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COMMISSION COMMUNICATION

TO THE COUNCIL AND TO PARLIAMENT

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subsequent to the conclusions of the Ruding Committee
indicating guidelines on company taxation linked
to the further development of the internal market

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Introduction

1. This Commission communication to the Council and to Parliament is further to that on guidelines on company taxation presented on 20 April 1990(1).

The first part of that communication was given over to an examination of the tax problems to be resolved with a view to the completion of the single market as defined in the Single European Act. The second part examined the new longer-term guidelines to be followed as the internal market was developed further. The Commission announced in that communication that it would ask a Committee of independent experts to study the possible need for new Community measures. That Committee, which was set up under the chairmanship of Mr Onno Ruding in December 1990, met twelve times between January 1991 and February 1992 and submitted its report to the Commission on 18 March 1992.

2. In accordance with the terms of reference it was given by the Commission, the Committee of experts examined the following questions:

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(1) SEC(90)601 - Commission Communication to Parliament and the Council on guidelines on company taxation - 20 April 1990.

(1) Do differences in taxation among Member States cause distortions in the functioning of the internal market, particularly with respect to investment decisions and competition? Special attention was focused on those distortions that involve discrimination, such as the treatment of foreign-source dividends.

(2) Insofar as such distortions do arise, are they likely to be eliminated simply through the interplay of market forces and tax competition between national tax systems, or is action at Community level required?

(3) In the event that Community action is deemed to be necessary, what specific measures should be taken to remove or mitigate these distortions?

3. This communication is divided into two parts. The first part is devoted to the findings of the economic analysis carried out by the Committee, while the second examines its recommendations and establishes a number of general guidelines for action at Community level. That examination also takes account of work carried out by international organizations and at national level, both in Member States and in certain non-member countries.

While the Commission does not always share the opinions expressed in the report, it nevertheless considers that, in view of the time limit imposed, the Ruding Committee has produced an outstanding and comprehensive analysis and has given specific answers to the questions put to it, so making a major contribution to the wide-ranging debate in progress within the Community and at international level on the part played by company taxation and its impact on cross-frontier financial and investment flows. This communication sets out the Commission's initial reactions to the Committee's conclusions and recommendations.

On the basis of the Committee of experts' report and this communication, the Commission intends to launch a comprehensive process of consultation of the tax authorities in the twelve Member States and other interested parties before formulating proposals for Community legislation in the second half of 1992.

PART ONE - ECONOMIC ANALYSIS AND MEDIUM-TERM OUTLOOK FOR COMPANY TAXATION

4. In examining the basic questions falling within its terms of reference, the Committee of experts first of all drew up a list of the main differences between the corporate tax systems of the Member States, focusing on the nature of the corporation tax system in each country, statutory tax rates, the definition of the tax base together with the various types of tax relief, withholding taxes on income payable to beneficiaries abroad, and the manner of alleviating double taxation of income derived from cross-border activities.

   Having drawn up that list, the Committee of experts carried out a simulation study and a survey with a view to determining whether the differences noted led to major distortions.

5. The analysis based on the simulation study was made applying the same principles as those adopted for the recent OECD report "Taxing Profits in a Global Economy", which was approved by the OECD's Committee on Fiscal Affairs. It has therefore been acknowledged and approved by all the tax administrations in the Member States. The Committee refined this analysis for the Community by carrying out additional simulations, particularly in respect of the tax treatment of cross-border income flows.

   The simulation study is designed to establish to what extent the tax systems of the different Member States include incentives for domestic and foreign direct investment. It is based on an analysis of the "corporate tax" component of the cost of domestic and foreign capital.

6. Not only does the tax component of the cost of capital for domestic investment vary between Member States as a consequence of tax differences between them, but, more importantly, for outward and inward investment it is, on average, generally higher than for domestic investment. The simulation study shows, for example, that

the tax component of the cost of capital for a typical investment project undertaken by a wholly owned subsidiary using funds provided by its parent company is 2.1%, if the subsidiary is located in another Member State, whereas it would only be 0.7% for a similar investment where the subsidiary was situated in the same State as its parent company. The discrepancy between the cost of capital for domestic and for foreign investment is even greater in the case of investment projects undertaken by newly created subsidiaries that depend heavily on their parent companies for finance. Furthermore, the tax component of the cost of capital for direct investment by companies in or from another Member States varies considerably depending on the country of residence involved.

7. The simulation results indicate that tax differences between Member States can affect the location of investment and cause distortion of competition that is detrimental to the efficient allocation of resources in the Community.

A. <u>Nature and scale of tax distortions</u>

8. It is possible to classify the sources of distortion according to their impact on external direct investment. The most important distortions arise from the international double taxation of dividends which is due mainly:

- to the withholding taxes levied by countries of origin on cross-frontier dividend payments between associated companies,

- to the imputation taxes (advance corporation tax, "précompte", etc.) applied to dividends distributed by parent companies from profits earned abroad,

- and, to a lesser extent, to disparities between corporation tax rates.

9. But the same findings also suggest that:

- withholding taxes levied by source countries on cross-border inter-corporate interest payments,

- differences between the corporation tax systems applied by Member States, and

- variations in the corporation-tax base in the Member States

constitute less important sources of non-neutrality. Clearly, any assessment of the relative scale of potential distortions is limited to the elements included in the model. Thus, in the case of the tax base, only depreciation allowances and stock valuation methods were used as parameters for measuring the impact on the cost of capital of the tax differences between Member States in this field. The variety and complexity of the tax arrangements relating to provisions made it impossible for the Committee - given the stipulated time limit - to include that parameter in the model. However, this does not call into question the results obtained.

10. Moreover, those results are confirmed by the replies to the comprehensive survey which the Committee of experts conducted among 8 000 companies based in 17 European countries, including all 12 Member States. That survey shows that, for multinational companies, the choice of the country in which they invest is indeed influenced by tax considerations. For example, 48% of respondents claimed that taxation is always or usually a major factor in the decision as to where to locate a production plant. The corresponding figure for a research centre is 41%. It is 78% in the case of a financial company. Such evidence suggests that tax differences between Member States have a real but varying impact on the foreign location decisions of multinational companies, depending on the nature of the investment and that these can distort competition, especially in the area of financial activities. This could produce misallocation

of resources within the Community, resulting in lower productivity which in turn could reduce the Community's overall competitiveness relative to non-member countries. Although it has not proved possible to quantify the economic efficiency losses stemming from tax-induced distortions of competition, there is every reason to think that they could be important given the influence that taxation has on the location of investment and on financing decisions.

11. However, the wishes of companies go beyond the elimination of the principal sources of tax distortion already identified by the simulation study. The survey had the advantage of pinpointing two additional problems, namely the complexity of tax legislation (in the Community as currently composed this complexity is multiplied twelve times over) and the instability of tax measures generally. Companies are urgently calling for real simplification and greater stability of the tax arrangements with which they are confronted in their day-to-day activities.

B. <u>Possible erosion of Member States' tax revenue</u>

12. In addition to the impact of tax distortions on economic activity within the Community, the Committee of experts sought to assess the effects of tax competition between Member States on corporate tax revenues. Owing to the lack of reliable statistical information, the Committee was unable to judge whether or not such competition would lead to considerable erosion of tax receipts.

13. However, there are a number of reasons to suggest that a serious erosion of corporate tax revenues is unlikely to occur. First, there is the necessity for Member States to maintain corporation tax as an adjunct to their personal income tax systems. Second, taxation is obviously only one, albeit an important, determinant of firms' location decisions.

At present, therefore, the threat of a loss of tax revenue does not seem to provide strong justification for total harmonization of corporation tax in the Community.

14. The Committee of experts is concerned, however, about Member States' tendency to introduce special tax schemes designed to attract internationally mobile business. These schemes normally cost the host country little in terms of tax revenue forgone. On the other hand, the loss in tax revenue by the country from which the activities are withdrawn can be considerable. There is also clearly a cost for that country in trying to match those special regimes in order to retain existing activities on its territory. There is, therefore, a danger that these special arrangements will lead to a reduction in both revenue and economic activity in some sectors.

The Committee emphasizes the need for the Commission to exercise stricter control over such incentives and calls for the adoption of a minimum statutory corporation-tax rate throughout the Community.

C. Tax convergence in the Community

15. Having noted the distorting effects caused by tax differences between Member States, the Committee wondered to what extent independent action by each government alone could reduce those differences or whether action was necessary at Community level.

16. There has been some convergence of Member States' tax systems during the past decade despite the absence of Community action. Statutory corporation-tax rates not only converged to some extent in Member States between 1985 and 1991; they also fell by an (unweighted) average of some seven percentage points from 46.9% in 1985 to 40.1% in 1991.

This convergence of rates can be explained only partially by tax competition between countries, whether Member States or non-member countries; it is primarily due to the growing desire of countries to establish more neutral tax regimes by cutting statutory tax rates and reducing tax concessions.

17. Another more interesting finding is that there was a marked convergence in the corporate tax component of the cost of capital in the various Member States over the decade as a whole and that this convergence was attributable primarily to the downward convergence in those countries' interest and inflation rates rather than to deliberate action on the part of the national tax authorities.

18. Thus, despite the tax convergence observed over the past decade, the Committee considers it unlikely that the main distortions affecting the functioning of the internal market can be reduced appreciably through independent action by Member States. The Committee therefore believes that action must be taken at Community level.

PART TWO - GUIDELINES PROPOSED IN THE LIGHT OF THE COMMITTEE OF EXPERTS' RECOMMENDATIONS

19. The recommendations made by the Committee of experts can be divided into two categories:

firstly, those which relate to the elimination of the double taxation of cross-border income flows and which focus in particular on the abolition of withholding taxes, the regulation of transfer pricing, the taxation of groups of companies, coordination of bilateral agreements, and the neutral treatment of foreign-source as compared with domestic-source dividends;

secondly, those which relate to corporation tax and which are concerned with the three aspects that are the rates, the tax base and the systems applied.

20. The Committee of experts has also drawn up a three-phase timetable for implementing the measures recommended: the phase I measures should be applied by the end of 1994, those in phase II should be implemented during the second stage of economic and monetary union and those in phase III should coincide with the completion of economic and monetary union.

20. bis Given the importance of taxation for Member States' sovereignty and the principle of subsidiarity, the Committee argues in favour of limiting Community action to the minimum necessary to ensure that the internal market functions smoothly.

In the light of the Committee's recommendations, the Commission favours a pragmatic and progressive approach, bearing in mind that taxation is only one factor amongst others in investment decisions. Thus, the Commission, in its approach, based on the subsidiarity principle, after consultation with interested parties, will propose specific measures to redress the problems resulting from distortions, taking into account the general fiscal environment of the Member States as well as budgetary constraints linked to establishing Economic and Monetary Union.

21. Broadly speaking, the recommendations concerning the elimination of the double taxation of cross-border income flows are a direct extension of the measures already adopted by the Council or proposed by the Commission. Furthermore, the justification for these measures generally is provided by the economic analysis set out in Part One.

22. The measures to align national corporation tax laws more closely call for a more differentiated assessment. This is due to their complexity, to the fact that the economic case seems to be less soundly based and to the effects which applying them would have on Member States' tax revenue and decision-making powers.

The timetable envisaged by the Committee of experts bears witness to the need - recognized in other fields, such as economic and monetary union - for action to be taken in successive stages and phases.

A. ELIMINATION OF THE DOUBLE TAXATION OF CROSS-BORDER INCOME FLOWS

23. The priority aim of the recommendations made by the Ruding Committee is to eliminate the double taxation of cross-border income flows. Those recommendations are directly in line with the company taxation strategy which the Commission put forward in its communication of 20 April 1990 to Parliament and the Council with a view to safeguarding the establishment and smooth operation of the internal market.

The Commission is glad to see that the Ruding Committee recognizes the fundamental importance of the guidelines adopted on 20 April 1990.

(1) Community measures already adopted and in the course of being transposed into national law or ratified

On 23 July 1990 the Council of Ministers adopted a package of three measures designed to encourage cross-border cooperation between companies from different Member States. That package comprises two Directives and a multilateral convention.

24. The "parent companies/subsidiaries[1]" Directive is designed to eliminate the double taxation of the profits distributed by a subsidiary in one Member State to its parent company established in another Member State. It provides for the Member State of the subsidiary to abolish any withholding tax and for the Member State of the parent company to exempt the dividends or to impute the tax already paid in the Member State of the subsidiary against its own tax.

25. The "mergers" Directive[2] provides for the deferral of the taxation of any capital gains arising from cross-frontier company restructuring carried out in the form of mergers, divisions, contributions of assets or exchanges of shares. Taxation of the capital gain is deferred until the assets in question are actually realized or are physically transferred across frontiers. This measure will permit the restructuring of Community companies without immediate tax cost, leading, inter alia, to an improvement in their competitiveness on world markets.

These two Directives should have been transposed into national law by 1 January 1992. Some Member States haven fallen behind in implementing their transposition programmes. The Commission will take any necessary measures for the two Directives to be incorporated into national law.

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(1) 90/435/EEC - Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member State. O.J L225, 20 August 1990.

(2) 90/434/EEC - Council Directive of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States. O.J L225, 20 August 1990.

26. Once it has been ratified by all Member States, the Arbitration Convention(1) will guarantee the elimination within a specified period of time, of the economic double taxation falling on a group where a tax authority increases the profits that an enterprise has earned through transactions carried out with an associated enterprise in another Member State without the latter's profits being reduced correspondingly.

27. The Ruding Committee has noted that the "mergers" and "parent companies/subsidiaries" Directives are currently being transposed into national law and has invited all Member States that have not already done so to ratify the Arbitration Convention as soon as possible.

(2) Further measures proposed

The Committee has also made recommendations which supplement or extend the measures already taken by the Commission.

2.1 Withholding taxes

28. The Committee is advocating:

- the extension of the scope of the "parent companies/subsidiaries" Directive to all enterprises subject to corporation tax, whatever

  their legal form (phase I), and, subsequently, to all enterprises subject to income tax (phase II);

- an appreciable reduction in the participation threshold provided for in the "parent companies/subsidiaries" Directive (phase I);

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(1) 90/436/EEC - Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises. O.J L225, 20 August 1990.

- the adoption of the proposal for a Directive on interest and royalty payments[1], the scope of which would be extended to encompass all such payments (phase I).

29. The Commission considers that the extension of the scope of the "parent companies/subsidiaries" Directive along the lines suggested by the Committee would be highly desirable as a means of further reducing the double taxation which most penalizes the international activities of companies. In order to prevent any discriminatory treatment, that extension should benefit both parent companies which are subject to corporation tax and those which are subject to personal income tax.

30. The Commission also sees a need to extend the scope of the "mergers" Directive in order to ensure greater uniformity for that Directive too. Its scope should be extended to all companies in respect of the four types of operation covered (mergers, divisions, transfers of assets and exchanges of shares) and, in addition, to sole proprietorships in respect of those operations which can concern them, namely transfers of assets.

In the light of current consultations, proposals for directives will be drawn up by the end of the year in all these fields.

The Commission also intends to study with Member States new procedures for simplifying and speeding up the mechanisms under which agreed withholding tax procedures are applied.

2.2. <u>General rules applicable to transfer pricing</u>

2.2.1. <u>Transfer pricing</u>

31. The Commission also endorses the recommendation inviting it to take steps, in agreement with the Member States, to establish appropriate rules or procedures for transfer price adjustments by Member States (phase I).

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(1) COM(90)571 - Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States. O.J C53, 28 February 1991.

This recommendation ties in with the idea that the Arbitration Convention, which guarantees retroactive elimination of double taxation, should be supplemented by measures designed to prevent double taxation. In this field, the Commission considers the principle of prices being determined under conditions of open competition ("dealing at arm's length") as the basis for transfer prices, as enshrined in the Arbitration Convention of 23 July 1990. The suggestions put forward by the Commission's departments have already been the subject of an initial discussion with the Standing Committee of Heads of National Revenue Departments (April 1991). They provide for the introduction of a consultation procedure prior to any adjustment of transfer prices - a procedure which could be facilitated by the organization of simultaneous or joint tax checks and the development of the practice of "rulings".[1]

2.2.2. <u>Thin capitalization</u>

32. The Commission also endorses the recommendation inviting it to propose, in agreement with Member States, a common approach to the definition and treatment of thin capitalization (phase II).

That recommendation is designed to prevent the double taxation which might arise from the application of different rules on thincapitalization in Member States or from differing interpretations of those rules by their tax authorities. Such would be the case, for example, where interest payments made between two associated companies situated in different Member States were unilaterally reclassified as dividends.

1 This practice enables a company to obtain from the tax authority a decision in advance concerning the tax implications of the economic and/or legal choice it intends to make.

2.2.3. Allocation of headquarter costs

33. The Committee of experts also recommends that the Commission put forward a proposal for a directive governing the allocation of headquarter costs in order to preclude situations where such costs cannot be deducted in any Member State.

The Committee also calls for that proposal to provide a common definition of the costs borne by the shareholder in order to preclude situations where they are deductible neither in the Member State of the parent company nor in that of the subsidiary.

As these problems may not be solved by tax agreements, the Commission welcomes both recommendations and will initiate consultations with interested parties for their implementation.

2.3. Bilateral agreements designed to prevent double taxation

34. The Commission also agrees with the recommendations regarding bilateral tax treaties. This applies both to the call for Member States to complete the network of treaties within the Community and to increase their scope (phase I) and to the definition of a common policy towards double taxation agreements with non-member countries (phase I). However, the Commission considers that such action should be limited to fields that are of major interest to the Community, which is particularly the case with arrangements covered by Community rules.

35. The Commission will ensure that the agreements concluded by Member States - both between each other and with non-member countries - are in strict accordance with the non-discrimination rules in the Treaty and with the established Community arrangements arising from the tax Directives adopted in 1990.

36. The Commission is in favour of all coordination efforts in this field and has already held informal discussions on these subjects with the tax authorities in the Member States. It will take further steps to coordinate action at Community level on a number of issues relating to bilateral tax agreements in line with the proposals put forward by the Committee of experts.

2.4. Taxation of groups of companies

37. The Ruding Committee considers that the absence of means by which Community-based groups of enterprises can offset losses incurred in one Member State against profits arising in another constitutes an impediment to cross-border investment.

It therefore recommends adoption of the proposal for a directive concerning the taking into account of the losses of permanent establishments and subsidiaries in other Member States(1).

38. Other recommendations in this area are aimed, firstly, at the introduction by Member States of full vertical and horizontal offsetting of losses within groups of enterprises at national level (phase II) and, secondly, at the full offsetting of losses within groups of enterprises in the Community (phase III).

With regard to the first recommendation, the Commission considers that Community action should be limited to dealing with transnational problems and that it should be left to Member States to adapt their domestic legislation, where necessary, to the rules governing relations between the Member States. This was the line followed by

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(1) COM(90)595 - Proposal for a Council Directive concerning arragnements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States. O.J C53, 28 February 1991.

the Council in the case of the two Directives adopted on 23 July 1990; the same approach underlies the proposal for a Directive on the taking into account of foreign losses.

The second recommendation could provide a Community solution in the long term. The introduction of such an arrangement could be envisaged only after closer convergence of the rules relating to the tax base. Such convergence would in particular eliminate the differences in results that arise because of different ways of calculating losses (applying the rules of the Member State of the permanent establishment or subsidiary or applying those of the Member State of the parent company). Full offsetting of losses within groups of enterprises basically leads to the same results - except for a few technical details - as a consolidation system under which account is taken of both profits and losses at group level.

2.5. <u>Neutrality of treatment as between foreign-source and domestic-source dividends</u>

39. The Committee of experts has made two particularly important recommendations concerning the elimination of discrimination affecting cross-border income flows.

The first recommendation would require those Member States levying compensatory taxes (advance corporation tax, "précompte", etc.) on dividends paid out of profits earned in another Member State to authorize, on the basis of reciprocity, the corporation tax paid in another Member State on the profits distributed by a subsidiary or on the profits earned by a permanent establishment to be set against those taxes.

The second recommendation would require those Member States applying tax relief systems to profits received by resident shareholders from resident companies to grant equivalent reliefs in respect of dividends received by resident shareholders from companies in other Member States.

These two measures should be implemented in phase I.

40. The Commission shares the Committee's aims and will initiate discussions with Member States on appropriate ways of putting these two recommendations into effect. It has reservations, however, about the condition of reciprocity. The imposition of such a condition would not eliminate all current forms of discrimination since it would limit the benefit of the first measure to Member States applying imputation systems and that of the second to Member States applying tax relief systems (including imputation systems) for shareholders who are natural persons. Profits originating in Member States not meeting these conditions would thus be excluded.

The Commission also notes that the Committee does not recommend that Member States applying imputation systems should be required to grant the tax credit to non-resident shareholders. The point can be made that this measure might distort investment decisions and capital movements since it would be designed to attract foreign investment through state aid, with the cost of the tax credit being borne by the budget of the Member State in which the company is resident.

B. MEASURES RELATING TO THE RATES, THE BASE AND THE SYSTEMS OF CORPORATION TAX

1. Corporation tax rates

1.1 Committee of experts' proposals

41. The Committee recommends the Council to adopt a Directive setting a minimum statutory corporation-tax rate of 30% for all companies, regardless of whether or not profits are distributed. It further recommends that all Member States should adopt a maximum statutory rate of 40%. Finally, the Committee recommends that Member States should apply only one type of tax to corporate income or, if that is impossible, that local taxes should be taken into account when the statutory corporation-tax rate is set so that the combined rate falls within the 30% to 40% range.

While the first measure would have to be applied during phase I, the other two measures would be implemented in phase II.

1.2 The Commission's position

(a) Principle of a minimum corporation tax rate

42. The economic analysis in the report shows that differences between statutory corporation-tax rates are one of the factors likely to create distortions in the choice of investment location (see paragraphs 3 to 5). The Committee of experts' recommendation of a 30% minimum rate is based partly on that analysis and partly on the belief that excessive competition between Member States through reductions in the statutory corporation-tax rate may lead to an erosion of tax revenue in the course of time. A minimum rate would thus set a limit to such competition.

43. The Commission considers that, with the other barriers to trade and to cross-frontier investment gradually disappearing, there is a danger that excessive competition might develop not only through tax rates but also through the tax bases (see below) if some Member States were to seek to attract internationally mobile investment, savings or activities through "tax dumping" measures. The risk is probably greater in the specific field of financial services.

The Commission is planning to enter into more detailed discussions with Member States on the principle and the level of a minimum rate.

44. Indeed, despite the interest of such a principle, which furthermore was adopted in the field of indirect taxation (VAT and excise duties), this proposal raises several problems.

The 30% level proposed by the Ruding Committee would seem at first sight to be too high.

Account must also be taken of the existing relationship between rates and the structure of tax bases.

The introduction of a minimum rate at this level might make it difficult for Member States to maintain reduced tax rates for profits below a given level, the main aim of which is to alleviate the tax burden on small and medium-sized firms.

Similarly, it must be borne in mind that the fixing of a minimum rate through Community legislation could render Member States more vulnerable to tax competition from non-member countries. Account must also be taken in this context of the tax arrangements, and in particular the national tax rates, in force in those EFTA countries which have applied for membership of the Community.

If a minimum rate were to be set, this could be established for a limited period only.

(b) Maximum corporation tax rate

45. The Commission does not see the need for a maximum rate. The Ruding Committee itself, in the wording of its recommendation (unilateral action by Member States instead of a Community decision), considered, in the light of the subsidiarity principle, that setting a maximum rate is a sovereign decision of the Member States.

(c) Taking account of local taxes in fixing the statutory corporation tax rate

46. The Committee of experts recommends that a single type of corporate income tax be applied in Member States and therefore proposes that all local taxes on enterprises be based solely on their profits and no longer on composite bases (assets/profits).

For political reasons, it will be difficult for those Member States using company taxation as a means of financing local authorities to carry out the legislative reforms advocated by the Committee.

2. Tax base for company profits

2.1 General rules for determining the tax base.

2.2.1. The Committee of experts' proposals

47. The Committee puts forward detailed recommendations covering all the elements of the tax base. It takes the view that there should be a minimum degree of harmonization for a number of reasons:

- differences between national rules may create distortions that are incompatible with the efficient operation of the internal market;

- the proposed measures concerning corporation-tax rates would make little sense without some degree of harmonization of the tax base itself;

- it is necessary to make incentives transparent, which is not the case where they are adopted through adjustments to the tax base;

- disparities in the tax-base rules considerably complicate intra-Community activity, particularly for small and medium-sized enterprises.

The Committee suggests that these measures be implemented gradually during phases I and II.

The Committee makes a further recommendation which, although not concerned properly speaking with an element of the tax base, can be linked to it. This is the proposal that the dates on which the commonly applied taxes become chargeable should be harmonized (phase II).

2.1.2. <u>The Commission's position</u>

48. The Commission understands the logic underlying the Committee's approach and recognizes that the tax base rules currently applied by the Member States can cause distortions not only between Member States

but also within a single Member State. They are not always neutral in their impact on decisions to invest in various types of asset (plant and machinery, industrial and commercial buildings), on decisions concerning the volume of stocks or on those relating to forms of financing (equity or loan capital).

49. However, the Commission considers that the Committee's recommendations on a number of elements of the tax base go too far and are not consistent with the principle of minimum harmonization endorsed by the Committee itself.

The economic analyses made by the Committee show that the differences in tax-base rules generally have relatively little impact on the divergences in the cost of capital between the different Member States.

The Commission would also point out that most of the harmonization measures proposed by the Committee would have the effect of reducing the corporation-tax base, which, all other things being equal would necessitate an increase in rates.

The Commission thus takes the view that there should at this stage be detailed discussion of the desirability and possibilities of harmonizing the tax base. Under these circumstances, it feels that the Committee's recommendation that a technical group of independent experts be set up is premature.

50. In the meantime, the Commission considers that certain specific Community measures may be desirable even at this stage, particularly with regard to the definition of taxable profits, the carry-over of foreign losses, the deductibility of pension contributions paid by or for expatriate workers and the deductibility of insurance premiums.

(a) Definition of taxable profits

The Commission agrees with the principle that the rules for determining taxable profits should under no circumstances be more favourable than those governing the calculation of profit for accounting purposes.

Such a rule of conduct would have the merit of providing greater economic transparency and of limiting the tax competition in which Member States engage by adjusting the corporate-tax base to attract economic activities. On the other hand, this should not have the consequence of distorting the accounting results under rules inspired purely by fiscal considerations.

(b) Carry-over of losses

The Commission considers that one special element of the tax base, namely the carry-over of losses for tax purposes is covered by a proposal for a Directive presented in 1984 and amended in 1985(1). The proposal in question should be examined together with that on the taking into account of the losses of permanent establishments and subsidiaries situated in other Member States.

(c) Deductibility of contributions paid to foreign pension funds by or for expatriate workers

With a view to facilitating the free movement of workers and to removing certain obstacles to the freedom to supply services in the Community, the Committee has recommended that the Commission take steps to ensure that contributions paid by or on behalf of expatriate workers to pension schemes are deductible for tax purposes, wherever the pension fund is situated.

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(1) COM(84)404 - Proposal for a Council Directive on the harmonization of laws of Member States relating to tax arrangements for the carry-over of losses of undertakings. O.J C253, 20 September 1984.

The Commission welcomes this recommendation. Its departments have already begun work in this field, and other institutions such as the OECD are also anxious to achieve the same aim.

The Committee also draws attention to the general problem posed by the existence of certain discriminatory measures involving the deductibility of insurance premiums and contributions to pension schemes.

Detailed analysis of this problem is in progress, particularly in the light of the Court's recent judgment which indicated that such non-deductibility is contrary to the freedom of movement of workers (and the right of establishment) but which also recognized, under certain very limited and very strict conditions, that the non application of these rights could be justified where tax coherence is concerned.

2.2. Small and medium-sized enterprises

51. The Committee calls for unincorporated enterprises to be given the option of being taxed as companies provided that such arrangements are applied for a minimum period (phase II).

52. The Commission has always supported measures designed to improve the economic environment for small and medium-sized enterprises and it therefore agrees with this idea which it has itself recommended in the past.[1]

The measures already adopted in connection with both direct taxation ("mergers" and "parent companies/subsidiaries" Directives) and indirect taxation (Directive on the transitional VAT arrangements[2])

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(1) See the report on the scope for convergence of tax systems in the Community (Supplement 1/80 to the Bulletin of the European Communities, page 60).

(2) 91/680/EEC - Council Directive of 16 December 1991 supplementing the common system of value added tax and amending Directive 77/388/EEC with a view to the abolition of fiscal frontiers.

are designed to abolish tax barriers and to alleviate the administrative burden on small and medium-sized firms wishing to operate across frontiers.

The proposed measure offers neutrality of tax treatment for enterprises, whatever their legal form. It would promote the self-financing capacity of unincorporated businesses since the corporation-tax rate is lower than the marginal rate of personal income tax in most Member States. Broadly similar arrangements already exist in France and Denmark. In France, for example, partnerships whose profits are normally subject to personal income tax in the hands of the partners may opt for the tax arrangements applicable to incorporated companies, namely corporation tax. There are comparable systems in Denmark.

The Commission therefore wishes to proceed in this direction and to study the possible practical implementation of such measures.

2.3. Tax incentives

53. The Committee argues that all tax incentive measures should be unrelated to the tax base and should be transparent. The Ruding Committee also argues that, given the increasing mobility of both capital and financial services, there is a danger that unfair competitive conditions will arise as a result of tax incentives. It calls on the Commission, which must authorize incentives constituting state aids within the meaning of Article 92, to apply stricter criteria than in the past.

The Commission is aware of the concerns expressed regarding the introduction, or proposed introduction, in some Member States of special tax arrangements as incentives in one field or another. Any plan which a Member State has to introduce specific tax measures of this type must be notified to the Commission as state aid. The

Commission recognizes that favourable tax arrangements can, under certain circumstances, have a legitimate role to play as one element in a cohesive regional development strategy.

It is clear that tax incentive measures adopted at Community level can have an important role to play. Such is the case, for example, with the incentives devised by the Commission in its proposal for a Directive introducing a tax on carbon dioxide and energy to assist investment projects designed to reduce industrial pollution.

It is also desirable that tax incentive measures intended, for example, to promote R&D and environmental protection should satisfy transparency criteria and that preference should therefore be given to instruments of the tax credit type rather than to those acting through the tax base.

3. Link between the tax treatment of shareholders and the corporate tax

3.1. <u>The Committee of experts' proposals</u>

54. Firstly, the Committee calls on the Commission and the Member States to examine, during the course of phase I, various approaches with a view to determining which provides the most appropriate basis for a common corporation tax system for the Community.

The Committee of experts argues that it is neither necessary nor possible to introduce a common corporation tax system in the short term. In the longer term, however, it considers that progress towards integration and in particular the establishment of economic and monetary union, will make it necessary to introduce a system which will ensure tax neutrality as regards the choice of the legal structures of companies, methods of financing and the location of investment and which will make it possible to create an efficient European securities market.

The majority of members of the Committee expressed a preference for a system of alleviating double taxation that is geared to the recipient of the dividends.

55. The Committee recommends, secondly, the introduction of a uniform withholding tax of 30% on dividends distributed by EC-resident companies, this tax not being applied where the recipient's identity is known (phase II).

3.2. <u>The Commission's position</u>

56. On a general level, the Commission shares the Committee's approach to the problems posed by the coexistence of widely differing corporation-tax systems in the Community. It considers that a debate on the choice of a common corporation-tax system should be initiated at Community level, as has already been done among OECD countries and in most industrialized countries. This debate should take account not only of the systems applied in Member States and in the principal non-member countries but also of the discussions under way in various national and international forums (US Treasury, taxation of cash flow, ACE system, etc.)

57. A number of reservations need to be made concerning the second recommendation. Firstly, the 30% rate is generally higher than those currently applied by the Member States. The question arises as to whether such a rate, which seems to be motivated mainly by the desire to combat tax evasion, might not further increase the tax bias in favour of loan finance given that in most cases the interest paid to non-residents is exempt from withholding tax.

It is important to note in this context that other proposals regarding corporation-tax systems (for example, those by the United States Treasury and those relating to the ACE system in the United Kingdom) advocate changes which would lead to greater neutrality between the different sources of company financing.

Secondly, a decision to apply such a withholding tax to dividends distributed to residents of non-member countries could not be adopted unilaterally by the Community but would necessitate the re-negotiation of the existing treaties between the Member States and non-member countries.

At this stage, the plan for a Community withholding tax on dividends paid to shareholders who are natural persons is a matter for the longer term.

CONCLUSIONS

The Commission invites the Council and Parliament to open a debate on the contents of this communication.

It particularly calls on the Council to discuss these guidelines at a forthcoming ECOFIN meeting.

In addition, the Commission urges the Council to adopt, before the end of 1992, the proposals concerning:

- the taking into account by parent companies of the losses of their permanent establishments and subsidiaries in other Member States;
- the abolition of withholding taxes on interest and royalty payments made between associated companies in different Member States.

Finally, the Commission intends, after consulting the interested parties on the ideas and guidelines contained in this communication, to present in due course proposals on company taxation that will be necessary for the further development of the internal market.