 25%), but can also remain exempted from the second, creditable part of the French corporation tax. Only if dividend must be considered to accrue from foreign profit, must the share company retain the "précompte", which to the resident shareholder, in his capacity as a taxpayer, is no more than an advance levy. The imposition of the "précompte", however, may not take place, in consequence of the legal presumption mentioned in sections 71 and 82.

106. The second restriction concerns the persons who are entitled to a credit. Non-resident shareholders are not so entitled, so that the moderation is not applicable to the categories of cases mentioned in the Table under I (1)b. For them, therefore, the French system is equal to a system of the type A, in the sense, however, that

the rate is higher than would be necessary for the same tax receipt, if it would also be of type A at home. Should, however, the dividends be considered to accrue from profit which is not subject to the full rate of the corporation tax, then the "précompte" of 33 1/3% of the dividend must be paid on that dividend. The "précompte" is the result of considerations of imposition technique and has, in the domestic sphere, no material consequences. If there are, however, non-resident shareholders, then it becomes a definite charge for the share company, against which for the non-resident shareholders no right to a credit exists. To demonstrate this the following comparison is given of two share companies, one with exclusively resident shareholders and the other with exclusively non-resident shareholders, which both distribute the same dividend from the same exempted foreign profit. The share company with resident shareholders can cover the "précompte" from the amount destined for payment of dividend. Its self-financing is not affected by it. Also its "dividend image" does not suffer from it, because for the shareholder the dividend is supplemented by the right to a credit which stands against the payment of the "précompte". The share company with non-resident shareholders on the contrary, must choose between a really lower dividend or reduced self-financing, as a direct consequence of the additional tax imposed on it in the form of the "précompte". The question therefore arises of whether in the sense of article 24, paragraph 5, of the OECD model convention (section 84), it does not bear a "taxation other or more burdensome" than that to which the first share company is subject.

107. The third restriction concerns the place of establishment of the distributing share company. The restriction has the consequence that the right to a credit is not attached to distributions accruing from profit of permanent establishment of foreign share companies taxed in France (Table under I (2)), even if the dividend accrues to residents.

108. The variant of system C existing in France therefore restricts the moderation of economic double taxation on dividends to the strictly domestic cases (Table under I (1)a). If it concerns foreign profit, or if the beneficiary of the dividend is a non-resident, or if the distributing share company is not established in France, the French system resembles a system of the type A. This statement is naturally only valid from the fiscal-technical point of view and does not apply if account is taken of such aspects as equality of competition, choice of the place of establishment, etc.

In certain cases a possibly imposed "précompte" is indeed refunded to non-residents. In accordance with the Franco-Swiss tax treaty the "précompte" is refunded to Swiss interested parties. By virtue of a unilateral administrative measure refund is also made to residents

of other countries with which France has concluded a treaty for the avoidance of double taxation. In those cases the additional taxation described in section 106 is also waived.

109. Under the French legislation no dividend tax is imposed as far as the domestic cases are concerned. There is no need for that, since the functions which a dividend tax can have in the domestic sphere are performed by the creditable part of the corporation tax. This creditable part amounts to 25 points on a "gross-dividend" (after deduction of 25 points of real corporation tax) of 75 and means therefore an advance levy of 33 1/3%.

According to the purport and content of the French legislation, the corporation tax is fully a real corporation tax in respect of non-residents. On outgoing dividends (and on the profit of permanent establishment of foreign share companies, section 115 quinquies Code Général des Impôts) a dividend tax of 25% must be withheld. Owing to this, the non-resident receives in his hands half of that which the resident declares as dividend.

	French shareholder	non-resident shareholder
dividend	50	50
avoir fiscal	+25	—
dividend tax	—	-12.5
	75	37.5

Should the shareholder be entitled to a credit against tax for the French dividend tax in his home country, then the dividend to be declared as income increases to 50.

110. In conventions concluded by France during recent years, the dividend tax on dividends accruing to investors has been reduced to 15% on the basis of reciprocity. Apart from the cases where the dividend is concealed in the home country, the reduction of the percentage only has significance for the investor who was already entitled to a credit if he has a low income, to the others the obtaining of a right to credit in the home country is of importance. Refund of part of the French corporation tax has, however, never been agreed upon. The discrimination against non-residents in comparison with residents, in consequence of the absence of the credit, has therefore, also under treaty positions, fully remained to exist. The French position of negotiation does not have the weak spot which can impede the negotiations for a country with system B (see section 89); the negotiations can therefore have the usual character of an exchange of concessions where it concerns impositions in the source country on a basis of reciprocity.

111. From a point of view of the international movement of capital and the relations between the stock exchanges strong discriminatory effects emanate from the French legislation. The exclusion of foreign profit and of foreign shares stimulates investment of French capital in France. The exclusion of non-residents is a disincentive to investment in France by non-residents in the form of share capital (whereby, sometimes, substitution by the granting of loans can occur, in as far as legal provisions do not form an impediment). The system therefore leads also to a certain isolation of the national capital market. The price of French shares, if the system is effective, will mainly be determined by the supply and demand of French residents. To non-residents which receive a smaller net return after taxation than residents, the purchase at the French prices will not be attractive. Only speculators who are out for capital gains will be an exception.

112. From the foregoing considerations it appears that, in principle, system C is suitable for diverging applications with regard to cases with an international element. The uniform imposition in the first phase on the profit of the share company allows freedom in the answering of the question of whether and, if so, how for international cases the economic double taxation will be moderated. Three variants have been examined.

C I. Equality for resident and non-resident investors in domestic shares.

The necessary complements to be added to the system make it materially come near system B, as this is applied in the Federal German Republic. The conclusions of section 95 are mutatis mutandis applicable.

C II. Equality for domestic investments and foreign investments of residents.

If sufficient data on the first phase of taxation are lacking, this variant cannot be applied in an acceptable way.

C III. Rejection of the moderation for cases with an international element. This form, which is that of the French legislation, has a strongly autarchic tendency.

IV. Other systems

a. Complete avoidance of economic double taxation of dividends

113. Economic double taxation is entirely avoided if only one tax is finally imposed on the profit which is distributed to the shareholders. In modern tax systems which contain a synthetic individual income tax, that single tax on dividends will be the individual income tax which makes allowance for the capacity of the shareholders to pay tax. This result can be achieved in

two ways: either by not imposing the corporation tax on the distributed profit, or by considering the corporation tax on the distributed profit entirely as an advance levy.

The first method is the extreme form of system B. The rate of distribution is nil, only the retained profit is taxed. This system exists in Greece.

In the second method, the corporation tax affects the whole profit, but the tax imposed on profit that has been distributed is fully credited against the individual income tax to which the shareholder is subject in respect of the grossed-up dividend. Any excess is "refunded" to the shareholder. This system is the extreme form of system C. In this form it existed until 1937 in the United Kingdom and it still exists in Ireland. This system has been proposed by the Canadian Royal Commission on Taxation (Carter-Commission) in its report of 1967; the proposal has not been adopted by the Canadian Government. Furthermore it is to be found in the advice of the "Wissenschaftliche Beirat" to the "Bundesministerium der Finanzen" of the Federal German Republic, mentioned in article 2.

114. From the discussion in the chapters II and III of the effects of the systems which contain a partial avoidance of economic double taxation on dividends, the direction of the consequences of a complete avoidance can be derived. On account of the fact that with an equal level of burden the rate of the corporation tax will surpass that in systems B and C (and naturally still more that of system A) the "tax quota" (section 33) on retained profit will be higher. The "tax quota" on distributed profit, on the contrary, is nil. The effects emanating from that will be of the same nature as in system B, or respectively (if the Irish form is chosen) in system C, but they will make themselves felt more strongly. There is less reason for a separate discussion of the merits and drawbacks which can be the consequence of those effects, because, in view of the increasing importance of modern large-scale business in the form of the public share company, it is not to be assumed that in future the imposition of a "real corporation tax" (section 5) on the distributed profit will be renounced.

b. Fiscal transparency

115. In addition, the complete avoidance of economic double taxation on dividends, as this is realized by Greece and Ireland in diverging ways, will not lead to the share company being materially eliminated as a tax subject. Whereas it is true that the corporation tax is indeed not imposed or is cancelled if the profit is distributed, it continues to be imposed on the retained profit. The burden on that profit deviates from that which matches with the income of the shareholders. The full consequence of the identification of the share company with its shareholders is only taken, if the

non-distributed part of the profit of the share company is accrued, pro rata parte, to the present shareholders, and is taxed in their hands as income. The integration of corporation tax and individual income tax in this system, unlike in the previous system, extends also to the retained profit.

116. This approach has been mentioned incidentally in section 49, because it has a certain attraction as an option possibility for private share companies. For numerous reasons it can be desirable or inevitable to conduct the enterprise in the corporate form, even if on account of that the fiscal burden increases. Making "fiscal transparency" possible—under guarantees against abuse, e.g. by making it compulsory to abide by the choice made during a certain period, can lead to a more reasonable system of taxation. Such an option right can, to a certain extent, contribute to the justification of the imposition of a real corporation tax being less controversial. If one can elect for imposition of individual income tax only, it may be assumed with more reason that, if no use is made of that possibility, in any case for the majority-shareholders the existence of an—whether of not mitigated—"economic double taxation", does not mean an extra burden, compared with the individual income tax on their share in the total profit. It should, however, be realized that the fiscal position of the shareholders can differ widely. This can lead to conflicts of interests, which are intensified by the necessity for the shareholders individually to dispose of sufficient money for the payment of tax.

This option possibility is occasionally to be found in the legislation. Furthermore the method has been mentioned as optional possibility by the Canadian Royal Commission on Taxation.

117. In literature one also sometimes finds a recommendation for the general application of the system discussed here. In order to avoid the obvious objection, that the shareholders cannot be expected to be able to pay tax on amounts they have not received, an advance levy on the share company in the form of a "profit beneficiary" tax is envisaged. The notification to the shareholders of the profit amount attributed to a share also mentions the tax credit which is to be set off against the individual income tax. If the tax credit exceeds the individual income tax, then the difference is refunded.

118. As main argument for this system which is put forward is that it replaces the proportional corporation tax by the individual income tax adapted to the capacity of the shareholder to pay tax. The holding of shares becomes thus more attractive for the small saver. "Growth shares" on which little is distributed will lose their special attraction for wealthy people. The advocates believe, that more favourable conditions arise for an improvement in the distribution of property. A certain

extension of the—at present still relatively small—group of shareowners and within this group a somewhat more equal distribution of property would be encouraged.

119. The idea discussed here evokes numerous objections which explain why its practical application has not been realized. It means a return to the conception of the nineteenth century—at that time very comprehensible—that the public share company does not represent anything else but a joint enterprise of the shareholders. In this conception the share company has no existence of its own. The profit retained by the share company is considered to be part of the current income of the shareholder, which he voluntarily decided to leave at the disposal of the share company.

120. This viewpoint is clearly contrary to reality. The shareholder is taxed under the individual income tax for an amount when it is uncertain whether at some time or another he will enjoy it, either as dividend or as capital gain. Shares change hands frequently and the prices at which they are sold and purchased do not run parallel with the size of the retention of profit by the share company. Both with respect to general price fluctuations and of special price fluctuations of a certain share it can be said that they are irregular and unforeseeable. Even if a price fluctuation is “regular” and foreseeable anomalies can occur. If favourable profitability prospects for the coming year make the price of a share go up, the advantage in case of transfer of ownership somewhere about the date of the balance sheet falls to the old owner and the tax due (and the credit for a possible “profit-beneficiary” tax) to the new owner.

On the other hand distributions from earlier profits remain untaxed for the shareholder of the moment, although they are income for him according to current conceptions. A policy of dividend equalization has no significance anymore for taxation purposes.

121. The drawbacks of implementation are considerable. In the systems A, B and C, the imposition of the individual income tax, apart from special cases, is independent of the difficulties in the computation of profit and of the taxation of the share company. The imposition of the individual income tax on the shareholder takes place according to a fixed datum, i.e. the dividend distributed. In the system discussed here, on the contrary, all complications that are met with in the share company, are expressed in the income of the shareholder to be declared and in the taxation of it. The size of allowable depreciation and the stock valuation have a direct influence on the amount to be paid by the shareholder. In its turn, the share company owning shares, must include in its profit the profit, pro rata parte, of enterprises in which it owns shares.

Also subsidiary companies belong to them, for the “Schachtelprivileg” does not fit in this conception. All these data must be known to the real party interested, i.e. the investor, if he is to be in a position to make a return and carry on legal proceedings concerning his assessment. If the investor has a share in an investment company with a dispersed share portfolio, then the number of data which are of importance still more considerably increases. Because in disputes on the profit of share companies a final decision is often only reached after several years, and such a decision makes itself felt via the holding of shares of investment companies and other share companies, just as a stone in a pond causes ripples until these reach the far-off corners, the assessments in the individual income tax of shareholders will, also after years and years, again and again, in one direction or the other, be subject to alteration.

122. In cases with a foreign element the system is not applicable. Non-resident shareholders will in their home country, only have to pay individual income tax (or corporation tax) on the dividend. The “profit-beneficiary” tax will be for them a corporation tax, in as far as it affects the retained profit and for the rest it will be a dividend tax. Resident holders of foreign shares, in the absence of data about the profit attributable to the share, can only be taxed for the dividend. For dividends from foreign participations the “Schachtelprivileg” will be able to remain in force, or indirect credit against tax can be granted. The data in respect thereto have to be passed on by the share company to the final investor, in order that this investor, in making his return, can make allowance for the exemption, respectively for the foreign tax to be credited.

c. Deduction of primary dividend

123. As one of the suitable methods to moderate the “economic double taxation” on dividends, there is also mentioned the deduction of primary dividend in determining the taxable profit. The basic idea of this method, however, is of an economic nature and proceeds from the desirability of leaving untaxed a primary interest on the equity capital. The usual commercial and fiscal concept of profit comprises more than the profit in a business-economic sense. It comprises also an element of financing expenses, consisting of the interest on the equity capital used in the enterprise. Only the surplus profit exceeding that interest, is a “rent” in the sense that infringement of it—also if in the conduct of an anti-cyclical policy the rate would be increased strongly—can be considered to present no danger for the continuity of the production. That rent could be approximated roughly—in any case in times when there is no inflation—by reducing the profit by the interest which the equity capital, when invested in debentures, would have produced.

The conception of the share company and its shareholders is here different from that of the two systems discussed before. There the shareholder are seen as partners jointly carrying on their business. In the conception presently discussed, the shareholders are first of all lenders to the share company, even though they are also entitled to that part of the surplus profit after taxation which the share company can distribute.

124. The advocates of this method draw still other conclusions from their analysis of the fiscal profit concept. They point out that just that part of the corporation tax that falls on the cost element of the interest on the equity capital will be shifted, in contrast to the corporation tax weighing on the rent part of the profit. The deduction will also contribute to fiscal neutrality in respect of the financing with equity or with loan capital and with regard to the treatment of highly capitalized industries on the one hand and industries requiring a great labour force on the other hand. Thus can also be expressed as follows: the ordinary form of corporation tax, which affects the full profit, really consists of a tax on the (surplus-) profit, together with a tax which, because it taxes a percentage of the capital, may be considered as a net worth tax (a tax of 50% on 6% of the net worth is equivalent to a net worth tax of 3%). The deduction of a primary interest removes this net worth tax element. The system is a counterpart of the thought defended in modern economic literature, implying that the use of the factors of production—capital and labour—should be charged, in order to stimulate their more efficient use.

125. The realization of the idea outlined in the previous sections, meets, however, with serious objections which compel the renunciation of the deduction of primary interest and the acceptance of the deduction of a fixed dividend percentage. An annual determination of the actual net worth—including hidden reserves—of all share companies would be a difficult task, the more so, now that the financial interest involved is much more considerable than this is the case with the net worth tax on entities as this presently exists in some countries. The correct interest percentage of the deduction can only be approximated. Furthermore the deduction of interest would miss the mark if the amount deducted is not distributed; for then the interest on the equity capital would remain untaxed, whereas the interest on loan capital is taxed in the hands of the creditor.

These two methods tend to lead to the result that, abandoning basic business economic thought, as a rule a deduction is defended which is equal to the lowest of the two following amounts:

- a. a certain percentage of the paid-up capital (or, if one wishes to avoid the complications of premium and informal capital brought in, a certain percentage of the nominal paid-up capital);
- b. the amount of the distributed dividend.

In this form a deduction of primary dividend is applied in the legislation of a few countries, but only as a temporarily stimulating measure restricted to new issues of capital. Thus in Belgium, by way of exception to the general regime, the dividends from capital brought in during the years 1967-1969 in the form of money—with the exclusion of the cases of absorptions, mergers, etc.—have been exempted to a maximum of 5%.

The system shows furthermore a superficial resemblance to the system of the Italian “imposta sulle società”. This, however, is a complement to the schedular system and does not establish a connection between distribution and corporation tax.

126. The restriction mentioned under a. means that the open and hidden reserves do not contribute to the deduction, even if the profit attributable to this part of the capital is distributed (which can appear from a dividend percentage which surpasses considerably the rate of interest on the capital market). In consequence thereof, the fiscal effect can vary strongly, also in the case of an equal dividend quota. On this point the system differs in its effects from system B.

127. If the capital is increased, the deduction increases. The system stimulates therefore the conversion of reserves into formal capital. The tax regime in the case of distribution of bonus shares is, in this system, of great importance. If these shares when they are received are not taxed, or if a mild regime is applied when the capital of the share company is increased, then a hollowing out of the corporation tax is to be expected. In the public share company the necessity of a reduction of the nominal dividend percentage can still be a psychological impediment for some time; in the private share company such a drawback does not exist. The hollowing out of the corporation tax will for the rest, as long as the increased capital does not exceed the really appropriated capital, be in accordance with the basic principle of the system.

128. Under this system the corporation tax will particularly continue to weigh on enterprises with a high profitability, which do not dispose of reserves capable of incorporation in the capital. These consequences entail—except perhaps if the percentage of the deduction, contrary to the basic principle, would be put very low—if this system is compared with systems A, B and C, that the supposition of an equal burden in the corporate sector cannot be maintained. A compensating increase of the rate of the corporation tax will still intensify the tendency to capital-increase. From this tax, at any rate for the time being, no sufficient budgetary compensation will therefore be achieved. This will, just as in the system of fiscal transparency, have to be sought for in other sectors.

129. The restriction mentioned in section 125 under b, means, that a share company which has to pass the dividend, is not entitled to a deduction. The denial of a deduction, in these cases forced by necessity, can be moderated by considering in the application of the system the primary dividend as "cumulative preferential dividend". This removes the drawback, provided that in later years sufficient profit can be made against which the denied deduction can be recovered.

130. Can an increase of the total of distributed dividends be expected from the introduction of the system of deduction of a primary dividend? If one assumes, with the advocates of this system, that it is precisely the tax on the primary dividend which is shifted, introduction of the system will ultimately, via the price and market mechanism, lead to reduction of the profit before taxation. Under that assumption an increase of the dividend quota, which overcompensates the tendency to dividend reduction as a consequence of the decrease of the profit, does not seem likely. A stimulus to increase of dividends occurs in those cases where the limit of the exempted dividend would not be reached. Of more importance, however, can be the cases in which it will be endeavoured to reduce the burden of the corporation tax in the coming years by retention of the surplus profit, followed by conversion of the retained profit into capital. No prediction can be made as to whether the system will have an influence in favour of more holding of shares among the groups of people with a moderate or low income.

131. The system leads to difficult problems for dividends and profits crossing borders. The problems resemble those of system B. If the shares of a share company are in the hands of a foreign parent company, it is uncertain whether the dividend left untaxed remains within the concern or not.

Also in the presently discussed system a "Nachsteuer" is necessary, and here also it can only try to achieve more equality in treatment in an "à forfait" manner. The "Nachsteuer", however, cannot, as in system B, be put at a fixed percentage of the dividend, for the extent of mitigation which a distribution has enjoyed varies according to the level of the dividend percentage. The "extra dividend tax" will have to be determined for each case separately. It will be necessary to include clauses in tax treaties which give scope for that. The roughness of the correction will, however, inevitably surpass that which must be accepted in system B. It is therefore not to be expected that treaty partners will agree to one-sided authority to impose an extra dividend tax of, say, two-thirds of the rate of the corporation tax, which indeed for dividends from profit that has remained fully untaxed, which perhaps in the parent company abroad are not going to be distributed, can be considered to be a suitable "forfait". Even such a high "Nachsteuer"

would not prevent the position that a foreign parent company, in case of complete retention of the profit—possibly followed by re-investment in the subsidiary company—would enjoy a considerable fiscal advantage, compared with domestic enterprises. Also the taxation of domestic permanent establishments of foreign companies will have to be done "à forfait".

132. Non-resident owners of domestic capital will place this capital with a domestic share company which is sufficiently capitalized for the corporation tax to be reduced to nil. This possibility and its direct consequences would encourage again the flight from taxation of domestic entrepreneurs and owners of immovables.

133. The other categories of the cases with an international element discussed in B, viz. domestic interests in foreign enterprises, also produce serious difficulties under the system of deduction of primary dividend. The nature of such difficulties appear from the above. It should only be indicated that the making of a connection between the corporation tax and the nominal capital compels, if for foreign profit elements exemptions exist, to an attribution of the capital to the domestic section of the business and to the business sections abroad.

d. Conclusion

134. In each of the three systems discussed, serious drawbacks present themselves: These sometimes concern the basic principle of the system which—as has been stated in section 5—does not fit in with the real contents of the forms of organisation of present industrial life. Notably this is the case in the system of complete avoidance of economic double taxation and to a still greater extent in the system of the fiscal transparency of the share company. In the system of deduction of a primary dividend, the question particularly arises of whether it will prove to be possible—assuming that the system is generally in force and not only for certain issues—to keep the application within the proper limits. The drawback of complexity is to be found in all three systems. This is least true for the system of complete avoidance of economic double taxation. On the other hand, it can be said without reserve that the general application of the system of the fiscal transparency, is excluded. The application to cases with an international element produces in the system of complete avoidance of economic double taxation objections of a similar nature as in system B and C, but intensified in proportion to the big difference in the tax regime for distributed and non-distributed profit. In the system of deduction of a primary dividend additional complications occur. The system of the fiscal transparency of the share company is not to be applied in the international sphere.

135. None of the three systems is eligible for acceptance as a harmonized system in the Member-States of the European Communities, because in none of the Member-States, nor in the United Kingdom, is the tax structure based on one of the three systems, the question is only raised during the period of transition to a harmonized system if the existing restricted, whether or not temporary, application of those systems can be continued.

In the following chapter the systems just discussed are left aside.

V. Systems A, B and C and the Common Market

136. The international aspects of systems A, B and C, discussed in chapter III, are of importance for the relations between the national economies in general. The way in which those consequences are evaluated and sought after at in a country, is dependent on the national objectives and the complete set of circumstances under which endeavour must be made to realize those objectives.

137. The countries of the European Communities occupy a special position, owing to the fact that they have accepted common objectives. This obliges them to test their policy against those objectives. As regards the good functioning of the Common Market, it is of importance what influence the various tax system have on the movement of capital between the Member States and on the development and the integration of the stock markets. This point concerns the elimination of all factors—distortions or discriminations—by which abnormal movements of capital can be caused and barriers between the capital markets can be maintained.¹⁾ It must be held in mind that, as has been remarked in respect of these problems in the Memorandum of the Commission of the European Communities to the Council,²⁾ the fiscal factor increases in significance in consequence of the growing economic integration of the Member States and the removal of the impediments to economic relations between them.

An important step on the road to the removal of an undesired influence of fiscal factors would have been taken if, as a harmonized system, a tax structure would be accepted which makes it possible to treat investments which cross the borders between the Member States fiscally in the same manner as equivalent domestic investments.

¹⁾ Compare the Programme for the harmonization of taxes, information of the Committee to the Council, given on 8-2-67, page 4 (Supplement Bulletin Nr. 8-1967 of the European Economic Community).

²⁾ "Mesures d'aménagements en matière d'impôts directs en vue de faciliter le développement et l'interpénétration des marchés de capitaux dans la Communauté économique européenne", 5 March 1969, COM (69) 201.

138. By equality of fiscal treatment it is not meant here that on domestic investments and analogous border crossing investments the same tax amount is due.

The differences between the national tax systems as regards the determination of the tax base, as regards the rates and as to the realization of the legal provisions, unavoidably lead to differences in the tax amounts due. Those differences could only be reduced or removed by means of a harmonization of legislation and implementation in respect of the points mentioned, a problem which is not under discussion here. The equality of fiscal treatment of domestic and border crossing investments, which is put here as a postulate, can be tested as follows.

In order to eliminate the differences caused by the factors mentioned above, it is assumed that the tax base, the rates and the implementation of the tax are equal in all countries. The test of equal fiscal treatment implies the question whether under these circumstances a system:

- (i) is neutral in respect of the investment by residents in their own country or abroad;
- (ii) is neutral in respect of the investment by residents or non-residents.

139. In the following this test will be applied, which gives to the conception of equal fiscal treatment a substance which in this connection is appropriate. However much one's opinion can differ on the question as to what extent and in what pace harmonization between the Member States of rates, determination of the tax base, etc. is necessary for a good functioning of the Common Market, it is certain that a tax structure which considerably fails in the realization of equal fiscal treatment in the sense indicated is not a good basis for such a harmonization. Such a system, on the contrary, can be a lasting impediment to having the Common Market approach an internal market and thus form an impediment to the achievement of the objectives mentioned.

140. The indicated conception of equal fiscal treatment is wider than the requirement of non-discrimination as this has been laid down in treaties.

Sometimes the non-discrimination stipulation is confined to the prevention of discrimination on the basis of nationality. In numerous tax treaties the non-discrimination extends to the shareholdership of residents of the treaty partner and to permanent establishments of those residents (see the notes to sections 84 and 93). The requirement of equal fiscal treatment also covers other categories of cases and also concerns privileged treatment of non-residents in the context of taxation in the source country (an example of an involuntary privilege has been mentioned in section 90).

System A

141. The test of equal fiscal treatment is complied with by system A. For the cases with an international element, this system has only to be supplemented by provisions for the avoidance of international double taxation (section 78).

Systems B and C

142. From the analysis in chapter III it follows that a similar judgement is not possible in respect of systems B and C. These systems inevitably cause differences in fiscal treatment between domestic and international cases.

Of the various variants of system C, system C I is discussed hereafter together with system B, to which it resembles when judged from the material results. System C II remains aside because it cannot be applied in a satisfactory way.

System C III

143. System C III is the variant of system C which is applied in France. Its purport is that no moderation of the economic double taxation is granted in cases with an international element. Equality of fiscal treatment does not exist in this system (sections 104-111). The French Government has given evidence of its willingness to enter into negotiations on the removal of the fiscal discrimination against non-residents, but exclusively in the relation with other Member States of the European Communities. It is said that such negotiations have taken place with the Federal German Republic; the result has not been published. The contents of the regulations, to which such a bilateral consultation could lead, will be dealt with hereafter in the discussion of system C I. It will suffice to mention two points here. In the first place a bilateral regulation can impede further progress on the road to the removal of distortions. Furthermore, a restriction of the measures to be taken to the relationship with other Member States, also if these measures are of a multilateral character, would tend to have the result that the discriminatory effects of the French system, in respect of other countries, would continue to exist. These measures would in that case also involve the other Member States in the autarkic tendencies of the French system.

System B and C I

144. The differences in fiscal treatment between domestic cases and international cases are smallest in systems B and C, if the broad conception is held according to which non-residents are also entitled to the moderation for the avoidance of economic double taxation. That broad conception fits in with system B (section 85), which in the form discussed is in accordance

with the main principles of the legislation of the Federal German Republic. In system C the broad conception leads to system C I (sections 97 *et seq.*).

145. The effects of systems B and C I in cases with an international element are essentially the same from a material point of view. In the sphere of investments in shares by natural persons or share companies, the test of equal fiscal treatment is satisfied. In the other categories of cases, however, the difficulties described in section 95 present themselves, which lead to inequality of fiscal treatment of domestic and international cases.

146. These difficulties arise specifically from the fact that in the case of taxation of outgoing participation dividends and of profits of permanent establishments of foreign enterprises, regulations "à forfait" have to be accepted. These agreed regulations at most bring about an approximate balance between the tax regimes for dividends and profits remaining in the country and for those going abroad. If one considers the individual cases, then it appears that the requirement of equal treatment of similar cases is not complied with. The individual micro-economic equality is, however, of great significance from a point of view of avoidance of competition and other distortions. For the good functioning of the Common Market it is perhaps more essential than a global equilibrium of the regimes. To achieve this it is required that the taxation on outgoing dividends and profits takes place with due regard to the circumstances relevant to the system, as they present themselves in the individual case. This means that for each of these dividends and profits it would have to be determined separately in how far their destination entitles the application of the lower rate, or a refund of part of the corporation tax.

On a participation dividend which leaves a country employing system B, a "Nachsteuer" in the form of dividend tax should not be imposed, if it is established that the dividend must be considered to have been fully distributed to investors by the foreign parent company. As far as that is not the case, the dividend ought to be charged to dividend tax amounting to the full *écart* between the two rates of the corporation tax, since concern-dividends remaining in the country, which are not passed on, are subject to a "Nachsteuer" of the same amount. For profits of permanent establishments belonging to foreign companies it must be established, in a similar way, how far they come under the low or under the high rate of the corporation tax. The foregoing is also applicable, *mutatis mutandis*, to system C.

147. For the application outlined above of system B or system C on outgoing participation dividends, the co-operation of the country where the parent company or the head office of the enterprise is established would be required. In a treaty for administrative assistance and

exchange of information the mutual rights and obligations of the countries would have to be regulated. According to such a treaty the tax administration of that country would have to supply the data concerning the size and nature of the distributions of the parent company (or of the company owning the permanent establishment) and concerning the volume, composition and origin of its total profit, which are necessary in order that the tax administration and the Courts of the other country can judge in how far the outgoing dividend or the outgoing profit can be considered to have been distributed and which imposition (in system B), or which refund (in system C) must consequently be applied. The tax officials of the country which provides the information must have sufficient knowledge of the legislation and the judicial system in the country asking information, in order to be able, in their investigation, to distinguish between relevant and non-relevant data.

148. It will also often happen that the country of the parent company or the head office of the enterprise does not have all data which are necessary for an exact application of system B or C available. This will occur if the enterprise established on its territory in its turn is a subsidiary of a company in a third country, with which no assistance treaty of the above mentioned wide character exists. In that case one must revert to the "à forfait" method, proportionate to the size of the participation. If the policy of a concern is directed towards a strong retention of profit, the "à forfait" method will be fiscally more advantageous. In order to achieve that the tax administration must apply such a method, the enterprise will channel the dividend or the profit to an affiliated company in a third country with which a treaty for the avoidance of international double taxation does exist, but no assistance treaty in the above sense.

149. It is to be assumed that many countries will not be prepared to provide detailed information to a foreign administration on the enterprises in their country. Indeed, they have no fiscal interest in the exchange of such information, unless they apply system B or C I themselves. There is no reason to assume that in the European Communities a different view will be taken. Should, however, all Member States be prepared to exchange information, in order to make it possible to apply a harmonized system B or C I in all Member States, without having to content themselves, also in their mutual relations, with approximate "à forfait" regulations, then that application would in practice, for the reasons mentioned in section 148, still show considerable defects from a point of view of equal fiscal treatment.

VI—Conclusions

150. In chapters II-IV the socio-economic and technical aspects of a number of tax structures have

been examined, which regulate the relationship between the individual income tax and the corporation tax in diverging ways. It appeared that on a number of points the uncertainty as to the causal connection leaves scope for diverging expectations as to the consequences. The influence of the tax structure can indeed be theoretically distinguished from the other influences on the price and market mechanism and the behaviour of the entrepreneurs, but the effect of this influence cannot be determined separately. Moreover, differences in the effects can also be expected according to time and place. Thus, the cyclical situation will have an influence on the extent of shifting of the tax, on the demand and supply on the capital market, and on the extent to which entrepreneurs, in view of their investment intentions on the one hand and their intentions to attract fresh capital on the other hand, will be inclined to distribute profit. The influence of a system will also differ according to the country where it is applied. The national socio-economic situation, institutional factors, the fiscal tradition and the tax morality lead inevitably to the consequence that the effects of a system diverge on a number of points from one country to another.

151. While the foregoing remarks concern the problem of the objective determination of the nature and the size of the effects to be expected, when attaching importance to those effects one enters the field of subjective appraisal. Those appraisals are based on a particular view of society and on the possibilities and desirabilities of its future development. The influence of the national background of the person making the appraisal is often unmistakable here.

152. With all the reservation ensuing from the two preceding sections, an effort is made hereafter to evaluate the effects of the systems, as they have appeared in the chapters II-IV, and to weigh them against each other, in order to come to a summarizing judgment as to the practical applicability of the various systems, with due observance of the objectives of European integration.

153. Of the six systems examined, the three systems which have been discussed in chapter IV prove not to be eligible, for numerous reasons, for acceptance as a harmonized system in the countries of the European Communities. Hereafter only systems A (classic system), B (system of a double rate) and C (system of credit) will therefore be discussed.

154. *In the domestic sphere* the effects of system B and those of system C, with an equal rate for the retained profit and an equal degree of integration of corporation tax and individual income tax, presumably resemble each other very much, whereby a reservation must be made for the period shortly after the introduction of an alteration of the system (see the notes to section 31 and section 42). The difference between the two systems

(section 23) leads to a number of differences of a more technical nature, which were discussed in sections 26-27 and 68-72. System C in general shows a greater flexibility, perhaps particularly appearing from the fact that there remains more scope for conducting a policy of dividend equalization by enterprises. Whether the two systems give a diverging result as regards the shifting of tax, is very uncertain. It is possible that in system C, which only leads to mitigation in the sphere of the shareholder, shifting occurs to a somewhat greater extent, but it does not seem to be excluded that, under certain circumstances, the contrary is the case (sections 31 *et seq.*).

155. The many points of resemblance between systems B and C make it possible to compare both systems together with system A. In a few respects that comparison is favourable to systems B and C. Presumably their effect is somewhat more neutral than that of system A as far as the choice of the legal form of the enterprise is concerned (sections 47-50), whereby it must be understood that the need for special fiscal provisions is greater for the private share company. Furthermore, under systems B and C there are smaller differences in the fiscal consequences of the financing with equity, or loan capital than under system A (sections 51-54). There is a weaker stimulus in system A to incur expenses which, from a business point of view, are not justified (section 55). On the point of shifting, system A perhaps occupies a middle position between systems B and C; one should be reminded, however, of the reservation made in section 154 in respect of the great uncertainty in this field.

As regards the points mentioned here, there will be little difference of opinion on the desiderata; the influence which these systems in fact exercise on these points remains, however, of a hypothetical nature.

156. The situation is somewhat different as to the influence of the systems on the dividend quota. It is to be assumed that, in any case in the long run, systems B and C will lead to a higher dividend quota than system A, although, for the reasons given in sections 41 and 46, the effect is not to be over-rated; the question whether this effect is desirable will, however, be answered differently. Apart from the more fundamental points of view, mentioned in section 40, a question of particular importance is whether the most important effect, i.e. a presumably relatively small increase of consumption, is positively estimated as a structural consequence.

157. The differences between systems B and C on the one hand and system C on the other hand are considerable from a point of view of the implementation of the tax. Both systems B and C, compared with system A, imply numerous special technical complications, be it that their nature and position (sections 66-73) in the

two systems are different. Those complications make the task of the tax administration heavier and constitute an extra burden for the taxpayers. When considering the question of which system is the most suitable to be accepted as a harmonized system in the European Communities, the technical factor must count for special attention, also in view of the harmonization of the means of application of the harmonized system. Since the balance of the socio-economic effects, mentioned in the preceding sections, gives an uncertain result, this factor of direct practical significance can be considered to be of sufficient importance to prefer system A, if only on account of the effects in the domestic sphere.

158. In the international sphere distinction must be made between different variants of system C. The following classification of systems that could be applied, seems the most suitable.

1. System A. This system realizes the equality of fiscal treatment in the sense of chapter IV. The avoidance of international double taxation does not present difficulties (section 76).
2. Systems B and C I. In these two systems equality of fiscal treatment is achieved for non-resident and resident investors in domestic shares (sections 95 and 97), it being understood that for this in system C I a refund to non-resident investors is necessary. In other categories of cases the situation is that, in the presence of an international element, an implementation of the system in accordance with the domestic application, recoils from a lack of the relevant data necessary for that implementation (sections 146-148). In respect of participation dividends going abroad and in respect of the profit of permanent establishments of foreign enterprises, regulations "à forfait" must therefore be accepted which do not make allowance for the circumstances of the individual case (sections 88-94, 100-101, 146-148). These regulations are, for participation dividends, expressed in "border adjustments" in the form of an "à forfait" dividend tax (in system B) or an "à forfait" refund (in system C I). The maintenance of such "à forfait" border adjustments in treaties sometimes proves not to be fully possible in system B (section 90). Systems B and C I can encourage import of capital, but also a flight from taxation (section 95). On numerous points the test of equal fiscal treatment is not satisfied.
3. System C III. In this system the mitigation of the economic double taxation is only granted in strictly domestic cases, that is, when no international element whatever is involved (sections 104 *et seq.*). Share companies with non-resident shareholders may be subject to an additional tax in the form of the "précompte" (sections 106-108). The system has

an autarchic tendency. It discourages both investments from abroad and investments abroad by residents (section 111).

159. If the domestic and the international aspects of the systems are reviewed together, the conclusion seems to be justified that system A is the most suitable to be adopted as a harmonized system in the European Communities.

160. In the transitional period towards a harmonized system, it would be desirable that the Belgian and French

systems, which are both of type C III, are altered to systems of type C I.

161. As to the regulations "à forfait" in the systems B and C I with regard to participation dividends and profit of permanent establishments such a scope should be given during the transitional period towards a harmonized system that the inequality of fiscal treatment of cases in the domestic sphere on the one hand, and those with an international element on the other hand, is restricted as much as possible.

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