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Company Taxation and the Internal Market

European company tax reform: Prospects for the future

Jack M. Mintz*

The European Commission's lengthy study of company taxation – almost 500 pages – proposes fundamental changes to the Europe's corporate tax systems.[1] The intent of the reforms is to harmonize company tax bases so that company taxes do not impose barriers on cross-border investment or impair the consolidation of business at the European level. The proposals, including moving to a pan-European corporate tax, are quite far-reaching and some quite novel. But, as the proposals are currently structured, it appears to an outsider that this debate on company tax reform will likely fail to achieve its objectives. Instead, to achieve significant results, a far more radical approach will be needed to consolidate EU company tax systems that will demand far greater political will than what the report sets out in its proposals.

The proposed models for reform

Briefly, the four proposals made are the following:

1. a pan-European harmonized company tax whose revenues would accrue to the European Union replacing existing systems;
2. a European consolidated company tax operating alongside national systems with some or all of the revenue accruing to the European Union;
3. a mutual recognition approach (Home State Taxation) in which a company could use its home state's tax law to define income for its European operations with the income allocated to jurisdictions according to a formula and taxed according to the rate where the income is earned;
4. a harmonized EU system for determining taxable income (Common Base Taxation) which would operate alongside national rules from which companies can choose the tax system they desire.

The essential problem is that trying to change the way that taxes are collected among 15 countries is often viewed as a zero-sum game since revenues are expected to be kept constant. Moving to a new method of collecting tax bases across countries means that some governments will lose while others gain. Moreover, with revenue neutrality, some companies will be better off while others could pay more tax.

One could try to increase the overall level of taxes to ensure each government will not lose revenue. However, increased revenues would mean a greater tax burden for companies, eliminating much of the political support for such measures. Alternatively, if some companies are likely going to pay more tax if the changes are revenue-neutral, governments could cut corporate taxes to buy greater political support but then governments lose fiscally. Revenue-neutral tax reforms are often difficult to accomplish.

A new EU system of taxation will create losers and winners

The motivation for reform – capital market efficiency

The only way that the Commission's proposals can gain wide acceptance arises if there is a positive sum game involved – governments and businesses must feel that there are sufficient economic gains that would make the whole exercise worthwhile.

It seems that the motivation for reform – removing tax obstacles that would facilitate cross-border investment and consolidation of businesses in

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[1] See the reports of the Commission of the European Communities (2001). See also Weiner (2001).

Europe – could improve capital market efficiency and provide a basis for political acceptance. Many businesses looking to create consolidated European enterprises are more inclined to support company tax reform if tax complexities that hinder market efficiency and business consolidation are lessened.

However, the report itself does not explicitly measure economic gains from harmonization and therefore provides insufficient evidence about the gains from simplification and harmonization of tax bases. The use of marginal effective tax rate[2] analysis to measure the impact of taxation on capital investments found that the statutory corporate tax rates were far more important in explaining differences among countries, than differences in the tax base. However, the analysis is limited since it focussed on some specific differences in tax bases, such as the tax treatment of depreciation and inventories costs. From this analysis, the impression given is that tax systems are pretty similar in terms of the base, not the rate of tax. If this were true, then it should not be a difficult matter for the European countries to agree to a common base. But, it is also true that harmonization of company tax base, rather than tax rate, in Europe may not be necessary.

The EU Commission's report provides insufficient evidence about the gains from tax harmonization

Nonetheless, such effective tax rate calculations – useful in other contexts – miss many important differences that are hard to account for but are very important to the company tax planner. As the report argues, the most tangible results from the harmonization of European company taxes would be to

- reduce compliance costs in dealing with 15 different systems,
- consolidate profits and losses at the EU level,
- simplify international restructuring and
- reduce the need to determine transfer pricing and allocating cost overheads.

Company tax systems among European countries differ widely for several reasons (see the Table for a comparison of some countries to illustrate these differences). Accounting practices, such as the treatment of reserves found in Germany, are quite different than that found in some other countries like the UK. Some countries require some reconciliation of book accounts with tax, while others do not. Further, cross-border acquisitions and mergers are affected by differences in the treatment of capital gains and change of control rules for the transfer of losses, valuation of assets upon merger, etc. Timing issues can also impact significantly on tax burdens – such as the carryforward and carryback provisions or tax losses or when reporting requirements differ (annually, monthly or quarterly).

Such differences among countries in tax systems can impair capital market efficiency, and if modelled, would suggest possibly significant differences in effective tax rates on capital. Businesses planning capital investments will seek the greatest returns, net of taxes paid by companies and their shareholders. Cross-border acquisitions could be discouraged if a higher tax, such as the withholding tax or dividend taxes on foreign investors, impose higher burdens on cross-border transactions.[3] On the other hand, certain international tax planning opportunities could, in fact, encourage too many cross-border transactions, especially when investments are channelled through third country entities. For example, cross-border transactions are preferentially treated when companies can take advantage of the infamous "double dip" deduction for interest or insurance expenses. The tax planning arises when a parent can invest in a subsidiary by issuing first debt to the subsidiary from a low-tax intermediary in a third country. The assets of the low-tax entity are funded with equity and the income from the low-tax entity is remitted tax-free to the parent. In turn the parent deducts interest on borrowed funds used to finance equity in the low-tax intermediary (see Fuest, Huber and Mintz (2002)).

The economic gain from increased capital market efficiency and reduced compliance costs arising from company tax reform for Europe is not easy to measure but some estimate would have been valuable. Thus, each of the proposals in terms of their contribution to improving economic efficiency and reduce compliance costs have not been well documented.[4] It is quite unclear as to whether the various proposals themselves would ultimately achieve the objectives stated above. Each proposal is discussed below.

[2] See Part II of Commission of the European Communities (2001).

[3] The EU has eliminated withholding taxes on income paid to residents of other member states. However, the current provisions for providing relief from dividend taxes (such as a lower dividend tax rate or tax credit) often apply to only residents of a country, not EU residents elsewhere. Further, some countries provide dividend tax relief for dividends distributed from income earned domestically, not those derived from other EU sources.

[4] Mintz and Weiner (2001) discuss some of the efficiency gains or losses by comparing Home State Taxation with Common Base Taxation.

Examples of Different Tax Provisions Across Selected EU Countries

Provision	Belgium	France	Germany	Italy	UK
Corporate Tax Rate	39% (top rate) plus 3% surtax	33 1/3 % plus 6% surtax Minimum tax on turnover	25% plus local trade income tax 55% surtax	36% in income (deduction for the cost of new equity finance). Regional tax on "value-added" (origin, income based)	30% (top rate)
Inter-corporate Dividends	95% exempt for qualifying participation	Subject to equalization tax, exempt from corporate tax if sufficient ownership	Exempt	Taxable if from resident company 95% exempt if from EU non-resident company	Exempt
Capital Gains	Capital gains exempt for dividend participation cases	Fully taxed except for shares in subsidiaries (19% rate plus surtaxes)	Taxed although rollover relief given for real estate disposals and exempt for shares held for one year in other companies	Under national tax with substitute tax of 27% or gains spread over 5 years for assets held at least three years	Taxable Relief is provided for inflation
Depreciation	Straightline except for special cases	Straightline except for industrial assets (declining balance)	Straightline or declining balance	Straightline	Straightline for buildings (industrial only) and declining balance for machinery and equipment
Inventory Costs	Lower of cost or market value LIFO[a)] is permitted	Lower of cost or market value LIFO not permitted	Lower of cost or market value LIFO permitted in some circumstances	Lower of cost market value LIFO is permitted	Lower of cost market value LIFO is not permitted
Reserves	Deductible for definite losses in the year	Deductible for losses and expenses, foreign investments and price increases	Reserves under GAAP deductible Some new restrictions apply	Deduction for bad debts, foreign exchange losses, retirement payments	Deduction for provisions as under GAAP but not more than once
Losses	Indefinite carryforward but restricted for change of control	Carryforward for five years except depreciation (indefinite) Three year carryback Change of control restrictions	Indefinite carryforward and one year carryback	Carryforward for five years Restricted upon change of control	Indefinite carryforward against income from similar trading source Group relief for losses
Foreign Source Income	Exempt by treaty or tax reduced by 75% on net income earned abroad	Generally exempt	Taxable with a credit Exemption given for dividends	Taxed with a credit for foreign taxes	Taxed with a credit for foreign taxes
Filing	Quarterly installments for specific dates	Quarterly installments based on fiscal year	Based on calendar year (filing by May 31) Quarterly installment payments	Filed within one month after approval of financial statements with advance payments according to a specified rule	Based on fiscal period Quarterly installments for large companies
Residency	Central management or registered address	Registered address	Corporate seats or place of management	Registered or administrative office, or principal corporate activity	Incorporation or central management or control
Consolidation	No	Yes	Yes	No	No
Special Regimes	Co-ordination, service and distribution centres	Headquarter and logistics centres	N/A	N/A	N/A

[a)] LIFO refers to "last-in-first-out" accounting methods to determine the price of the inventory stock.

European company tax (Option 1)

The creation of a common European corporate tax would accomplish significant harmonization. With a common base used by all 15 countries, tax bases would be substantially harmonized. Companies would be taxed on their European profits, therefore facilitating the consolidation of European operations. Tax administrators would face less difficulty in dealing with transfer pricing, overhead cost allocations and other features of cross-border transactions.

Tax harmonization means tax centralization

The first option, a mandated harmonized European tax, would achieve the greatest efficiencies. However, significant issues arise in that effectively the tax is centralized. If revenues accrue to the EU Commission, the state governments would need to find alternative resources or receive a transfer to make up the difference. The transfer to be calculated would presumably be related to the amount of corporate income earned in each member country, which would effectively be a revenue sharing arrangement. Member countries would need to agree to a common base and would effectively lose the flexibility to adapt their company tax systems for their own needs. Moreover, with a centralized company tax, member country personal tax systems would need to be revised since rules determining personal taxes on income accruing to investors reflect existing tax systems.

Optional european consolidated company tax (Option 2)

The option to select the EU tax or the national tax would lead to serious distortions

To ease the degree of change faced by member countries, a second option is proposed that the new tax base would be optional for companies. Thus, both the European corporate tax and existing national tax systems would be available for companies to select. Thus, companies operating in the same country could operate under quite different company tax regimes. Several substantial distortions could therefore arise.

The first would be the possibility that businesses in competition with each other domestically could face quite different tax bills if one business is taxed under the European company tax and another under the national tax.

The second is significant erosion of the tax base. For example, companies, not part of a corporate group, would be able to engage in tax arbitrage to reduce taxes paid on their inter-company transactions with others. For example, if the European company tax is levied at a higher rate than the domestic Greek tax, financial transactions with debt borrowed by the European company from the Greek entity would result in a sharp reduction in tax paid.

A third problem is that differential taxes will distort the types of real and financial transactions and the organization of businesses in partnerships or stock companies. Even differential treatment of such capital cost deductions can sharply impact on business decisions. For example, a company operating under the European company tax with, say, little depreciation given for machinery costs, could lease assets from companies operating under domestic regimes with, say, far more generous tax writeoffs for depreciation.

Even if the distortions possible under an optional European company tax were minimal, further difficulties arise. One important issue is with respect to the use of revenues generated by the tax as in the case of the first option. If the revenues are paid to the European treasury, member countries will find that they are short of funds. One would have to consider offsetting intergovernmental transfers. Instead, governments, according to some formula, could share the revenues, but, under revenue-neutrality, some governments will gain and others lose fiscally.

Home State Taxation (Option 3)

The option of Home State Taxation, consistent with mutual recognition, would provide a far different and perhaps more practical approach to company tax reform. A company's European income would be taxed according to the rules of the resident country but with the base allocated according to a formula with the tax paid determined by the rate of tax where the income is allocated. The countries would need to agree to a set of factors, such as distribution of payroll, assets, sales and/or value-added[5], to determine how income

[5] The proposed use of value-added is an intriguing idea. On one hand, the European rules are fairly well harmonized so that it would be easy to implement the use of value-added to determine the factors for allocating revenue. On the other hand, value added, as taxed in Europe, is primarily income accruing to labour (and fixed factors of production). To use value-added to measure the factors, the allocation method would be particularly poor in measuring income earned by capital-intensive industries in each country.

should be allocated to each country. Rules would be needed to determine what companies belong to a corporate group.

Home State Taxation itself raises a number of difficult issues for implementation.[6] As in the case of the European company tax proposal, companies operating near each other in a particular jurisdiction could be taxed under quite different systems. For example, a UK company operating in Sweden would still use UK rules to determine the tax base while a Swedish company in Sweden would use Swedish rules. Thus, many of the difficulties mentioned with business competitiveness, tax base erosion and economic distortions would prevail under Home State Taxation.

A further distortion with Home State Taxation is that companies might change residency to reduce their tax liabilities by choosing a country with a more favourable tax base. However, not all companies will be in the same position to do "country shop". Some companies, by changing location, might find it more difficult to raise capital from their home jurisdictions (given regulatory and other barriers to cross-border transactions). A company might also have considerable "goodwill" associated with operating in a particular country, making migration more difficult. Finally, some countries impose capital gains taxes on the disposition of shares when a company migrates so that companies might find it more difficult to change residency if it triggers substantial capital gains taxes for its existing shareholders.

Another problem with Home State Taxation is with regard to the administration of the tax system. Each country's revenue department would be auditing companies that might operate under 15 different regimes, depending on their residency. Countries could come to an agreement to let the home tax authority have the responsibility of auditing tax payments of the European operations of the home-based country. However, letting foreign auditors handle tax compliance for another country raises a number of serious problems with respect to incentives to collect tax on behalf of other countries, consistency with jurisprudence and various procedural issues related to appeals and other matters.

[6] For a general discussion on the problems faced in using allocation methods for corporate income taxation, see Mintz (1999).

Common Base Taxation

The option of Common Base Taxation is similar to that found in the US, Canada, Germany and Switzerland. Companies would use a similar base for their European operations. The income would be allocated according to an allocation formula and the tax rate imposed on income allocated to a jurisdiction would be the domestic tax rate. Each country would therefore receive its tax revenues according to the allocation of the tax base and its own tax rate. In principle, countries could use tax credits that would provide some divergence from the tax base since they would be deducted from tax determined by the allocation method.

Home State Taxation with formulary apportionment raises other issues for implementation

Although similar to existing systems found elsewhere, the European proposal for Common Base Taxation differs in one important matter. As proposed, companies could choose whether they wish to adhere to the Common Base or continue to follow the rule of their country of residence or operation. Many of the difficulties, already raised above with the optional European consolidated company tax apply here. However, some further concerns should be considered.

Common Base Taxation not only requires governments to agree to a common set of rules, they must also agree to rules to allocate income to various jurisdictions. If governments are given a choice of the factors, as in the United States, substantial difficulties arise in that companies could, ultimately, have more or less than 100% of their income allocated across jurisdictions since country-factors could add up to more or less than one depending on the factors used.

Common Base Taxation requires agreement on allocation rules

A further problem is with respect to the tax treatment of international income. Common Base Taxation would be used for determining the allocation of European income to each country. However, income earned from sources outside of Europe could be subject to domestic tax or a European tax. If the latter applies, countries would need to agree to a common treatment of international income. Given that some countries, like Italy and the UK, tax foreign-source income (with a credit for foreign taxes) while others provide significant exemptions especially for dividends (Netherlands and France), there is no common approach used in Europe for the taxation of foreign-source income.

A need to rethink the company tax reform in the EU

Outside of the compulsory EU company tax, which would result in a single harmonized tax, the other proposals are fraught with problems. The optional approach, inherent in the three remaining options, would substantially erode efficiency gains from harmonization since companies would have greater opportunities to engage in tax arbitrage domestically, not just with respect to cross-border transactions. A serious question arises as to whether an optional EU company tax, Home State Taxation or Common Base Taxation, is worth the effort. The objectives set out for harmonization will be achieved in a limited way given these three options:

Only the mandated European company tax would result in significant gains

- Compliance costs in dealing with 15 different systems will be somewhat simplified for businesses that choose the consolidated base. However, complexity will be introduced in other ways. Since some companies will remain with national systems, rules will grow to limit opportunities for tax arbitrage. Further, some conglomerate companies will find that they must deal with 16 rather than 15 systems in terms of tax planning.
- It will be easier for businesses to consolidate profits and losses at the EU level. However, with the existence of national systems, significant trading of losses will transpire through various financial transactions (asset disposals, financial swaps etc.) that might result in restrictive rules imposed by countries to limit such trading.
- International restructuring will be simplified to a certain extent but it will require clear rules to be adopted for the tax treatment of foreign-source income earned by consolidated companies.
- Although transfer pricing and allocation of costs will be more easily dealt with for consolidated companies, such problems will continue to exist for foreign companies and national companies.

Alternatively one could seek common rules for certain aspects of domestic tax systems, a piecemeal approach

Given that the allocation method itself introduces certain complexities and the optional approach could result in substantial inefficiencies and unfairness, it seems that the latter three options would result in minimal economic gains, if any at all. This leaves the first option, the mandated European company tax, as the remaining option with potential significant gains. However, shifting a taxing power from national governments to the European Union raises other issues that are quite difficult to deal with, as discussed above.

Conclusion: Some alternatives

My overall conclusion is that the proposed reforms in the EU for company tax would unlikely achieve desired results. However, two approaches, neither explicitly dealt with in the Commission approach, could be considered.

The first would be to have a mandated consolidated tax with an allocation approach to divide the tax base amongst the EU members, similar to that used in North America, Switzerland and Germany. This would require a common base and allocation system for the system to work best. But, each national government would have sufficient flexibility in that it would levy a tax rate and a regime of tax credits that would allow it to receive revenues and to conduct industrial policy as it wishes. However, to achieve a pan-European consensus on a common tax base and factors is not a simple matter since, unlike Canada and US, there is no federal company tax to model company tax bases at the national level. Thus, it would take considerable political will on part of EU countries to agree to a common tax base.

The second would be to seek limited harmonization by implementing common rules for certain aspects of domestic tax systems to deal with the more egregious areas of inefficiency. As an example, the EU countries have successfully agreed to eliminate withholding taxes amongst themselves to encourage cross-border transactions. In a similar vein, countries could provide for the deferral of capital gains taxes on cross-border mergers. Dividend tax relief could be provided for both resident and EU investors. A system for the consolidation of profits and losses could be considered, similar to the UK loss transfer system, although without a common base it would be difficult to devise a proper one. These reforms are piecemeal in approach so that they do not achieve all the objectives being sought.

If EU countries wish to maximize efficiency gains, then it seems that a move to a non-optional common tax base would best achieve results. Otherwise, the approaches being considered will

not provide sufficient economic gains to make the effort worthwhile.

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