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Harmonization of Company Taxation Systems

by Dr Heinrich Hölzler, Berlin *

The author of the following article gives a survey of the different corporation tax systems and rates in the individual EC-member countries, explains the need for a harmonization of direct company taxation within the Community, and discusses the Commission's recent proposal as compared with other possible approaches.

Despite some setbacks in the development of the European Communities the process of tax harmonization in Europe has shown some remarkable progress in recent years. According to authority in Article 99 of the Rome Treaty some indirect taxes have already been adjusted and some important proposals have been submitted to the Council¹. There is no such explicit authority for direct taxes, but it is generally acknowledged that the Council may be empowered under Article 100 of the Rome Treaty to step forward in harmonizing also direct taxes of corporations². There is no question that within the EC coordination of the political, economic, social, and fiscal spheres should be achieved in the long run. Concerning fiscal matters there have been brought up the following most important reasons for the need to harmonize direct company taxation in Europe:

Within a common market, the choice in which member state the headquarters of an enterprise should be located, should not depend on fiscal matters, i.e. on the aggregate tax burden for distributed or retained profits of a company.

The flow of investments and the free movement of capital should not be hampered by tax differences between national legislations, by double taxation of capital or dividends when crossing the border, but should in the first place be guided by traditional financial considerations.

The gap between national differences in the systems and dimensions of indirect taxes in the EC being closed, the competitive discriminations intensify, resulting from different tax burdens by different tax rates on company profits.

At the end of July 1975 the EC Commission has submitted to the Council the long awaited "Proposal for a Directive of the Council Concerning the

Harmonization of Systems of Company Taxation and of Withholding Taxes on Dividends"³ (cited as "Company Taxation Proposal"). This step is not only an answer to the many demands for such a proposal but also one step forward in the sense of the resolution of March 22, 1971, in which the Council decided that the harmonization of direct taxes should form part of the first stage of the creation of an economic and monetary union.

System Changes and Proposals

The conception of the "Company Taxation Proposal" had to take into consideration many differences in existing tax systems and tax rates in the EC member states. The Commission tried, therefore, to solve the problems of tax system harmonization altogether, but at the same time — in a compromise — to respect specific peculiarities of the tax administrations of some member states. The difficulties of this task become apparent by having a look at the major tax system changes or proposals for such changes which preceded this "Company Taxation Proposal" since 1962⁴:

1962: The so-called "Neumark Report" recommends the split rate system (for distributed and retained profits) as best common system for the Community.

1965: The United Kingdom replaces the former mixed imputation type system by the separate system (classical system).

1965: France replaces the former classical system by a partial imputation system.

1968: The Netherlands renounces its intention to abandon the classical system.

1968: Italy announces its intention to replace the former "schedular" system by the classical system.

* Bundeskartellamt (Federal Cartel Office).

¹ See for example "Proposals for Harmonizing Consumer Taxes other than VAT. Proposed Council Directives on Excise Duties and Similar Taxes" (transmitted on March 7, 1972), Bulletin of the European Communities — Supplement 3/72, Brussels 1972; and "New Proposal on the Harmonization of VAT" (submitted to the Council by the Commission on June 29, 1973), Bulletin of the European Communities — Supplement 11/73, Brussels 1973.

² Article 100 of the Rome Treaty is directed to any harmonization of regulations or rules that might have a direct effect on the creation or working of the Common Market.

³ Com (75) 392 final, Brussels, July 23, 1975.

⁴ See "Taxation of Company Profits — an Assessment of Policy Options — a New OECD-Report", Intertax, Vol. 1974, No. 2, p. 75. See also "Company Tax Systems in OECD Member Countries", OECD (Ed.), Paris 1973.

1970: One EEC Consultant Report recommends the classical system as the best common system.

1971: The United Kingdom announces its intention to replace the classical system by either the split rate system (as in Germany) or the imputation system (as in France).

1971: Germany announces the possibility of replacing the split rate system by a fully integrated imputation system.

1972: The United Kingdom adopts the imputation system to come into effect in April 1973.

Ireland also recommends the adoption of an imputation system, but does not follow the United Kingdom.

1975: Now the EC Commission recommends the partial imputation system as the best common EC system.

Differences in Corporation Tax Rates

Besides the question of harmonization of tax systems also the necessary elimination of different corporation tax rates in the EC had to be considered. This becomes obvious by having a look at the normal corporation tax rates presently in force in the member states⁵:

Belgium: 42 p.c. (from tax years beginning 1975: 48 p.c.).

Denmark: 37 p.c.

Germany: 51 p.c. (non-distributed profits),
15 p.c. (distributed profits) normal rate,
23.44 p.c. (distributed profits) effective rate⁶.

Till 1976 those rates are raised by the "Ergänzungsabgabe" by 3 p.c., i.e. the tax is raised to 52.33 p.c. and 24.55 p.c., respectively.

France: 50 p.c.

Ireland: Mixed system,
corporation profits tax: 23 p.c.,
income tax: 35 p.c.

The tax on corporation profits is deductible from the tax base on which income tax is charged.

Italy: 25 p.c. (1974 and 1975: 35 p.c.).

Luxembourg: 40 p.c. (for profits of 1,312,000 Francs and above).

Netherlands: 48 p.c.

United Kingdom: 52 p.c.

One more problem arises from the fact that in some of the member states additional taxes on company profits are raised as for example the *Gewerbeertragsteuer* (trade tax on gains) in Germany, which in other member states is not known at all or at least not raised to that extent. So, the aim to abolish tax induced disadvantages to eco-

nomical competition, which are based on different tax burdens, must in the long run be directed at the complete elimination of "unique" taxes in the EC.

Proposals for Harmonization

The discussion about the question, which tax system to choose as the common European company tax system, started with the Neumark Report in 1962. This report recommended the split rate system which is still in effect in Germany. Later, in 1970, one EEC Report recommended the classical system which taxes the profits on the corporate level and once again the distributed dividends at the shareholders' level. Now the EC Commission has after long studies and numerous consultations decided to adopt the partial imputation system. The Commission admitted that the classical system is very simple to handle in international tax relations and succeeds in avoiding distortions, while the imputation system brings along technical difficulties when dividends are paid across the borderline. These difficulties are to be solved, however, by establishing a special international tax clearing institution.

The partial imputation system is based on the principle that the double taxation of distributed profits is prevented (in part) by granting a tax credit, which represents part of the corporation tax for the recipient of the dividend. The recipient is allowed to deduct this credit from his (individual) tax liability for income or profits. If this liability is not sufficient to cover the full credit, the excess will be paid back by the Revenue. The Commission has decided to adopt this system, since in its views important arguments can be brought against the classical system and in favour of the (partial) imputation system⁷:

□ The imputation system tends to encourage dividend distributions and this favours the reinvestment via the market, while the classical system favours the self-financing of enterprises since distributed profits are not relieved of double taxation. It should be noticed, however, that this is exactly the same argument of "best allocation of resources" by the market selection function which has been emphasized by introducing the split rate system in Germany. And it should not be overlooked that the relation between self-financing (retained profits) and equity financing of companies contrary to financing from outside sources (especially loans and credits) has changed in recent years more and more in favour of debt financing, since interest costs are deductible from profits. So, the hope of the Commission, that the imputation

⁵ See "Company Taxation Proposal", p. 6.

⁶ This "shadow effect" has its reason in the fact that the tax on distributed profits is not deductible from the amount on which corporation tax is charged.

⁷ See "Company Taxation Proposal", p. 2 ff.

system puts loan and equity financing on a more equal footing, is based on the assumption – which has to be proven – that distributed profits will easily flow back to the company by additional capital increases through new share issues instead of more financing by loans and credits.

Depending on the distribution rate of profits, the classical system tends to encourage or to discriminate enterprises whose profits are subject to corporation tax, compared with partnerships or undertakings whose profits are directly taxed on individual ownership level by the progressive income taxation. The tendency and direction of that effect depends moreover on the gap between the highest income tax rate and the normal corporation tax rate. Since both rates are converging in recent years and the imputation system grants tax relief for distributed profits, this system seems to be more neutral for the choice of legal forms of business organization than the classical system.

Within the classical system it is often in the interest of majority shareholders to accumulate profits on the corporate level because of higher rates of income taxes and the double taxation of distributions. On the other hand it is usually in the interest of minority shareholders to realize cash dividend payments instead of potential share price increases through retained profits. Since the imputation system induces distributions, the Commission has reason to believe that the tendency of larger shareholders to retain profits at the corporate level as a means of tax saving (or tax avoidance by incorporating a business just for that reason) will decrease, and due to larger distributions the share market will more likely attract new classes of less wealthy savers. But this very common argument seems to be more a viewpoint of opportunism which has been used also as an argument in favour of the split rate system in Germany. There are other factors, however, that are as important for the decision to invest savings in the share market as are fiscal matters. The experience in Germany in this field has shown significantly that the rate of return in cases of distributions has to be seen in connection with the share price increase and, above all, with the financial risks that go with this form of investment. And the British experience since the introduction of the imputation system in respect to the stock market development since 1973 does not support the Commission's point of view.

Tax Rates and Credits

While the classical system does not produce many difficulties in international tax organization, the imputation system – if realised in the EC – will require some tax securing and tax balancing measures. The respective corporation tax rates in

the member states should not vary too much in order to secure taxation neutrality, i.e. to prevent tax induced capital movements from one member state to another. Article 3 of the "Company Taxation Proposal" provides that each member state shall apply a single corporation tax rate to undistributed and distributed profits which may not be lower than 45 p.c. nor higher than 55 p.c. The Commission grants exceptions from this rule – especially with respect to economic recessions – and allows temporary increases or reductions of the chosen tax rates. But such exceptions could easily become the rule if a regulation like this does not provide stricter limits to the application of exceptions. Article 5 sets out the principle that the tax credits have to be given by that member state, to whose taxes the recipient of the distributions is subject. The financial compensation procedure between the taxing and tax credit granting state's level takes place according to Article 13 of the "Company Taxation Proposal".

The tax rate limits which are fixed by the Commission between 45 p.c. and 55 p.c. are linked with the tolerable limits for the tax credit rates. Those shall be determined in such a way, that the tax credit shall also be between 45 p.c. and 55 p.c. of the corporation tax liability on the sum of the distributions, increased by such tax. In application of that rule some more complicated questions arise in cases where

the distributions originate from profits which have not been taxed at all or taxed at a reduced rate;

the distributions are derived from dividends from a subsidiary or from a permanent establishment in another member state.

In the case of non-taxed or at lesser rates taxed profits the tax credit has to be compensated at the corporate level by a special tax, corresponding to the respective tax credit attached to the distributed dividends. In the United Kingdom, however, this problem does not arise with its realized imputation system. According to that system, every company which distributes a dividend, has to pay to the Revenue an amount of "Advance Corporation Tax" (ACT) which equals the fixed fraction of the actually paid dividend. The company will charge this ACT against the company's final corporation tax liability on its profits. If this method would be used in the EC as a compensatory tax, the advance payments should not be repayable, of course, as far as profits have not been subject to corporation tax within the above mentioned limits. Another way for tax compensation is used in the French imputation system, where by means of the *précompte* the taxation at the corporate level is accordingly raised to the level of the granted tax credit.

When a parent company distributes dividends originating from subsidiaries in other member states, the shareholders shall receive a tax credit at the rate in force in the corporation's state, no matter which rates are effective in the subsidiaries' states. This means that at the corporate level a further tax-adjustment has to take place. The EC Commission proposes a solution which gives the parent company the right to set off the received tax credit attached to the subsidiary's dividend against the compensatory tax of the parent company when distributing the received dividends. On the other hand shall the parent not be entitled to a financial claim when the received tax credit is higher than the compensatory tax. The Commission believes it for technical reasons to be preferable to depart in this context from the desired principle of non-discrimination in international tax affairs. The same principles which are laid down in the directive for subsidiaries are adopted to cover permanent establishments.

Withholding Tax on Dividends

The EC Commission has considered the question whether there arises any need for an additional withholding tax for distributed dividends, since within the imputation system the payment of full corporation tax at the corporate level is already a withholding tax. Nevertheless the Commission has decided to introduce an additional withholding tax which serves to prevent recipients of dividends, who are taxed by high income tax rates, not to declare their dividend income. The withholding tax rate is fixed at 25 p.c. of the amount of distributed dividend, which means an aggregate tax burden at source of about 50 p.c. This measure will not be necessary when a dividend is paid by a subsidiary to the parent company, since the parent is not taxable on that income. The "Company Taxation Proposal", too, leaves it to each member state, not to apply the withholding tax when the risk of tax evasion does not exist, be-

cause the recipient of the dividend can be identified and taxed. Very similar to the mechanism of financial compensation for granted tax credits, also the compensation for withholding taxes shall work between the member states.

Consequences

The "Company Taxation Proposal" has been submitted to the Council at a time, when the existing tax systems in the individual member states do neither correspond to each other nor to the proposal. The consequence of a directive passed by the Council in the above sense would be that each member state would have to bring its existing system in accordance with this EC system. So, it could be the only hope of the Council that each member state would in fact take over this common system, even if its national tax system has up to that time been more favourable for its enterprises. Such a development, however, seems doubtful, since each government will — as many times before — only adopt those measures which have any advantage for its system and can be integrated without intensive variations or any discriminations to resident persons or enterprises. Therefore it seems to be more reasonable, and also more in the sense of Article 100 of the Rome Treaty, first to coordinate — as it is done with the harmonization of the European company laws⁸ — the national laws with regard to the same system and to similar tax rates. This brings the tax burdens of enterprises within the Community to around the same level. After the coordination it will be much easier to unify the EC corporation taxation. In this sense the "Company Taxation Proposal" can be viewed as a very useful basis for further discussions and as a signal to the national governments in which direction to move their future tax policy.

⁸ In the field of the harmonization of the EEC company law two reform processes are closely related. The first process aims at an increasing similarity among national laws, the second process aims at transnational coordination. The second process will advance on the results of the first. See Eric Stein: Harmonization of European Company Laws, Law and Contemporary Problems, Vol. 37 (1972), p. 318 ff.

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