
**REPORT
OF THE COMMITTEE
OF INDEPENDENT EXPERTS
ON COMPANY TAXATION**

COMMISSION OF THE EUROPEAN COMMUNITIES

March 1992

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Preface

Background to the establishment of the Committee

This report has been prepared for the Commission of the European Communities in accordance with the Committee's mandate which is reproduced after this preface. The Committee was set up following the Commission communication 'Guidelines on company taxation' (SEC(90) 601) of 20 April 1990. The Committee received its mandate in January 1991.

Membership of the Committee

Bill Robinson resigned from the Committee in February 1991, following his appointment as special adviser to the Chancellor of the Exchequer in the United Kingdom. The Committee would like to thank him for his contribution to the initial stage of its work.

Secretariat

The Secretary of the Committee was Michael Daly, who was ably assisted by Luc De Hert (Assistant Secretary), Philippe Pelle, Mary Clynes, and David Carr (who joined the secretariat in November 1991).

Professors Michael Devereux (Keele University and Institute for Fiscal Studies, London) and Peter Sørensen (the Copenhagen Business School) advised and assisted the secretariat both in the drafting of the report and in the preparation of background material for the Committee.

Operation of the Committee

The Committee met on 12 occasions. The first seven meetings, in January, February, April, May, July, September, and October 1991, were for one day, while the meetings held in November and December 1991, and in January 1992, lasted two days. Two final one-day meetings took place in February 1992. All meetings were held in Brussels.

Consultations

The Committee's consultations mainly involved informal contacts between individual members of the Committee or the secretariat and various persons and organizations, some of whom provided written submissions. These are listed in Annex 1A of this report.

Acknowledgements

The Committee is especially indebted to the Fiscal Affairs Division of the OECD, which laid much of the groundwork for the analysis used in this report and made available its computerized tax model for calculating marginal effective tax wedges. As a consequence, the estimates of the tax wedges found in Chapters 4 and 8 of this report correspond to those published in the OECD's recent study entitled 'Taxing profits in a global economy'. The Fiscal Affairs Division also provided the Committee with information concerning tax rules in non-EC countries.

In addition, the Committee is very grateful to Michael Devereux (Keele University and Institute for Fiscal Studies) and Mark Pearson (Institute for Fiscal Studies) who performed the computer simulations reported in Chapters 4 and 8 of this report, and undertook the business survey on the Committee's behalf.

A special acknowledgement is also due to Unice, which greatly facilitated the Committee's business survey by providing advice on the questions addressed, and by distributing the questionnaire to its members.

Furthermore, the Committee would like to acknowledge the cooperation of the national tax administrations of the EC, as well as those non-EC countries (Austria, Canada, Japan, Sweden, Switzerland, and the United States) which provided the Committee with specific details of their tax legislation.

The Committee is also grateful to Joann Weiner (Harvard University) and Philippe Thalmann (University of Geneva) who prepared background studies concerning taxation in the United States and Switzerland, respectively.

Finally, the Committee wishes to acknowledge the helpful suggestions and comments offered by a very large number of persons and organizations in oral or written submissions, either to the Committee itself or to its individual members. A complete list of the names of these individuals and organizations is found in Annex 1A of this report.

Format of the report

The report consists of 10 chapters. The first nine chapters are essentially factual and analytical, while the 10th summarizes the Committee's main conclusions derived from the previous chapters and presents a number of recommendations. These 10 chapters were endorsed unanimously by the Committee. Much of the rather more detailed background material considered by the Committee (but not necessarily endorsed by it) is contained in the annexes, which are referred to in the relevant chapters.

The Committee

Members	Onno Ruding, Chairman Donal de Buitleir Jean-Louis Descours Lorenzo Gascon Carlo Gatto Ken Messere Albert Rädler Frans Vanistendael
Assistants	Francisco Berruguete Jens Blumenberg Yves Darolles Marco Tucci Olf Van Laar
Secretariat	Michael Daly (Secretary) Luc De Hert (Assistant Secretary) Philippe Pelle David Carr Mary Clynes

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Brussels, 25 October 1990

**Mandate given to Mr Onno Ruding for the Committee
established to examine company taxation
in the European Community**

The Committee will evaluate first and foremost the importance of taxation for business decisions with respect to the location of investment and the international allocation of profits between enterprises. An assessment of the impact of taxation relative to other factors on such decisions is necessary in order to determine whether existing differences in corporate taxation and the burden of business taxes among member countries lead to major distortions affecting the functioning of the internal market.

If such distortions do arise, it is essential to examine all possible remedial measures, taking into account the influence that other policies (e.g. economic and monetary union) might have on the extent of the tax-induced distortions. In order to determine the most appropriate action at the Community level, it is necessary to distinguish clearly between the main elements of the corporate tax system, namely the type of tax system, the tax base, and the statutory tax rate. Moreover, since some businesses are not subject to corporation taxes as a consequence of their legal status, the question also arises as to what action is required concerning non-corporate income taxes.

In this regard, it is essential to define the priorities among the different measures that the Committee envisages, preferably with proposed dates for their implementation. The Committee will also have to give its opinion on the legal nature of any envisaged measure in order to determine whether the objective is to harmonize certain aspects or to limit it to the establishment of a framework for national tax legislation.

Finally, the Committee should consider the demands placed on the tax system by other political objectives, such as those pertaining to the environment, health and social affairs, to address the question of how and to what extent it will still be possible to take into account non-tax considerations.

Other questions could also be addressed, if need be.



Ch. Scrivener

Executive summary

This report is the work of the Committee, chaired by the Honourable Onno Ruding, which was set up by the Commission of the European Community in December 1990, on the initiative of Mrs Scrivener, Member of the Commission, following the communication of the Commission 'Guidelines on company taxation' of 20 April 1990. The Committee met 12 times between January 1991 and February 1992. The Committee's mandate was to evaluate the need for greater harmonization of business taxation within the European Community. In carrying out its work, and on the basis of its mandate, the Committee considered the following questions:

1. Do differences in taxation among Member States cause major distortions in the internal market, particularly with respect to investment decisions and competition? Special attention is focused on those distortions considered to be discriminatory.
2. In so far as such distortions arise, are they likely to be eliminated simply through the interplay of market forces and tax competition between Member States, or is action at the Community level required?
3. What specific measures are required at the Community level to remove or mitigate these distortions?

The Committee's main findings are briefly summarized below.

1(a) Principal tax differences (Chapter 3)

There are major differences in the corporate tax systems operated by each Member State, as well as considerable variations in the statutory corporation tax rates and corporation tax base (which determine the level of taxable income).

In addition to these basic differences, there are, more specifically, differences in the tax treatment of cross-border income flows (dividend, interest and royalty payments). These not only concern the imposition of withholding taxes at the point of payment, but also methods and extent of relief for double taxation in the hands of the recipient. And on the other side of the coin, there are differences in the methods of allowing losses incurred by a branch or subsidiary in one Member State to be offset against the profits of the parent in another Member State.

(b) Distortions

The Committee reviewed the evidence which included a simulation study and an empirical survey to establish how far the differences identified caused major distortions or were discriminatory.

The simulation study (Chapter 4) examined how far each Member State's tax system provided incentives to both domestic and foreign direct investment, and modelled the corporate tax component of the cost of capital in each country from domestic and foreign sources. It suggested that withholding taxes levied by source countries on cross-border dividend payments between related companies are the main reason for bias against inward and outward direct investment.

Other significant sources of bias are:

- (i) differences among Member States in the method of providing relief for double taxation on cross-border income flows;
- (ii) differences in corporation tax rates between countries; and
- (iii) the discriminatory effect of unrelieved imputation taxes (*précompte*, advance corporation tax, etc.) related to distributions by parent companies from profits earned abroad.

The empirical survey (Chapter 5) examined how far location decisions are influenced by tax considerations. The evidence suggested that tax differences among Member States distort foreign location decisions of multinational firms, and cause distortions in competition, especially in the financial sector. The strength of the evidence suggested that the distortions could be large, but it was not possible to quantify the consequent misallocation of resources in a satisfactory way.

(c) Other considerations (Chapter 2)

In examining the differences and distortions arising, the Committee was aware of the need for any recommendations to take into account considerations of fairness, administrative feasibility, compliance costs and transparency. This latter point was considered particularly important to avoid distortions of competition within the Community through the use of hidden tax incentives.

Experience in non-EC federal countries was also taken into account (Chapter 9).

2. Convergence and competition (Chapters 7 and 8)

The Committee found that there has been some convergence of different countries' tax regimes despite the absence of concerted action. However, many of the changes seem to have arisen from a general desire by the countries concerned to establish tax regimes which are more neutral from a domestic viewpoint. This has involved cutting both corporate and personal statutory tax rates and reducing tax concessions.

Overall, the corporate tax component of the average cost of capital across Member States converged over the past decade. However, much of this convergence was attributable to downward convergence of interest and inflation rates rather than deliberate action on the part of tax authorities. (The exceptions were Germany and the United Kingdom where tax reform also made a significant contribution.)

There is no evidence to suggest that independent action by national governments is likely to provoke unbridled general tax competition leading to erosion of the corporate tax revenues of Member States. However, the Committee was concerned about the

tendency of Member States to introduce special tax schemes designed to attract internationally mobile business, particularly in the financial sector.

There was also specific concern about tax competition in the area of withholding taxes on cross-border flows of interest from portfolio investment.

3. Conclusions and recommendations (Chapter 10)

Despite the observed convergence over the past decade, wide differences in tax regimes remain. Some of these differences distort the functioning of the internal market both for goods and for capital, and it is unlikely they will be reduced significantly through independent action by Member States. Accordingly, action is needed at Community level.

However, other considerations, such as the need to allow Member States as much flexibility as possible to collect revenue through direct taxes, and the principle of subsidiarity, argue in favour of focusing Community harmonization on the minimum necessary to remove discrimination and major distortions.

So at this stage in the Community's development, action should concentrate on the following priorities:

- (a) removing those discriminatory and distortionary features of countries' tax arrangements that impede cross-border business investment and shareholding;
- (b) setting a minimum level for statutory corporation tax rates and also common rules for a minimum tax base, so as to limit excessive tax competition between Member States intended to attract mobile investment or taxable profits of multinational firms, either of which tend to erode the tax base in the Community as a whole; and
- (c) encouraging maximum transparency of any tax incentives granted by Member States to promote investment with a preference for incentives, if any, of a non-fiscal character.

A programme of total harmonization is not justified at this stage. None the less the Committee believes that the adoption by all Member States of a common system of corporation tax is a desirable long-term objective.

Detailed recommendations

These fall into three categories. Each proposal in each category is classified as falling in one of three phases according to the urgency of implementing it. Phase I should be implemented by the end of 1994. Work on Phase II should commence immediately with a view to implementation during the second phase of economic and monetary union. Implementation of Phase III is envisaged as being concurrent with full economic and monetary union. The recommendations are to be found in Chapter 10 of the report, which sets out the Committee's conclusions and recommendations in more detail.

A — Elimination of the double taxation of cross-border income flows

To ensure the elimination of withholding taxes levied by source countries on dividends paid by subsidiaries to parent companies, the Committee recommends:

- that the scope of the ‘parent/subsidiary’ Directive be extended to cover all enterprises subject to corporate income tax irrespective of their legal form (Phase I). The Directive should subsequently be extended to all other enterprises subject to income tax (Phase II); and
- a substantial reduction in the participation threshold as prescribed in the ‘parent/subsidiary’ Directive (Phase II).

To combat evasion, a sufficient level of taxation at source should be ensured, so the Committee recommends:

- that the Commission propose by way of directive a uniform withholding tax of 30% on dividend distributions by EC-resident companies subject to waiver where appropriate tax identification is provided (Phase II).

To eliminate other withholding taxes levied by source countries on payment between enterprises in different Member States, the Committee recommends:

- that the proposed ‘interest and royalties’ Directive be adopted and that the scope of the Directive be extended to encompass all such payments between enterprises together with accompanying measures to ensure that the corresponding income is effectively taxed within the Community in the hands of the beneficiary (Phase I).

To eliminate double taxation arising from transfer-pricing disputes, the Committee recommends:

- that the Commission urge all Member States to ratify the Arbitration Convention as soon as possible (Phase I); and
- that the Commission take action together with the Member States to establish appropriate rules or procedures concerning transfer-pricing adjustments by Member States (Phase I).

To reduce impediments to cross-border investments likely to generate losses in early years, the Committee recommends:

- that Member States adopt the draft directive dealing with losses of permanent establishments and subsidiaries in other Member States (Phase I);
- that all Member States introduce full vertical and horizontal offsetting of losses within groups of enterprises at the national level (Phase II); and
- extension of the draft directive to allow full Community-wide loss offsetting within groups of enterprises (Phase III).

To ensure that bilateral agreements for minimizing double taxation are on a proper footing, the Committee urges:

- Member States not only to conclude bilateral income tax treaties where none exist between them, but also to complete those where coverage is limited (Phase I);

and recommends

- action by the Commission in concert with Member States aimed at defining a common policy on double taxation agreements with respect to each other and also with respect to third countries (Phase I).

B — Corporation taxes

To reduce discrimination between the tax treatment of domestic- and foreign-source income, the Committee recommends:

- that existing discrimination in the taxation of dividends from profits earned in another Member State be removed. To this end:
- Member States which apply imputation taxes on the distribution of profits earned in another Member State should be obliged, on a reciprocal basis, to allow such tax to be reduced by corporate income tax paid in another Member State in respect of dividends remitted by a subsidiary, or profits earned by a permanent establishment (Phase I); and
- Member States with various forms of tax relief for dividends received by domestic shareholders from domestic companies should be obliged, on a reciprocal basis, to provide equivalent relief for dividends received by domestic shareholders from companies in other Member States (Phase I).

To achieve a more fully harmonized corporation tax system within the Community, the Committee recommends:

- that the Commission and the Member States examine in the course of Phase I alternative approaches to determine the most appropriate common corporation tax system for the Community (Phase III).

To reduce the risks of serious erosion of corporate tax revenues, the Committee recommends:

- that a draft directive be prepared by the Commission prescribing a minimum statutory corporation tax rate of 30% in Member States for all companies, regardless of whether profits are retained or distributed as dividends (Phase I);
- adoption by all Member States of a maximum statutory corporation tax rate of 40% (Phase II); and related to this,
- that there should be only one kind of tax on corporate income in Member States. If this cannot be achieved, local income taxes should be taken into account when fixing the statutory corporation tax rate so that the combined rate of tax falls within the range of 30 to 40% prescribed by the Committee (Phase II).

In addition there should be

- a set of minimum standards for the tax base to cover:
depreciation practices (to include intangibles such as goodwill),
leasing,
stock valuation,

provisions,
business expenses,
headquarters costs of enterprises,
pension contributions by or for expatriate workers,
carry-over of tax losses, and
capital gains

(Phases I and II).

Since the time at which corporation taxes are payable varies from one Member State to another, the Committee recommends:

- that the Commission should seek to establish common rules by way of directive to harmonize the dates at which taxes of common application are payable (Phase II).

To improve neutrality between different forms of business organizations, the Committee recommends:

- that the Commission should seek to establish common rules which would permit unincorporated enterprises the option of being taxed as if they were a company, with the proviso that such a regime should apply for a minimum period of time (Phase II).

C — Other issues

To remove different burdens arising from additional mixed-base taxes, the Committee recommends:

- that Member States having such multibase local business taxes replace them by an on-profits tax levied on the same base as the central government corporation tax (Phase II).

Glossary of terms

- Marginal effective tax wedge:* the difference between the required pre-tax and the post-tax rates of return on a prospective marginal investment over its lifetime.
- Marginal effective tax rate:* the marginal effective tax wedge divided by the real required pre-tax rate of return.
- Marginal investment:* a project whose return is just sufficient to cover its cost inclusive of taxes.
- Cost of capital:* the minimum inflation-adjusted pre-tax rate of return that an investment project must earn in order for it to be undertaken. The cost of capital is also commonly known as the 'hurdle' or 'break-even' rate of return.
- Real interest rate:* the nominal interest rate minus the rate of inflation.
- Capital import neutrality (CIN):* CIN occurs when taxation is neutral with respect to the import of capital because domestic and foreign suppliers of capital to any national market obtain the same after-tax rate of return on similar investments in that market.
- Capital export neutrality (CEN):* CEN prevails where taxation is neutral towards the export of capital since investors in the capital-exporting country face the same marginal effective tax rate on income from similar investments, whether they are undertaken domestically or abroad.
- International double taxation:* a situation where income of the same taxpayer is taxed in two different countries.
- Economic double taxation:* a situation where profits are subject firstly to corporation tax and secondly to personal income tax when received by a shareholder in the form of dividends.

- Integration:* any reduction or elimination of economic double taxation, whether granted at the company or individual shareholder level.
- Classical corporation tax system:* a system under which little or no relief is provided for economic double taxation.
- Imputation system:* a system whereby a (full or partial) tax credit is given to shareholders under the personal income tax for the amount of corporation taxes actually paid on profits distributed as dividends.
- Imputation tax:* the term used to describe the mechanism by which Member States which operate an imputation system ensure that any dividend distribution which carries a tax credit has been subject to domestic tax at the corporate level. It includes *précompte* (France), *Ausschüttungsbelastung* (Germany), *imposta di congualio* (Italy), and advance corporation tax (Ireland and UK). Although these taxes work in different ways, which in part reflects differences in the way the underlying systems work in practice, they are intended to achieve the same objective.
- Dividend-deduction system:* a system whereby a (full or partial) deduction from the corporate tax base is allowed for distributed dividends.
- Split-rate system:* normally a system analogous to a dividend deduction system whereby a lower corporation tax rate is levied on dividend distributions. (It is possible for a higher corporation tax rate to be levied on dividend distributions but the effects are different.)
- Subsidiarity:* as now defined in the Maastricht Treaty, the principle that in areas where the Community does not have exclusive competence, that it should only act when and to the extent that the objectives cannot be achieved to a sufficient extent by the Member States, because of the scale of the measure envisaged, the objectives can best be achieved at the Community level. No Community measure should exceed what is necessary to achieve the objectives of the Treaty.

- Convergence:* a process or series of developments where Member States' tax bases, rates, systems, revenue yields, etc. become closer together ('divergence' being the term used to indicate the contrary), irrespective of whether this happens as a result of EC coordination or the interplay of market forces.
- Harmonization:* the occurrence of greater convergence as a result of action at the Community level by the Commission or other agencies of the Community such as the European Court of Justice. 'Full harmonization' describes the situation where identical tax bases, rates, systems, etc. are proposed or achieved among Member States. By contrast, 'partial harmonization' involves something less than identical bases, rates, systems, etc. (such as approximation of the base, minimum or maximum statutory tax rates).
- Coordination:* any action or measures taken by the Commission or some or all EC countries to influence the tax practices of member countries, (such actions might take the form of directives, conventions, recommendations, guidelines, etc.).
- Competition:* a process where, in contrast to tax coordination, the interplay of market forces might achieve similar goals (generally that of convergence).