HARMONISATION OF CORPORATE TAX LAW
IN THE EUROPEAN COMMUNITY

BY

GEORGE MAVRAGANIS

THESIS SUBMITTED TO THE UNIVERSITY OF LONDON
FOR THE DEGREE OF DOCTOR OF PHILOSOPHY

UNIVERSITY COLLEGE LONDON

JULY 1992
ABSTRACT

The purpose of this thesis is to contribute to the knowledge of a subject whose importance is inversely proportional to the amount of research that has taken place so far. However, the establishment of the Single Market and the accelerating process of European integration together with recent initiatives taken at Community level (Adoption by the Council of two Directives and of a Convention, Proposal for new Directives by the Commission, Setting up of the Ruding Committee) have revived the academic interest on this topic.

The research has been carried out taking into account that the topic covers two fields of law, namely European Community law and international tax law. As a result, the content of the thesis is a synthesis of both laws and covers several aspects of the topic. More specifically, after a theoretical analysis of the concept of harmonisation of laws with particular reference to the harmonisation of tax laws in the EC it follows the identification of the problem, that is the potential distortions that will be caused to the Single Market by the existence of twelve different corporate tax regimes.

The identification of the problem is supplemented by the analysis of its sensitive political aspects and by detailed reference to the principles which should characterise any attempt to solve the problem. In addition, the close examination of the legislative measures which have been proposed or adopted at Community level and are intended to tackle some parts of the problem occupies a significant position in the thesis. Finally, the research on the topic concludes with the critical juxtaposition of the possible solutions and with a brief speculative description of the prospects of the process of corporate tax harmonisation.
ACKNOWLEDGEMENTS

I am grateful to numerous people and institutions for their help while this thesis was being written. My warmest thanks go to my supervisors, Professor Francis G. Snyder and Jacqueline Dyson, who helped to shape the thesis more than they realise and who provided much shrewd advice and gentle criticism; any errors are of course my own responsibility. I wish to thank particularly the Faculty of Laws at University College London where I spent four years as a postgraduate student, the Greek Ministry of National Economy which covered a significant part of the costs of my research through the NATO's Scholarships Fund and the European University Institute in Florence where I spent one month as an exchange student under the Erasmus Programme. I am grateful to my colleague Yannis Tzionas who provided me with data of significant importance for my thesis. I am also pleased to acknowledge my thanks to Linda Lynch who was my tutor in English in Athens. I would like to express my warmest thanks and appreciation to Nikolaos Arvanitis for the encouragement I received from him during the last year of my research. My greatest debts are to my fiancée, Katerina Arvaniti, for her invaluable and constant support during the three years of my research. But the thesis would never have been written without the constant encouragement of my parents to whom it is gratefully dedicated.
To my Parents,

Σπυρος & Λεμονιά
CONTENTS

CHAPTER 1
HARMONISATION OF LAWS IN THE EC AND THE SPECIAL CASE OF TAX LAW

1.1. Introduction 16
1.2. The Concept of Harmonisation of Laws 16
  1.2.1. Identifying the Context of the Term 16
  1.2.2. Analysis of the Term 18
  1.2.3. Comparison with Similar Terms Employed in the EC Treaty 26
  1.2.4. Harmonisation Versus Unification? 33
  1.2.5. Types of Harmonisation 36
  1.2.6. The Concept of Harmonisation of Tax Laws 39
1.3. The Process of Harmonisation in the EC and the Case of Tax Harmonisation 44
1.3.1. Aims and Methods 44
1.3.2. The Legal Framework 49
1.3.3. The Instruments 57
1.4. The Progress of Tax Harmonisation in the EC 67
1.5. The Significance of Corporate Tax Harmonisation 76

CHAPTER 2
THE PROBLEM

2.1. Introduction 78

2.2. Principal Differences Between the Twelve Corporate Tax Laws 78

  2.2.1. Cross-Border Operations 79
  2.2.2. The Corporate Tax Base 85
  2.2.3. Tax Rates 98
  2.2.4. The Corporate Tax System 100
  2.2.5. Local and Other Specific Income Taxes on Companies 105
  2.2.6. Tax Incentives 106

2.3. Distortions Caused by the Tax Differences to the Single Market 107

  2.3.1. Tax Distortions to Capital Flows 108
  2.3.2. Tax Distortions to Free Competition 113
  2.3.3. Distortions to Economic Efficiency 115
  2.3.4. Discriminations 116
  2.3.5. Administrative and Compliance Problems 117

2.4. The Urgent Need for Measures Dealing with the Problem 118

APPENDIX TO CHAPTER 2

Tables 1-23 121-147
CHAPTER 3
THE POLITICAL ASPECTS OF THE PROBLEM

3.1. Introduction 148
3.2. The Great Obstacles 148
  3.2.1. The Correlation Between National Sovereignty and Corporate Tax Harmonisation 148
  3.2.2. Different Approaches to Corporate Taxation Among Member States 154
  3.2.3. Problems Arising from the EC Treaty 155
  3.2.4. The Lack of a Widely Accepted Strategy on the Part of the Commission 160
  3.2.5. The Conflict of Interests in the Process of Corporate Tax Harmonisation 171
3.3. The Interaction Between Corporate Tax Harmonisation and European Integration 179
3.4. Corporate Tax Harmonisation and Subsidiarity 186
3.5. Corporate Tax Harmonisation and Regional Policy 192

CHAPTER 4
THE PRINCIPLES FOR THE SOLUTION OF THE PROBLEM

4.1. Introduction 194
4.2. The Principle of Subsidiarity 195
4.3. Tax Neutrality 196
  4.3.1. Locational Neutrality 198
  4.3.2. Neutrality Toward the Legal Form of Undertakings 204
  4.3.3. Neutrality with Respect to the Type of Investment 206
  4.3.4. Neutrality Toward the Means of Financing 207
  4.3.5. International Neutrality 209
CHAPTER 5

LEGISLATIVE MEASURES INITIATED BY THE COMMUNITY AND AIMED AT SOLVING THE PROBLEM

5.1. Introduction 236

5.1.1. Classification of the Measures 236

5.1.2. Which Legislative Measures? 238

5.2. Adopted Measures 240

5.2.1. The Mergers Directive 240

5.2.2. The Parent-Subsidiary Directive 257

5.2.3. The Arbitration Convention 271

5.3. Proposed Measures 277

5.3.1. The Proposed Directive Concerning Arrangements for the Taking into Account by Enterprises of the Losses of Their Permanent Establishments and Subsidiaries Situated in other Member States 277
5.3.2. The Proposed Directive on Carry-Over of Losses
5.3.3. The Proposed Directive on A Common System of Taxation Applicable to Interest and Royalty Payments Made Between Parent Companies and Subsidiaries in Different Member States
5.4. Withdrawn Measures
5.4.1. The 1975 Proposed Directive on the Harmonisation of Systems of Company Taxation
5.4.2. The 1988 Preliminary Draft Proposal for a Directive on the Harmonisation of Rules for Determining the Taxable Profits of Undertakings
5.5. Indirect Measures
5.5.1. The Council Regulation on the European Economic Interest Groupings
5.5.2. The Proposed Regulation on the Statute for a European Company
5.6. What Next?

CHAPTER 6
THE SOLUTION AND THE UNCERTAINTY:
The Prospects of Corporate Tax Harmonisation in the EC
6.1. Introduction
6.2. The Federal Experience
6.2.1. Centralized Federal States
6.2.2. Decentralized Federal States
6.2.3. Mixed Federal States
6.2.4. Some Interesting Conclusions
6.3. Which Could be the Desirable Solution for the EC?
6.3.1. Factors Affecting the Choice 323
6.3.2. Why Harmonisation and not Unification or Coordination? 327
6.3.3. Which Harmonisation? 331
6.4. The Hybrid Solution 334
6.4.1. Measures Concerning Cross-Border Operations 334
6.4.2. Measures Concerning the Tax Base 343
6.4.3. Statutory Corporate Tax Rates 354
6.4.4. The Corporate Tax System 356
6.4.5. Other Issues 358
6.5. The Uncertain Future of Corporate Tax Harmonisation 361
**APPENDIX TO CHAPTER 2**

<table>
<thead>
<tr>
<th>Table</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Table 1</td>
<td>Withholding Taxes on Cross-Border Payment of Dividends-Interest-Royalties</td>
<td>121</td>
</tr>
<tr>
<td>Table 2</td>
<td>Methods Relieving Double Taxation</td>
<td>123</td>
</tr>
<tr>
<td>Table 3</td>
<td>Tax Treatment of Foreign Branches</td>
<td>124</td>
</tr>
<tr>
<td>Table 4</td>
<td>Group Taxation</td>
<td>125</td>
</tr>
<tr>
<td>Table 5</td>
<td>Tax Treaty Network</td>
<td>126</td>
</tr>
<tr>
<td>Table 6</td>
<td>Definition of the Corporate Tax Base</td>
<td>127</td>
</tr>
<tr>
<td>Table 7</td>
<td>Principal Exclusions from the Tax Base</td>
<td>129</td>
</tr>
<tr>
<td>Table 8</td>
<td>Transfer Pricing</td>
<td>131</td>
</tr>
<tr>
<td>Table 9</td>
<td>Depreciation Rules</td>
<td>132</td>
</tr>
<tr>
<td>Table 10</td>
<td>Deductible Expenses</td>
<td>134</td>
</tr>
<tr>
<td>Table 11</td>
<td>Reserves and Provisions</td>
<td>135</td>
</tr>
<tr>
<td>Table 12</td>
<td>Valuation of Stock</td>
<td>136</td>
</tr>
<tr>
<td>Table 13</td>
<td>Carry-Over of Losses</td>
<td>137</td>
</tr>
<tr>
<td>Table 14</td>
<td>Capital Gains</td>
<td>138</td>
</tr>
<tr>
<td>Table 15</td>
<td>Thin Capitalisation</td>
<td>139</td>
</tr>
<tr>
<td>Table 16</td>
<td>Statutory Corporate Tax Rates</td>
<td>140</td>
</tr>
<tr>
<td>Table 17</td>
<td>Corporate Tax Systems</td>
<td>141</td>
</tr>
<tr>
<td>Table 18</td>
<td>Local and Other Specific Income Taxes on Companies</td>
<td>142</td>
</tr>
<tr>
<td>Table 19</td>
<td>Tax Incentives</td>
<td>143</td>
</tr>
<tr>
<td>Table 20</td>
<td>Effective Tax Rates for Purely Domestic Investments</td>
<td>144</td>
</tr>
<tr>
<td>Table 21</td>
<td>Effective Tax Rates When the Subsidiary is Financed by Retained Earnings</td>
<td>145</td>
</tr>
<tr>
<td>Table 22</td>
<td>Effective Tax Rates When the Subsidiary is Financed by New Equity from the Parent</td>
<td>146</td>
</tr>
</tbody>
</table>
INTRODUCTION

The purpose of this thesis is to show that the disparities between the corporate (income) tax laws of the Member States cause serious distortions to the Single Market and to propose a possible solution to the problem caused by these distortions. As the deadline for the establishment of the Internal Market is approaching (1/1/1993) the need for the adoption of measures which will abolish such distortions becomes urgent. Otherwise tax induced distortions to the Single Market will contribute to its fragmentation and ultimately to its failure.

There was sufficient scope for the research topic of the thesis since its importance for the post-1993 era is great, whereas the publications on it are few. When this thesis started in 1989 the interest in corporate tax harmonisation in the EC was declining after numerous failures in the adoption of harmonisation measures at Community level. This trend has been reversed during the first two years of the current decade and the interest in corporate tax harmonisation has revived. The first decisive step towards such a change of attitude was the adoption of three harmonisation measures and the proposal of two others in 1990-91. The second was the appointment by the Commission of a Committee of Independent Experts on Company Taxation (1991) which presented its recommendations in March 1992.

Several methods were employed in this thesis. The first method was description and was carried out in the following three ways: i) by developing the concept of corporate tax harmonisation, ii) by classifying the concept and iii) by analysing certain factors
which influence it. The second method was based on the generation of empirical relationships and its main tools were pattern recognition and identification of correlations. The third method was based on causal explanation and prediction with explanation being mainly used in policy analysis. In certain parts of the thesis (Chapters 1, 5, 6) the comparative method was used and produced significant conclusions.

Chapter 1 presents the theoretical framework within which the thesis develops. In particular, it contains an extensive analysis of the concept of harmonisation of laws and adapts tax harmonisation to the findings of this analysis. It also outlines the major developments in the field of taxation in the European Community.

Chapter 2 describes the main differences between the twelve corporate tax laws of the Member States. The description is facilitated by the respective Tables which are included in the Appendix to Chapter 2. The last part of this Chapter examines how the disparities between the twelve corporate tax laws cause serious distortions to the Single Market.

Chapter 3 explains why corporate tax harmonisation has not made a significant progress so far. Then, it argues that the lack of progress is mainly attributed to the sensitive political aspect of corporate taxation and considers the factors that influence the process of corporate tax harmonisation. It also looks at the two competing views of corporate tax harmonisation namely that favouring imposed and the other one supporting competitive corporate tax harmonisation.

The principles to which corporate tax harmonisation should adhere are discussed in Chapter 4. Such principles are destined to
characterise the solution of the problem which was described in
Chapter 2. Thus, Chapter 4 can be regarded as encompassing the
"ideology" of corporate tax harmonisation.

Chapter 5 focuses on the corporate tax harmonisation measures
which have been adopted or proposed so far and examines them in the
light of the principles mentioned in Chapter 4. It also identifies
the imperfections in these measures and the problems that may be
caused by such imperfections. The last part of Chapter 5 outlines
certain corporate tax harmonisation measures which have been
withdrawn by the Commission. Some company law measures having an
indirect relationship to corporate tax harmonisation are also
outlined in this Chapter.

Finally, Chapter 6 considers the corporate tax experience in
federal States and draws some useful conclusions from this
experience. Then, it reviews the factors affecting the choice of the
type of corporate tax harmonisation which is the most suitable for
the needs of the Single Market. The second part of the Chapter
focuses on the specific measures forming the solution which is
proposed by this thesis.

The law and the developments concerning corporate taxation
have been stated as at 1/7/1992 and it is presumed that the Treaty On
European Union (Maastricht Treaty) will be ratified.
CHAPTER 1

HARMONISATION OF LAWS IN THE EC AND THE SPECIAL CASE OF TAX LAW

1.1. Introduction

This Chapter is aimed at providing the necessary theoretical framework of the thesis by defining and discussing the concept of harmonisation of laws in the European Community focusing concurrently on the special case of tax harmonisation. The consideration of the meaning of harmonisation will be followed by an analytical description of the process of harmonisation as it takes place in the European Community with particular references to tax harmonisation.

1.2. The Concept of Harmonisation of Laws

1.2.1. Identifying the Context of the Term

Before attempting to define the term "harmonisation of laws" it would be worth referring to the context within which it develops. The starting point for such reference should be the concept of integration and especially that of European integration. The former, that is integration, can be defined as a complex process which incorporates economic, political and legal elements and purports, by bringing together different parts, to achieve the desired degree of unity. What clearly derives from this definition is that the concept of integration has three aspects, namely the economic (economic integration), the political (political integration) and the legal (legal integration). In addition, it has to be mentioned that there
is an interrelation between those three aspects of integration. In particular, economic integration affects the progress of political integration, whereas legal integration is the vehicle for the promotion of the other two forms of integration.¹

The concept of integration has been in the centre of the developments that have been taking place in Western Europe since the end of the Second World War. The birth of economic integration was attributed to the need for economic cooperation between Western European countries with a view to overcoming the economic difficulties resulting from the War. However, such cooperation presupposed cross-border exchanges which were hampered by the existence of different national rules. Furthermore, the birth of political integration was the consequence of the need for a certain degree of political cooperation which would secure peace and prevent the emergence of new conflicts. The removal of the obstacles to cross-border economic cooperation and the definition of the institutional framework of the political cooperation could be achieved by the means of legal integration.

As a result, "the legal elements [of integration] play a double role; they are both the object and the agent of integration",² because they are subject to change in order to facilitate the promotion of economic and political integration and simultaneously

¹ Further discussion on the concepts of economic and political integration takes place in Chapter 3.
constitute the means by which integration is carried out. In other
words, legal integration can be defined as the process which aims at
diminishing the differences existing between national laws by
employing certain instruments and with the purpose of attaining
certain degree of economic or political unity.

The instruments at the disposal of legal integration are: i) The
conclusion of international agreements between States and the
incorporation of such agreements into national legal order which
takes place through their ratification by national Parliaments and
results in the assimilation of national laws with regard to the issue
that constitutes the subject-matter of the agreements in question.3
ii) Harmonisation of laws, and iii) Unification of laws.4 In
conclusion, harmonisation of laws is one of the instruments by means
of which legal integration is carried out.

1.2.2. Analysis of the Term

The concept of harmonisation presupposes the existence of
certain disparities or differences which need to be eliminated or
diminished. To harmonise means to bring one thing into harmony
(=agreement, accord) with another.5 In the case of the European


3 Although Conventions under Article 220 of the EC Treaty could be
often considered as harmonisation measures, if they are judged not by
their form but by their content.

4 Harmonisation and unification of laws will be further discussed
later in this Chapter.

p.1125.
Community there are twelve Member States for the time being, which means twelve different legal systems from at least two large families of law (Roman, Anglo-Saxon). Despite the great or small differences, those twelve legal orders must be brought into alignment in respect of various issues, if the aims of the EC are to be fulfilled.⁶

Many problems have arisen with regard to the definition of the term "harmonisation of laws" due to the fact that its use in the Treaty of Rome is unclear and ambiguous.⁷ Another reason that adds to the controversy on the exact meaning of the term is that there are such different approaches to the concept of harmonisation of laws that the term is widely or narrowly construed according to the angle from which it is considered. Finally, one must bear in mind that, apart from the legal aspect, the process of harmonisation of laws involves certain political and economic elements which make the

---

⁶ Article 2 of the Rome Treaty as amended by Article G(2) of the Treaty on Political Union concluded at Maastricht in December 1991 reads: "The Community shall have as its task by establishing a Common Market, and an Economic and Monetary Union and by implementing the Common policies or activities referred to in Articles 3 and 3a to promote throughout the Community a harmonious and balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, a high degree of convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living and quality of living and economic and social cohesion and solidarity among Member States".

⁷ The use of the term in the Treaty will be discussed later in this Chapter.
attempt of definition even more difficult.

Starting from the literal meaning of the word harmonisation as it was mentioned above, one could define the "harmonisation of laws" as a compound process within the Community legal order which follows various patterns in order to counteract the distortive effects the disparities of national laws have on the Community's objectives, in a way that produces similar or, in very exceptional and rare cases,9 identical rules throughout the Community. It is apparent that the aforementioned definition contains a number of elements which are worth being discussed separately.

The first element refers to the compound character of the process implying that harmonisation has not only legal but also economic, political and social dimensions. First, the legal dimension stems from the fact that the object of the process of harmonisation is legal provisions. In addition, if the harmonisation of certain rules has been imposed by the Community and is not the result of the competition of legal systems9 the entire process is based on the provisions of a legal text (Treaty of Rome) and is carried out with legal instruments. Secondly, the economic dimension is related to the very nature of the European Community which is primarily an economic Community and, above all, to the economics of

---

9 Harmonisation of laws produces similar rules by the means of Directives, but it can produce identical rules by the means of Regulations. Detailed reference to this issue will follow.

9 The distinction between imposed and competitive harmonisation will follow in this Chapter.
the Single Market which constitute the decisive and guiding factor in
the process of harmonisation. Thirdly, the process of harmonisation
is directly linked with political issues, since it affects the pace
of political integration and includes disputes, compromises and a
great deal of political bargaining between Member States and between
the Community's Institutions. Finally, the outcome of harmonisation
has a social impact, since it often deals with social issues\textsuperscript{10} or has
social repercussions.\textsuperscript{11}

The second element in the definition (within the Community
legal order) denotes that harmonisation is a process which concerns
the legal systems of the Member States regardless of whether it is
imposed or market-led. Furthermore, imposed harmonisation is legally
based on general or specific provisions of the Treaty of Rome and is
carried out in accordance with the principles and conditions set out
in those provisions.

The third element in the definition (various patterns) implies
that harmonisation may be carried out by several means. In other
words, there is not a certain predetermined formula, but the method
and the instruments vary according to the field of law where the
object of harmonisation lies and the relevant provisions of the
Treaty of Rome which apply to the specific case. The reason that
explains the need for such a variety of means is identified in the

\textsuperscript{10} Directive 76/207 on equal treatment in employment (OJ 1976,
L39/40).

\textsuperscript{11} e.g. Directives regulating professions such as that 75/363 on
Doctors (OJ 1975, L167/29), etc.
fourth element (to counteract the distortive effects) which requires flexibility. Indeed, harmonisation of laws in the EC is aimed at modifying those parts of national laws which obstruct the fulfillment of the Community's objectives. What is significant is that not every single provision of national laws should be the object of harmonisation, but only those which are responsible for causing distortions.

The fifth element (the disparities of national laws) is closely related to the aforesaid, since it seems to be a cause-effect relationship between the disparities of national laws and the distortions resulting from them. It is absolutely justified for such disparities to exist, because they reflect different social structures and historical developments of the twelve Member States. Taking into account that a legal system is destined to serve the needs of the society within which it operates, it has to be mentioned that the needs of the twelve have been to a great extent different due to numerous factors. However, there have been many cases to which the legal systems of the 12 have responded in a similar way, forming certain legal principles which have been recognized by them and considered as a kind of preamble to harmonisation.\(^\text{12}\)

The last element in the definition requires that the process of harmonisation should result in the enactment of rules which are similar or, in very exceptional cases, identical in all Member States. Similar rules are produced in the case of imposed

\(^{12}\) For example all Member States have corporate tax laws and all apply corporate tax to taxable profits.
harmonisation by the means of Directives,\(^{13}\) whereas in the case of competitive harmonisation it is common for a State to adopt the rules already in place in another State and to adapt them to its own needs, which means that because of such adaptation the rules in question will be similar, not identical. Identical rules are introduced when harmonisation in limited and exceptional cases employs the means of Regulations something which is implied by Articles 27, 99 and 100A of the Treaty of Rome.\(^{14}\)

Although it is common for harmonisation to opt for a synthesis of the laws of the Member States nothing excludes the possibility that it will amount to something quite new and original which will not be necessarily the result of a synthesis of national laws. As has rightly been suggested,\(^{15}\) harmonisation "...has a law-making function quite independent of compromises as between national provisions".

Considering the definition of harmonisation as a whole one

---

\(^{13}\) After their transposition into national laws.


Further discussion will follow in this Chapter.

could draw the conclusion that the expression "harmonisation of laws" represents a concept which is quite flexible, adaptable and wide enough to cover many things. It is exactly that wide character of the concept which causes some problems in its interpretation. For instance, it has been argued\textsuperscript{16} that harmonisation of laws, as planned and carried out, has taken the meaning of standardisation.

From a literal point of view, standardisation has the meaning of bringing certain things to a standard or uniform size, strength, form of construction, proportion of ingredients.\textsuperscript{17} This definition does not prevent standardisation from being included in the concept of harmonisation of laws, especially of those relating to technical matters such as safety limits and consumer's protection. Nevertheless, there has been an attempt to extend the meaning of standardisation so as to cover non-technical matters as well.\textsuperscript{18}

As a result the term standardisation has been employed in order to declare a process in which the central authority decides on how a specific issue should be dealt with and then calls Member States to follow its guidelines. The first argument against this theory is that standardisation cannot be stripped of its technical nature which constitutes the subject matter of the concept in question. The second argument against it is that even if this approach towards

\textsuperscript{18} J. Chown, \textit{loc. cit.}
standardisation were right it would still be included in the concept of harmonisation, since it would satisfy the various elements mentioned in the definition of harmonisation.

Unfortunately, the text of the Treaty of Rome with some ambiguous references to harmonisation has its share in maintaining the dispute on the exact meaning of the term. The first reference to the term is made in Article 99 of the EC Treaty which states: "...adopt provisions for the harmonization of legislation concerning...". It is apparent from this Article that "harmonization of legislation" is a very broad term and this view is strengthened by the fact that the draftsmen of the Treaty\(^{19}\) did not specify the legal instruments by which this process would be carried out. On the contrary, they provided those who would implement the Treaty with many options by mentioning the words "...adopt provisions..." which are very general and can imply all the means and methods at the Council's disposal.\(^{20}\)

In addition, the Treaty in Article 100A(4&5) uses the words "...harmonization measure..." which denote that harmonisation should not be interpreted in a narrow sense. This indicates that the draftsmen of the Treaty\(^{21}\) did not want to restrict the concept of harmonisation by describing the legal form and the rest of the

---

\(^{19}\) In this case the draftsmen of the Single European Act that amended some of the provisions of the original Treaty.

\(^{20}\) From the uniform rules introduced by Regulations even in exceptional cases to the less effective Recommendations.

\(^{21}\) In this case of the Single European Act.
characteristics of such "harmonization measures". Further evidence is provided by Article 100B which states: "...draw up an inventory of national laws, regulations and administrative provisions...which have not been harmonized". By implying that the object of the harmonisation process can be any legal rule irrespective of its legal form (Act of Parliament, Decree, Administrative Decision of a Civil Servant, etc.) Article 100B broadens the concept of harmonisation even more.

Finally, the lack of clarity with regard to the use of the word harmonisation in the EC Treaty is confirmed by the fact that the word in question does not refer only to legal rules. For example, Article 112(1) reads: "...harmonize the systems whereby they grant aid for exports...", Article 117 refers to the harmonisation of working conditions and standards of living for workers, and in the second paragraph mentions the harmonisation of social systems. In conclusion, the aforementioned provisions confirm the view that the concept of harmonisation of laws has many aspects, is very flexible and because of this considerable controversy about its exact meaning has been caused.

1.2.3. Comparison With Similar Terms Employed in the EC Treaty

It is widely accepted that the employment by the EC Treaty of two other terms (approximation-coordination), which are similar to the concept of harmonisation, causes a great deal of confusion. Literally to approximate means to bring close or to cause to approach
especially in quality, quantity or degree.\textsuperscript{22} Therefore, approximation of laws seems to imply a process that brings national laws closer to each other. But how could this happen and what are the differences between bringing laws into harmony and bringing them closer to each other?

In the first place, to bring laws into harmony is different from bringing national laws close to each other, because the former implies a more intensive and advanced procedure whereas the latter can be achieved with less effort. It is the concept of harmony that presupposes the successful combination of different factors for the attainment of an objective. In the case of the European Community those different factors are, for instance, the existence of different national laws and their impact on the Single Market, the existence of political agreement, the involvement of the Community's Institutions, while the objective is the establishment and the proper functioning of the Common Market.

Secondly, the approximation of national laws is likely to take place regardless of whether there is a purpose which must be served. For example, it may happen as a result of the relations between two States (economic, cultural) and of the mutual influences that usually exist in such relations. Thus, it seems that in theory harmonisation is a more complicated and wider concept than that of approximation but it remains to be seen, first, whether such a view is not called into question and, secondly, whether it is acceptable in the context.

of European Community law.

With regard to the first question, some authors\(^{23}\) argue that approximation could be construed to indicate "every harmonization of the Member States' national laws with the purposes and provisions of the Treaty". Conversely, others\(^{24}\) believe that "harmonisation appears to connote a measure laying down an identical standard for the entire Community, whereas approximation applies more broadly to all those measures which seek to achieve a greater degree of alignment between the laws of the Member States while permitting margins of divergence". What is apparent from the aforesaid views is that a dispute exists about which of the two concepts is wider.

In order to reach a conclusion on the aforementioned problem one could seek recourse to the text of the EC Treaty. The use of the word "approximation" in the EC Treaty is quite extensive and does not refer only to legislation. For instance, Article 44(3) and Article 45 refer to the approximation of prices. On the other hand, Article 3(h) provides for the "approximation of the laws" as an activity serving the purposes of the Community, Article 27 reads among others "... approximate provisions laid down by law, regulation or administrative action", the third chapter of the third part of the Treaty is under the heading "Approximation of Laws", Articles 100 and


100a(1) refer again to the same term and the same wording is found in Article 117(b) which is included in the social provisions of the Treaty. In view of these provisions, two conclusions can be drawn. First, that the word harmonisation can take the place of the word approximation where the latter is mentioned without any change in the meaning. Secondly, it seems that the draftsmen of the Treaty did not use the two different terms with the purpose of denoting two different procedures.

As concerns the other term employed by the Treaty (coordination), the problems arising from its use are similar to those relating to approximation. Starting from the literal interpretation of the term, to coordinate means to place or arrange things in proper position relatively to each other and to the system of which they form parts or to bring things into proper combined order as parts of a whole, which implies a similarity to the meaning of harmonisation. For this reason some authors have expressed the view that coordination has a narrower sense expressing a higher degree of harmonisation. Conversely, one could argue that coordination has a more general content and that it is less stereotype than approximation and harmonisation offering more discretionary powers to Member States. In addition, it must be

---

25 As amended by Article G(22) of the Treaty on European Union.


mentioned that coordination of policies and strategies with a view to dealing with a specific problem is very common in cases where bilateral or multilateral cooperation between States has been established.28

The view that coordination has more general application and concerns economic and political matters to a greater extent than legal matters is based on the wording of certain Articles of the Treaty of Rome. In particular, Article 3a(1)29 mentions the "...coordination of Member States' economic policies...", Article 40(2b) refers to the "compulsory coordination of the various national market organizations" and 41(a) to the "effective coordination of efforts in the spheres of vocational training". In addition to those, Article 70 applies to the "coordination of the exchange policies" and other Articles contain the following references to "coordination": Article 103(1)30 "...their economic policies...and shall coordinate them...", 103(3)31 "...coordination of economic policies..."Article 130b32 "...conduct their economic policies and shall coordinate them...", Article 130d33 "...coordination of the

28 e.g. coordination of exchange rates and external trade policies within the Group of Seven with the purpose of combating economic recession etc.
29 Article G(4) of the Treaty on European Union.
30 Inserted by Article G(25) of the Treaty on European Union.
31 Ibid.
32 Amended by Article G(38) of the Treaty on European Union.
33 Ibid.
Funds...", Article 130h\textsuperscript{34} "...coordinate research...activities...", and Article 145 "Ensure coordination of the general economic policies...".

In spite of the previously mentioned provisions the legal aspect of coordination cannot be disregarded, first, because the coordination of economic policies involves a law-making function and secondly, because the text of the EC Treaty clearly refers to the coordination of laws. Article 54(3g) states: "...by coordinating to the necessary extent the safeguards which..., are required by Member States" and Articles 56(2)\textsuperscript{35} and 57(2)\textsuperscript{36} refer to the "...coordination of the provisions laid down by law, regulation or administrative action...". In the latter case the wording is identical with that applying to approximation of laws which indicates that the three terms are interchangeable in the text of the Treaty of Rome without any differences in the meaning and, above all, that they must not be interpreted in isolation but in their context in the Treaty.

The last resort in the attempt to find the exact meaning of the three terms could be the four original texts of the Treaty in French, German, Dutch and Italian. The French text employs the three terms in question (rapprochement = approximation, harmonisation, coordination) and one more, that is "l' equalisation" (=equalization), in Article 117(1) and the German version further complicates matters by using the word "angleichung" for the French

\textsuperscript{34} Ibid.

\textsuperscript{35} As amended by Article G(12) of the Treaty on European Union.

\textsuperscript{36} As amended by Article G(13) of the Treaty on European Union.
words "rapprochement" and "egalisation", and the words "harmonisiert", "vereinheitlicht" or "einklang zu bringen" for the French word "harmoniser" (=harmonise). Moreover, the Dutch text includes the terms "aanpassing" (=approximation), "geharmoniseerd" (=harmonise), while the Italian text is similar to the French. What becomes apparent is that the interchange of terms of the English version can be found in the other versions as well and that no conclusion can be drawn from the Treaty with regard to the exact meaning of each of the three terms.

The notion that there is no clear distinction between the three terms in question is strengthened by the governmental analyses which were prepared for the ratification of the Treaty by the national Parliaments of the Member States. The French Report\textsuperscript{37} regards harmonisation as equivalent to approximation, the German\textsuperscript{38} considers "angleichung" as a synonym for "annahernung" (=approaching) and "anpassung" (=adjustment), the Dutch\textsuperscript{39} and partly the Luxemburger\textsuperscript{40} refer to the harmonisation of laws as a general concept which embraces all the other similar concepts.

\textsuperscript{38} Deutscher Bundestag, 2 Wahlperiode, Drucksache 3440/1957, pp.129-30.
\textsuperscript{39} Tweede kamer der Staten-Generaal, Zitting 1956-57 I 4725 1-4, pp.26-27.
\textsuperscript{40} Chambre des Députés, Session Ordinaire 1956-57, No.636, 637, 638 pp.8-9.
In conclusion, if the basic three terms used by the EC Treaty are examined separately, they may be distinguished from each other, but examined in the context of the Treaty, they can be regarded as synonyms. It has been argued⁴¹ that "each term implies a process which may lead as far as the creation of a uniform rule but may also stop short of such result". However, it has to be mentioned that the term "harmonisation" has prevailed over the other two terms in the sense that is used more often than the two others in the Community law jargon.

1.2.4. Harmonisation Versus Unification?

The attempt to draw a distinction between the concept of harmonisation and the other concepts which are close to it would be incomplete if mention was not made of the unification of laws. Both harmonisation and unification of laws are instruments for the integration of laws.⁴² Unification of laws could be defined as a process aiming at the enactment of uniform rules which replace the respective conflicting rules of national laws with the purpose of attaining an objective. In the case of the European Community the objective is the removal of obstacles to the establishment and the proper functioning of the Common Market and the obstacles are put by the existence of different and conflicting national rules.

Nevertheless, the word unification does not exist in the text.

---

⁴² See 1.2.1.
of the EC Treaty despite an indirect reference to it in Article 113 which states that "...the common commercial policy shall be based on uniform principles...". If, however, careful consideration is given to Article 189 par.2, the conclusion which can be drawn is that this Article might be regarded as the legal basis of unification, because it implies unification by describing an instrument (Regulation) to achieve it.

The provision in question permits the adoption of Regulations which contain uniform rules and replace national rules that existed until the adoption of those Regulations and fall within the subject-matter of the Regulations. Furthermore, uniform rules adopted under Article 189 par.2 render automatically inapplicable any conflicting provision of current national law and Member States are obliged to repeal conflicting legislation according to the judgment of the European Court of Justice in the French Merchant Seamen case. Consequently, what a Regulation achieves is to unify different national provisions relating to the subject-matter of the Regulation into a single Community rule which is common for all Member States. As a result, Member States apply exactly the same rule to cases covered by an adopted Regulation.

There is no doubt that comparing the definitions of the two concepts, that is harmonisation and unification, one can identify

---

\(^{43}\) As amended by Article G(28) of the Treaty on European Union.


certain similarities. First, both have the same purpose, namely to eliminate the disparities of national laws to the extent that such disparities hamper the fulfillment of the Community's objectives. Secondly, both of them are instruments of legal integration and are intended to facilitate the process of economic and political integration within the EC. Thirdly, both result in the introduction of new rules by using different procedures and instruments.

Those similarities have led certain authors to the conclusion that unification could be embodied in the concept of the harmonisation. Such view has been thrown into doubt by others who favour the idea that the two concepts are different and neither of them can include the other.

Nevertheless, the two concepts cannot be considered as


declaring the same process due to the existence of certain and significant differences. First, unification of laws means uniformity of laws which is translated in the context of Community law into the existence of a single rule enacted by a supranational legislative body. Conversely, harmonisation of laws leads to a similarity of laws and in its classical and most common form requires the transposition of the rule adopted at Community level into national laws and this duty rests with national authorities.48

Secondly, unification of laws connotes greater transfer of legislative powers from the national to supranational level and, therefore, greater surrender of national sovereignty than harmonisation of laws. Hence, the two concepts must not be regarded as identical but should be treated as two different instruments in the service of legal integration.

1.2.5. Types of Harmonisation

For the benefit of a thorough interpretation of harmonisation reference should be made to the classification of the concept. Mentioning the several types of harmonisation at this point is quite important, because there will be relevant references in other parts of the thesis.

48The exceptional cases where harmonisation by employing the instrument of Regulation results in uniformity of laws will be discussed separately.
a) Total-Partial

Total harmonisation means that the harmonisation measure covers every single aspect of the object under harmonisation so that there is no room for separate national legislation on the same issue. Conversely, when the harmonisation measure covers certain aspects of an issue leaving the rest of them to the competence of each Member State that measure is linked to partial harmonisation.

b) Vertical-Horizontal

The term "vertical (or bilateral) harmonisation" denotes the harmonisation (=compliance) of national laws with the provisions of the EC Treaty. For instance, Article 52 imposes on Member States the obligation to remove from their laws restrictions relating to the freedom of establishment of nationals and Article 95 par.3 provides for an analogous obligation. The opposite term (horizontal or multilateral harmonisation) has the meaning of bringing national laws into alignment with each other with a view to adapting them to the Community's aims and policies.\textsuperscript{49}

c) Positive-Negative

The term "positive harmonisation" should be interpreted as including all harmonisation measures which are taken pursuant to certain Articles of the EC Treaty and harmonise national laws with the purpose of enabling the fulfillment of the Community's

objectives. Conversely, "negative harmonisation" is based on standstill clauses of the Treaty (Articles 12, 31, 37 par.2, 53, 95) which prevent Member States from introducing measures in conflict with the objectives of the Treaty and which set up timetables for the abolition of the existing measures that hamper the fulfillment of the Treaty objectives (13, 32, 33, 37 par.1).

d) Gradual- Single Phased

Gradual harmonisation is carried out step by step and is known in Community law jargon as "salami tactics". Harmonisation in such cases is executed in different stages, each of which cover a different aspect of the subject. The opposite, that is "single phased" takes place at one stage and all the related aspects are dealt with during this single stage.

e) Imposed-Competitive

This classification is related to the initiator of harmonisation. More specifically, in the case of imposed (top-down) harmonisation the initiator is a central authority (Community Institution) which initiates, promotes and supervises the process of harmonisation. In the case of competitive (market-led or bottom-up) harmonisation national laws compete with each other in creating the best legal framework which will attract capital. When the law of a Member State manages to do so more effectively than the laws of the rest of the Member States the latter may try to bring their laws in line with the law of the original Member State with a view to improving their competitiveness.
1.2.6. The Concept of Harmonisation of Tax Laws

Harmonisation of tax laws or, tax harmonisation,\textsuperscript{50} is one of the instruments of fiscal integration.\textsuperscript{51} The latter can be defined as the process which aims at diminishing the differences that exist between national tax laws by employing certain instruments with the purpose of attaining a certain degree of economic unity. In other words, fiscal integration can be included in the concept of legal integration, since it concerns developments relating to a field of law (tax law) and at the same time can also be considered as a significant area of economic integration. This can be attributed to the dual nature of tax which combines the legal aspect (= the legal rule by which a tax is expressed and enforced) and the economic (= the role of tax in the economy).\textsuperscript{52}

From the legal point of view harmonisation of tax laws refers to the harmonisation of legal rules by which taxes are levied and administered. In the context of the European Community the content of the concept is restricted by two factors: a) The different approaches Member States have towards taxes and b) The limits imposed by the EC Treaty.

\textsuperscript{50} The term "harmonisation of tax laws" gives emphasis on the legal dimension of the process, whereas the term "tax harmonisation" implies both aspects of the process, that is the legal as an instrument of legal integration and the economic as an important area of economic integration.

\textsuperscript{51} The other two are tax cooperation or coordination and tax unification.

\textsuperscript{52} The purpose of this thesis is to deal mostly with the legal aspect.
As regards the first factor, it is worth mentioning that although Member States more or less interpret the concept of tax similarly,\textsuperscript{53} when it comes to the point of classifying a levy as tax there is not always accord. For example, social security contributions are classified as a form of direct taxation in the U.K., a view that is not shared by U.K.'s continental partners. Such differences may trigger off controversies and delay the entire process of tax harmonisation. None the less, it must be accepted that in the context of EC the term "tax harmonisation" refers to the harmonisation of the legal rules applying to indirect\textsuperscript{54} and direct\textsuperscript{55} taxes.

Turning to the second factor, it is significant that the EC Treaty does not permit tax harmonisation to be carried out unless it is linked with the concept of the Internal or the Common Market.\textsuperscript{56} Consequently, not every single rule that concerns taxation may become the object of tax harmonisation, but there must be a relation between the need for harmonisation of that rule and the establishment or the functioning of the Internal or the Common Market.\textsuperscript{57}

\textsuperscript{53} A compulsory payment or transfer to a public authority not made in consideration of specific goods or services.

\textsuperscript{54} Excise duties, VAT, other sales or turnover taxes. In the case of customs duties the introduction of a Common Customs Tariff has resulted in tax unification rather than tax harmonisation.

\textsuperscript{55} e.g. income taxes, wealth taxes, etc.

\textsuperscript{56} The distinction between the two concepts will be discussed later.

\textsuperscript{57} Articles 99, 100 of the EC Treaty.
Another important point stemming from the EC Treaty (Article 3) is that tax harmonisation is not among the objectives of the EC described in Article 2 but it can be classified into the activities by which those objectives are to be achieved. Being a part of the approximation of laws and given that the latter is one of the activities set out in Article 3 tax harmonisation takes its place in the Community legal order.

After all these references to the theoretical framework of tax harmonisation the attempt to define the concept in question has been facilitated to a great extent. As a result, "harmonisation of tax laws" can be defined as that part of the process of harmonisation of laws which is destined to eliminate the obstacles to the establishment and the distortions to the proper functioning of the Common Market (or the Internal Market) put by the disparities of national tax laws in a way that produces similar or, in exceptional cases, identical tax rules\(^{58}\) throughout the EC.

Apart from tax harmonisation there are some other terms which are often used when reference is made to the tax developments in the EC. The first is tax approximation which, if it is interpreted in the context of international tax law, means that tax laws are assimilated as a result of the interrelation between tax systems of competing economies. For example, when a State reforms its tax law with a view to making it more efficient and more attractive to foreign investors, other States which are in a state of economic

\(^{58}\) When Regulations are employed as instruments of harmonisation; See Note 14.
competition with the former are tempted to follow the trend of changes.\textsuperscript{59} Thus, it can be supported that approximation of tax laws connotes a less elaborate and advanced process than harmonisation and a process that is the outcome of the spill-overs between competing tax systems and economies. However, in the context of the EC no clear distinction can be made between the two terms.

The same conclusion can be drawn in respect of the relation between harmonisation of tax laws and coordination of tax laws.\textsuperscript{60} The latter is another instrument of fiscal integration and implies a process that secures the concerted coexistence of tax laws of different States in cases where there is ground for conflict or there is a need for combined legal action. For instance, double tax agreements prevent the tax laws of the States that have entered these agreements from conflicts over jurisdiction. The result is the achievement of a coordinated involvement of different tax laws in cases where more than one jurisdictions are involved. Moreover, coordination of tax laws exists when combined legal action from different countries is needed for tackling a problem.\textsuperscript{61}

In view of these, it has become apparent that tax coordination in the context of international tax law does not necessarily involve

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{59}] UK Corporate tax reform in 1984 was followed by a series of similar reforms in other developed countries: US 1986, Germany 1988, etc.
\item[\textsuperscript{60}] Tax coordination is often used for tax policies rather than tax laws.
\item[\textsuperscript{61}] e.g. exchange of information on tax evasion cases, coordination of activities against tax evasion, etc.
\end{itemize}
\end{footnotesize}
changes in tax laws as tax harmonisation and, above all, does not contain any law-making function at central (supranational) level as harmonisation does. As a result of it, tax coordination does not need a common strategy decided at central level, as imposed tax harmonisation does, and requires little or no surrender of national sovereignty compared with imposed tax harmonisation. None the less, in the EC jargon it is common practice not to distinguish tax coordination from tax harmonisation and only in few cases the term "tax coordination" is used with the purpose of expressing a less centrally imposed process of assimilation of tax laws.

The third term, that is unification of tax laws or tax unification, is completely different from tax harmonisation even when it is interpreted in the EC context. In particular, the term "Tax Unification" declares a process in which different national tax rules are replaced by a single common rule adopted at central (supranational) level. As a result, fiscal sovereignty and, consequently, national sovereignty of Member States is diminished and fiscal policy-making and decision-making are transferred from national to central authorities with almost nothing left to be decided by individual States. For example, tax unification in the EC

---

62 Proposal for Directives by the Commission, Adoption of Directives by the Council and then transposition of the Directives into national laws.


64 The third instrument of fiscal integration.
exists with regard to customs duties.

Finally, as regards the types of harmonisation, all of them can be identified in the process of tax harmonisation (total-partial, vertical-horizontal, negative-positive, gradual-single phased, competitive-imposed). The most important though is the distinction between imposed (or top-down) and competitive (market-led or bottom-up) tax harmonisation and on these two types this thesis will focus. Although both types will be discussed more emphasis will be given to imposed tax harmonisation, because it is more complex and it involves much more elements of Community law than competitive.

1.3. The Process of Harmonisation in the EC and the Case of Tax Harmonisation

1.3.1. Aims and Methods

The first objective of harmonisation of laws is described in Article 3(h) of the EC Treaty which links harmonisation with the functioning of the Common Market. In addition, Article 100, the general provision on harmonisation goes further and connects approximation of laws with the establishment and the proper functioning of the Common Market. It is interesting to note at this

---

65 See 1.2.5.

66 In fact, the Article refers to approximation but as has been mentioned above there is no distinction between the two terms in the context of the EC Treaty.

67 Ibid.
point that the Common Market has the meaning of "a market in which every participant is free to invest, produce, work, buy and sell, to supply or obtain services under competitions which have not been artificially distorted wherever economic conditions are most favourable". What harmonisation of laws does is to eliminate the obstacles to the establishment and the proper functioning of that market raised by the disparities of the different national laws.

Given that the Common Market is one of the stages of economic integration and that harmonisation of laws is orientated towards the establishment and the proper functioning of that Market it can be concluded that the promotion of economic integration is among the objectives of harmonisation. This view is confirmed by the fact that harmonisation of laws is one of the instruments of legal integration which in turn is intended to serve economic integration.

Another objective of harmonisation of laws is the establishment (and the proper functioning, though it is not mentioned) of the Internal Market pursuant to Articles 7A and 100A. Before making any comments on that objective it is worth mentioning

---

69 The others are Free Trade Area, Customs Union, Economic Union: Detailed analysis will follow in Chapter 3.
70 See 1.2.1.
71 It was Article 8A after the Single European Act but became Article 7A when it was amended by Article G(9) of the Treaty on European Union.
in advance\textsuperscript{72} that the concept of the Internal Market does not coincide with that of the Common Market. The former is defined in Article 7A as "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty" and as a result it can be regarded as a narrower concept than the Common Market which contains more common elements and implies a certain degree of coordination of policies.\textsuperscript{73} In conclusion, the concept of the Internal Market can be included in the concept of the Common Market.\textsuperscript{74}

The establishment (and the proper functioning) of the Internal Market is highly dependant on the harmonisation of laws, since the latter is the most important means by which the obstacles to that Market are removed and the necessary legal framework is set up. The link between the establishment and the proper functioning of the Internal Market and harmonisation of laws is implied in Article 7a of the EC Treaty and clearly mentioned in Article 100a(1) of the Treaty. In addition, the majority of Community measures relating to the establishment of the Internal Market are adopted in the form of Directives which is the most important instrument of harmonisation of laws.

\textsuperscript{72} Detailed reference will follow when comparison between Article 100 and 100A of the EC Treaty is made.


Harmonisation of tax laws as a part of the process of harmonisation of laws aims at enabling the establishment and the proper functioning of the Common Market (Article 100). Furthermore, tax harmonisation, at least insofar as indirect taxes are concerned, is aimed at contributing to the establishment of the Internal Market. Both objectives can be further specified and construed as meaning the removal of tax obstacles to cross-border movements and cooperation and the securing that competition in the Internal or Common Market is not distorted by the existence of disparities between national tax laws.

Another perhaps long-term objective of tax harmonisation is its contribution to Economic and Monetary Union as the latter is defined in Article 3A and Title VI of the EC Treaty.\(^75\) Although there is no direct reference to taxation\(^76\) the imposition of fiscal discipline by Article 104C\(^77\) and by the Protocol on the Excessive Deficit Procedure will have certain repercussions on the tax policy choices of the individual Member States. Moreover, the Werner

\(^{75}\) These Articles were introduced by Article G(4) and G(25) respectively of the Treaty on European Union.

\(^{76}\) There is only a general reference to fiscal policy in Article 3A(3): "sound public finances" and in Article 104C which refers to government deficits.

\(^{77}\) Introduced by Article G(25) of the Treaty on European Union.
Report\textsuperscript{78} and the Council's Resolution\textsuperscript{79} adopting that Report stressed the importance of harmonisation of rules concerning VAT, excise duties and taxes influencing capital movements and company taxation. In conclusion, all these objectives of tax harmonisation in combination with its significant role in the process of fiscal integration shape a unique relation between harmonisation of tax laws and economic integration according to which the former is aimed at facilitating the progress of the latter.

As far as the methods for carrying out harmonisation (including tax harmonisation) are concerned, there are two approaches. According to the first those parts of national laws which directly or indirectly affect the establishment of the Internal or the Common Market should constitute the object of detailed harmonisation.\textsuperscript{80} Such method was favoured by the Commission during the first twenty years of the Community and has a significant advantage, that is the attainment of legal certainty. Indeed, the result from the application of this method is the introduction of similar or, in exceptional cases, identical rules in all Member States. Notwithstanding the legal certainty, the method at issue is time consuming since the process of imposed harmonisation involves long and difficult negotiations and results in a serious diminution

\textsuperscript{78} P. Werner, 'Report to the Council and the Commission on the Realisation by Stages of Economic and Monetary Union in the Community', (3/1970) \textit{Bulletin of the EC, Supplement.}


\textsuperscript{80} The so-called "systematic harmonisation".
of national sovereignty.\(^{81}\)

The second method gained ground after the ruling of the European Court of Justice in the *Cassis de Dijon*\(^{82}\) and became the Commission's favourite choice.\(^{83}\) According to this approach where it is feasible and permissible mutual recognition should replace harmonisation, while the latter should be restricted to deal with those disparities of national laws which cause serious distortions to the Single European Market and cannot be eliminated by other means, for instance by mutual recognition or the interplay of market forces.\(^{84}\) This approach has been legally endorsed by the inclusion in the EC Treaty (Article 3B) of the subsidiarity clause\(^{85}\) which depends any action taken at the Community level (= harmonisation measures in this case) in respect of an issue on the inability of the Member States (= conflicting national laws in this case) to deal with that issue sufficiently.

1.3.2. The Legal Framework

a) General Provisions

The first general provision that concerns harmonisation of laws, though there is no clear reference, is Article 3B, the so-called "subsidiarity clause" inserted by Article G(5) of the Treaty on European Union.

---

\(^{81}\) Since many issues will be decided at supranational level.

\(^{82}\) Case 120/78, [1979] ECR 649; [1979] 3CMLR 337.


\(^{84}\) The so-called "essential harmonisation".

\(^{85}\) Article G(5) of the Treaty on European Union.
Treaty on European Union. According to this Article "In areas which do not fall within its exclusive competence, the Community shall take action, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community". In terms of harmonisation this provision is an official recognition of the concept of "essential harmonisation" mentioned above.

Thus, in the areas of direct and indirect taxation where the Community does not have exclusive competence, with the only exception of customs duties, harmonisation measures may be proposed and adopted in so far as they deal with issues that cannot be dealt more sufficiently by the tax laws of the Member States. In addition to this, the European Court of Justice, provided a relevant case is brought before it in future, is entitled to call into question the essential character of a tax harmonisation measure.

In fact, the most important provision with regard to harmonisation is Article 100 of the EC Treaty (supplemented by Articles 101 and 102) as was amended by Article G(21) of the Treaty on European Union. Not only does it set out some basic elements of the harmonisation process, but also being a general provision (lex generalis) constitutes the legal base of the entire harmonisation process in respect of fields of law for which there is no special provision (lex specialis) in the EC Treaty, as for instance is the

\[86\] Such areas are Customs Duties, Common Agricultural Policy, External Relations.
case of rules concerning direct taxes.\textsuperscript{87}

Nevertheless, there has been a practice to base harmonisation measures both on the specific provisions and Article 100.\textsuperscript{88} but this approach was not favoured by the European Court of Justice which ruled that "...that Article [100], a general one under which Directives may be adopted for the approximation of laws of the Member States, cannot be relied on as a ground for restricting the application of Article 43 [and thus of any other specific provision] of the Treaty".\textsuperscript{89}

It is apparent from the wording of Article 100 that approximation\textsuperscript{90} of laws may take place when the provisions of national laws under approximation "...directly affect the establishment or functioning of the Common Market". The concept of the Common Market embraces the Customs Union, the free movement of persons, goods, capital and services (= the Internal Market), the measures for the preservation of effective competition, as well as the Community

\textsuperscript{87} Since Article 220 which provides the conclusion of Conventions for the abolition of double taxation cannot be the legal basis of direct tax harmonisation and this has been proved by its limited use.

\textsuperscript{88} For example the Directive 71/305 on Public Bids was based on Articles 57(2), 66 and 100 (1971 JO, L185/5), and many measures of the Common agricultural Policy were based on Articles 43 and 100 (Directives on the Elimination of Animal Diseases).


\textsuperscript{90} = harmonisation; See analysis in 1.2.3.
policies.\textsuperscript{91} Thus, when the subject matter of the national rules is related to one of those issues the first requirement set by Article 100 is satisfied.

As regards the second requirement (directly affect), it has been suggested\textsuperscript{92} that it does not mean "a certain causality, but a certain intensity of effect". Such a wide interpretation allows the use of Article 100 as the legal basis for the harmonisation of provisions relating to issues which cannot be clearly identified in the aforesaid categories but nonetheless exert a degree of influence on economic relations between Member States to the extent that the establishment of the principle of free competition is affected. The most significant examples are offered first, by issues relating to safety standards and public health,\textsuperscript{93} environmental and consumer protection,\textsuperscript{94} and thirdly by public procurements and direct taxation.\textsuperscript{95}

\begin{enumerate}
\item C. D. Ehlermann, Lecture given in the University of Edinburgh on 18/11/1977 and published as Appendix 3(b) to the 22nd Report of the House of Lords Committee on the European Communities.
\end{enumerate}
There is no doubt that Article 100 plays a central role in the harmonisation in the field of direct taxation by setting up the legal framework within which harmonisation of direct taxes can develop. If Article 100 is applied to the case of direct taxation\(^9^6\) the following conclusions can be drawn in respect of the process of the harmonisation of direct taxes:

i) The object of harmonisation is laws, regulations or administrative provisions concerning direct taxes.

ii) The harmonisation of rules concerning direct taxes must be essential for the establishment or the proper functioning of the Common Market (directly affect).

iii) The instrument by which harmonisation is carried out is the Directive.\(^9^7\)

iv) Tax Directives are proposed by the Commission and after the consultation of the Parliament and the ECOSOC the Council may adopt them acting unanimously.

Another general provision is Article 100A, a deviation from Article 100, which was inserted in the Treaty by Article 18 of the Single European Act and amended by Article G(22) of the Treaty on European Union. This Article makes the harmonisation process much easier because it provides for qualified majority voting and does not confine the instruments of harmonisation to Directives only.


\(^9^6\) Article 100 cannot be applied to the field of indirect taxation since there is a specific Article in the Treaty, that is Article 99.

\(^9^7\) Except for the cases covered by Article 220.
Conversely, by referring to "harmonisation measures" Article 100A permits the use of other means such as Regulations, Recommendations etc. in the process of harmonisation. What makes Article 100A narrower in scope than 100 is the reference to the Internal Market and the exclusion of certain areas to which Article 100A does not apply (taxation, free movement of persons).

b) Specific Provisions

Apart from the general provisions the EC Treaty contains a number of specific provisions on which harmonisation of certain fields of laws can be, and has already been, based. The first of these provisions is Article 27 which concerns the harmonisation of laws with respect to Customs matters, a very important field for the establishment of the Common Market and one of the initial targets of the European Community. Unfortunately, the instrument of harmonisation provided in Article 27 (Recommendations) failed to produce a satisfactory result and, therefore, recourse was sought to Article 235 and to the use of Regulations. As a result, Article 27

---

98 Although the Declaration on Article 100A at the end of the text of the Single European Act provides that "the Commission shall give precedence to the use of the instrument of a Directive" it is not legally binding and does not prevent the use of another instrument. What this declaration does is to create a political obligation to the Commission which is not legally enforceable; See also N. Green-T. C. Hartley-J. Usher, The Legal Foundations of the Single European Market. London, 1991. p.85.

practically remained inapplicable and due to the use of Regulations the process of tax harmonisation in the field of customs duties was transformed into a tax unification process.

The second bunch of provisions is included in Part Three of the Treaty\textsuperscript{100} (Title III) and concerns the harmonisation of rules dealing with the "...special treatment for foreign nationals on grounds of public policy, public security or public health" (Article 56)\textsuperscript{101} as well as the harmonisation of provisions relating to "...the taking up and pursuit of activities as self-employed persons" Article 57).\textsuperscript{102} The former provision was the legal basis for the Directive 64/221\textsuperscript{103} and the latter for a number of Directives.\textsuperscript{104}

Another Article that provides for harmonisation in a specific area is Article 99 as it was amended by Article G(20) of the Treaty on European Union. According to Article 99 harmonisation of rules concerning turnover taxes like VAT, excise duties and other forms of indirect taxation may take place "...to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the Internal Market within the time limit laid down in Article 7A". It is worth noting that the legal basis for the harmonisation for indirect taxes is different from that one relating

\textsuperscript{100} As it was formed by the Treaty on European Union.
\textsuperscript{101} As amended by Article G(12) of the Treaty on European Union.
\textsuperscript{102} As amended by Article G(13) of the Treaty on European Union.
\textsuperscript{103} Official Journal Special Edition, 1963-4, p.117.
to direct taxes in two points: i) It links the harmonisation of indirect taxes with the concept of the Internal Market and ii) It does not confine the instruments of harmonisation only to Directives.

c) Provisions Relating to Common Policies

The EC Treaty in its Chapters dealing with common policies contains some Articles which constitute the legal basis for the adoption of harmonisation measures. More specifically, those provisions are Article 43 (Common Agricultural Policy), Article 75 (Common Transport Policy), Article 112 (State Aids within the Common Commercial Policy) and Articles 117 and 118A (Social Policy); all of them provide for a kind of harmonisation of national laws in so far as that harmonisation results in the adoption of common rules, necessary for carrying out those Common policies. The only comment that might be offered is that the aforementioned provisions have been expressed in broad terms so that they may cover the adoption of harmonisation measures as well as of directly applicable Community legislation.

d) Article 235

Article 235 is one of the Articles of the EC Treaty with the broadest meaning and is aimed at dealing with situations and needs which could not have been predicted by the draftsmen of the Treaty. Its impact on the harmonisation process is very important, since it

---

105 Amended by Article G(16) of the Treaty on European Union.
106 Amended by Article G(33) of the Treaty on European Union.
plays a role which may be considered as supplementary to Article 100, where the conditions set out by Article 100 cannot be met or the instruments provided in this Article are not the appropriate ones. For example, if harmonisation of direct taxes, in exceptional cases, requires the use of Regulations, Article 235 could be the only provision upon which the deviation from Article 100 could be legally based.

1.3.3. The Instruments

Harmonisation of laws in the European Community is carried out by several instruments which differ from each other both in their content and in the legal form they take. Though debated to a great extent, these instruments are worth being examined in the light of the harmonisation process and in particular in relation to the tax harmonisation process.

a) The EC Treaty

The EC Treaty is the first instrument at the disposal of the European Community for promoting the process of harmonisation of laws, since it contains some provisions through which negative harmonisation\(^{107}\) is carried out. These provisions are usually standstill clauses providing for the gradual repealing of those parts of national laws which hamper the achievement of certain aims of the Community. Such provisions are Articles 12-14 (abolition of customs duties between Member States), 30-31 (abolition of quantitative

\(^{107}\) See 1.2.5.
restrictions) and Article 95(3) (abolition of discriminatory tax rules on goods).

On the other hand, there are a few provisions in the Treaty which provide for direct positive harmonisation in the sense that they lay down some fundamental principles to which national laws must conform and given that Treaty provisions by superseding national laws "...render automatically inapplicable any provision of current national law"\(^{108}\) [that contradicts them] the provisions in question achieve the harmonisation of laws in the specific fields to which they refer. The most apparent example stems from Articles 85-86 of the EC Treaty which "perform the function of federal anti-trust laws"\(^{109}\) and coexist with national competition laws.

The serious disadvantage of the Treaty as an instrument of harmonisation is that international treaties like the EC Treaty primarily consist of general provisions which aim at setting the framework within which specific rules will later be adopted. In addition, the EC Treaty is regarded as a constitutional text which by virtue of its nature cannot deal with specific matters in detail, because such detailed references would make this text out of date after some years and would revoke its constitutional role.

b) Regulations

The second instrument of harmonisation is Regulations which

---


because of the fact that they replace different national rules with a uniform Community rule are considered as an instrument of unification rather than harmonisation of laws. Nevertheless, as has already been mentioned, it is accepted that in restricted cases the use of Regulations in the harmonisation process may be justified by special circumstances. For example, "...the Regulation may be used merely to impose an obligation upon the Member States to ensure that certain principles are enshrined in their systems".

In addition, the reference in two Articles (99&100A) to harmonisation measures in general and not to Directives strengthens the view that Regulations could be used in some cases for the achievement of harmonisation. Finally, the fact that Regulations are directly applicable "...rendering automatically inapplicable any conflicting provision of current national law" and the uniformity they achieve make them essential for the harmonisation process in a limited number of cases.

---

110 See Note 14.


112 D. Lasok, loc.cit.


CHAPTER 1

The most serious disadvantage of Regulations stems from the fact that they result in a transfer of competence from the national to Community level as regards the issue they deal with and thus they cause a diminution of national sovereignty, since normally there is no implementation process carried out by national authorities.\textsuperscript{116} Given that taxation is one of the most important areas where national sovereignty is expressed, Regulations are avoided as an instrument of tax harmonisation, but this cannot theoretically exclude them from being a potential instrument of tax harmonisation. With regard to indirect taxation Article 99 of the EC Treaty can accommodate the use of Regulations,\textsuperscript{117} whereas for direct taxation Article 100 does not provide the necessary framework and recourse should be sought in cases where Regulations are needed for the harmonisation of direct taxes to Article 235.

c) Directives

The instrument most extensively used for the harmonisation of laws is the Directive. Many provisions in the EC Treaty provide for Directives as the sole instrument for carrying out harmonisation (21, 54 par.2, 56 par.2, 57, 63 par.2, 69, 70, 100, 101 par.2, 112).\textsuperscript{118}


\textsuperscript{117} Council Regulation 218/92 of 27/1/92 on Administrative Cooperation in the Field of Indirect Taxation (VAT) (OJ 1992, L24/1).

\textsuperscript{118} Articles 69 and 70 shall cease to exist after 1/1/1994 pursuant to
Such preference for Directives is justified by reason of their flexible nature which is the result of the specific procedure according to which they are put into effect. Directives set out the objective(s) that must be achieved and leave Member States to which they are always addressed the choice of form and methods for the achievement.¹¹⁹

As regards the forms and methods it is apparent that they include two elements: i) The form of national legislation passed with a view to transposing the Directive into the national legal order¹²⁰ and ii) The content of that legislation.¹²¹ Hence, the advantages of Directives are that the process of their transposition into national law diminishes the element of surrender of national sovereignty and offers the Member States a greater degree of discretion. What

Article G(15) of the Treaty on European Union.

¹¹⁹ In exceptional cases Directives may be so detailed that they do not offer any choice or discretion to Member States, e.g. Directive 75/34 on the right of nationals of Member States to remain in the territory of another Member State after having pursued therein an activity in a self-employed capacity (OJ 1975, L14/10).

¹²⁰ It can have the form of a Parliamentary Act, of a Decree, of a Decision or whatever the Constitution of the respective Member State provides, but it cannot have the form of administrative practice.

¹²¹ "It can be a verbatim reenactment which has the advantage of preserving the Community nature of the instrument or a translation into the legal idiom of the Member State, which may make the measure more comprehensible to the citizens", A. Easson, 'Approximation and Unification of Laws in the EEC', (1978-79) 2 Journal of European Integration 375 at 383.
safeguards Directives from any attempts of the Member States to circumvent them by not transposing them is that they become directly effective after the time limit they provide in their final provision has elapsed,\textsuperscript{122} in so far as the other conditions for becoming directly effective are met.

On the other hand, the most serious disadvantages of Directives are also related to the specific procedure followed for their implementation. In the first place, Member States often do not transpose Directives at all or transpose them into national law improperly which results in the appearance of serious deviations from the framework laid down by those Directives.\textsuperscript{123} Secondly, even if Member States are willing to comply with a Directive and to transpose it properly, the process of transposition may take considerable time so that there will be a gap between the adoption of the Directive and its coming into effect. Thirdly, there is a lack of uniformity since Member States by passing legislation in order to transpose a Directive may not enact identical but similar rules and such a similarity may imply differences capable of undermining the original objectives set out by the Directive.

All the above mentioned comments apply to tax Directives as

\textsuperscript{122} Ratti, Case 148/78, [1979] ECR 1629.

\textsuperscript{123} See House of Lords Select Committee on European Communities, 17th Report, 23/7/1991, p.19: "In regard to the problem of national implementation of Directives he [Prof. J. Usher] stressed that the development by the EC of the doctrine of direct effect had been a response to national failures to implement or using a spot of wishful thinking as to what the Directive actually says".
CHAPTER 1

well with emphasis on that referring to the diminution of national sovereignty. Indeed, this is the main reason that explains why tax harmonisation almost exclusively has employed this instrument. Furthermore, it has to be mentioned that the drafting of tax Directives is quite difficult since effort must be made not to leave loopholes and consideration must be given to the special circumstances often existing in one or more Member States.

d) Decisions

Decisions might theoretically constitute an instrument of harmonisation in so far as they are addressed to Member States and request them to adapt their laws to the content of a Decision. However, such view can hardly be put into practice and for this reason some authors do not include Decisions among the instruments of harmonisation. It seems though that in some cases Decisions might be used as an instrument of coordination of policies rather than as an instrument of harmonisation of laws.

e) Recommendations

Recommendations having no binding effect may play only an indirect and minor role in harmonisation of laws. They can be used in order to preserve an already achieved harmony (Article 102) or as

a preliminary step towards harmonisation (Article 27).\textsuperscript{125} However, their practical contribution to the process of harmonisation is almost non-existent.

f) Conventions

Although Conventions are an instrument for cooperation rather than harmonisation of laws, their inclusion in Article 220 of the EC Treaty transforms them in respect of the cases mentioned in this Article into an instrument of harmonisation. Consequently, if Conventions are used outside the framework described in Article 220 there will be a violation of Article 5 of the Treaty.

Article 220 of the EC Treaty provides for the conclusion of Conventions relating to specific matters and constitutes the legal basis of the harmonisation of laws by means of Conventions. Five Conventions have already been signed so far: a) The Convention on the Mutual Recognition of Companies and Legal Persons of 29 February 1968\textsuperscript{126} b) The Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters of 27 September 1968\textsuperscript{127} and its latest version signed on 16 September 1988,\textsuperscript{128} c) The Convention on

\textsuperscript{125} Although in this case the instrument of Recommendations proved to be ineffective and recourse was sought to Article 235 and to Regulations.

\textsuperscript{126} EC Bulletin Supplement 2/1969.

\textsuperscript{127} OJ 1978, L304/77.

\textsuperscript{128} OJ 1988, L319/9.
the Simplification of Formalities in Trade of Goods,\textsuperscript{129} d) The Convention on a Common Transit Procedure of 20 May 1987\textsuperscript{130} and e) The Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises of 23 July 1990.\textsuperscript{131} Furthermore, other Conventions\textsuperscript{132} signed by the Member States but not pursuant to a provision of the EC Treaty could be considered under certain conditions\textsuperscript{133} as part of Community law.

In certain cases Conventions may be the appropriate instrument and especially in areas where there is not only Community but also international interest and the achieved result (Convention) has to be extended to cover non-EC countries. However, the small number of the so far concluded Conventions together with the fact that even in the areas described in Article 220 harmonisation has been carried out by other instruments rather than by Conventions imply the existence of some disadvantages. Indeed, Conventions need several rounds of negotiations, are subject to ratification by national Parliaments and the signing parties are entitled to express their reservations in declarations at the end of the text of a Convention.

\textsuperscript{129} OJ 1987, L134/2.
\textsuperscript{130} OJ 1987, L226/2.
\textsuperscript{131} OJ 1990, L225/10.
\textsuperscript{132} Community Patent Convention signed on 15/12/1975 (OJ 1976, L17/1), but still not in force.
g) Judgments of the European Court of Justice\textsuperscript{134}

An indirect, though significant, instrument for harmonisation of laws is the judgments of the European Court of Justice, in so far as they are related to legal interpretation. Such interpretation often involves the establishment of doctrines and may lead to an indirect making of law, as in the \textit{Cassis de Dijon}.\textsuperscript{135} This should be considered in line with the Member States' obligation to comply with the Court's judgments\textsuperscript{136} which means that the doctrines included in the rulings of the Court receive a wide recognition by the Member States and more or less take their place in each Member State's legal system. As regards tax harmonisation the Court has played a significant part by interpreting fundamental tax concepts and giving rulings which contain some conclusions that cannot be disregarded by national tax laws. For example, there are some very important judgments on the interpretation of Article 95 concerning discriminatory internal taxation,\textsuperscript{137} on the interpretation of VAT

\textsuperscript{134} Or of the Court of First Instance.

\textsuperscript{135} Case 120/78, [1979] ECR 649.

\textsuperscript{136} Articles 5 and 171, the latter as was amended by Article G(51) of the Treaty on European Union.

rules and on discriminatory application of corporate taxation.

1.4. The Progress of Tax Harmonisation in the EC

Harmonisation of indirect taxes has followed a different pattern from the harmonisation of direct taxes. In the first place, there is a difference in the legal basis in the sense that the harmonisation of indirect taxes is based on a specific Article (Article 99), whereas the harmonisation of direct taxes is based almost exclusively on a general Article (Article 100). Secondly, although both categories of tax harmonisation share the same general objectives, they differ in relation to the specific ones. In particular, the harmonisation of indirect taxes has been targeted towards the abolition of the fiscal obstacles which hinder the free movement of goods, whereas the harmonisation of direct taxes is aimed

---


140 With the exception of customs duties which have been unified and not harmonised under Part Three Chapter One of the EC Treaty.

141 In some cases the harmonisation of direct taxes can be based on Article 220 but in practice preference has been given to Article 100.

142 The promotion of fiscal integration and the progress of economic integration in the European Community.
at dealing with the disparities of national tax laws which cause distortions to the flow of capital, to competition and result in a waste of resources. Thirdly, the harmonisation of indirect taxes has almost been accomplished, whereas the harmonisation of direct taxes is at its very first stages.

Despite the foregoing differences, the two categories of tax harmonisation are considered as the two sides of the same coin. In view of this, it is believed that there is a great deal of interaction between the two categories, to the extent that both of them are essential for a Market free of tax distortions. For instance, the elimination of fiscal barriers by the means of the harmonisation of indirect taxes reveals another kind of tax distortion, that is the distortion of competition and the waste of resources caused by the disparities of the different national corporate tax laws.

Another aspect of the special relation between the two categories of tax harmonisation is that the progress and the problems of the harmonisation of indirect taxes could lead to useful conclusions with regard to the potential trends and problems in the process of the harmonisation of direct taxes, which is in its primary stage. A comparative study of the evolution tax harmonisation in both fields could also display the caution and often the hesitation with which tax issues are approached in the Community's legal order.

The first step towards fiscal integration was the EC Treaty signed in Rome in 1957 and put into effect from the 1st of January 1958. Apart from the inclusion of an Article on the harmonisation of indirect taxes (Article 99) and from another general Article that
could accommodate the harmonisation of direct taxes (Article 100),
the Treaty included an exhaustive timetable for the abolition of
customs duties between Member States (Articles 12-18) and detailed
provisions for the adoption of a Common Customs Tariff (Articles
19-29). Where it was necessary secondary Community legislation
(Regulations) completed the legal framework provided in the Treaty
and the result was the achievement of a Customs Union by the
instrument of tax unification.

The second important step towards fiscal integration and the
first by the means of tax harmonisation has been the imposition of a
common turnover tax without cascade effects. The first notion on
such tax can be found in the Report of "Working Group Number One" set
up with the task of assessing the impact of differing systems of
indirect taxation on Community Trade. A further recommendation for
a common system of turnover taxation was made by the Neumark
Committee in its Report released in 1963. In view of these Reports
a Value Added Tax was introduced in 1967 with the 1st VAT Directive,
which provided for a consumption type tax comprising all stages of

---

143 e.g. Regulation 802/68 on the Determination of Origin of Goods (JO
1968, L148/1); Regulations 222/77 (OJ 1977, L38/1), 1901/85 (OJ 1985,
L179/6) and 1062/87 (OJ 1987, L107/1) concerning Community Transit;
Regulation 1224/80 (OJ 1980, L134/1) relating to Common Valuation
Rules, etc.

144 European Documents IV/5285/89.

145 International Bureau of Fiscal Documentation, The EEC Reports On
Tax Harmonization, Amsterdam, 1963.

production and trade and using the tax credit method. In addition, the second VAT Directive\textsuperscript{147} described the structure of the new tax which was scheduled to be imposed from 1/1/1970. The following three VAT Directives amended the deadline, since some Member States were not able to comply with their obligation and the date of the imposition changed to 1/1/1973. However, the most important measure with regard to the new tax has been the sixth VAT Directive\textsuperscript{148} which established a uniform basis of assessment for the tax.\textsuperscript{149}

Two important documents, namely the "Report on the Scope for the Convergence of Tax Systems"\textsuperscript{150} and the Commission's White Paper on the Internal Market\textsuperscript{151} gave a notion of the Commission's views vis-à-vis indirect taxation in the 80's. These views were shared by the Council of Ministers (ECOFIN) which reached a political agreement on 24 June 1991. The main points of the agreement are the following: i) The introduction of an interim VAT System which will apply from 1/1/1993 to 31/12/1996 (Transitional Period) and will be based on the destination principle with the exception that VAT will not be levied at the borders but in the hands of the importer, ii) From 1/1/1996 the origin principle will apply,\textsuperscript{152} iii) A normal rate was agreed from 1/1/1993 equal to or higher than 15%, iv) One or two reduced rates

---

\textsuperscript{147} Directive 67/228 (JO 1967 L1303).
\textsuperscript{148} Directive 77/388 (OJ 1977, L145/1).
\textsuperscript{149} Since then several Directives have been proposed and adopted.
\textsuperscript{150} EC Bulletin, Supplement 1/80.
\textsuperscript{151} COM(85) 310 final.
\textsuperscript{152} The tax will be levied in the Member State of origin.
are permitted equal to or higher than 5% for certain goods which were listed.\textsuperscript{153} v) The introduction of a system of administrative cooperation in the field of indirect taxation with the aim to counteract tax evasion when border controls are abolished and f) Minimum rates of excise duties on mineral oils alcohol and tobacco were agreed.\textsuperscript{154}

However, the political agreement achieved in June 1991 must become legally binding by the inclusion of its points in legal instruments. So far one Directive on the transitional VAT system\textsuperscript{155} and one Regulation on the administrative cooperation\textsuperscript{156} have been adopted and what remains to be done is the adoption of a number of legislative measures that give legal effect to the remaining points of the political agreement. The adoption of these measures must have been completed in time for the establishment of the Internal Market (1/1/1993).

As regards the other forms of indirect taxation it must be

\textsuperscript{153} During the transitional period any reduced rates lower than 5% may be kept.

\textsuperscript{154} From mineral oils only the rates applying to kerosene and LPG/methane remain to be decided, from alcohol the rates applying to wine and other stronger spirits and from tobacco the rates applying to products other than cigarettes.

\textsuperscript{155} Directive 91/680 supplementing the Common system of VAT and amending Directive 77/388 (OJ 1991, L376/1), including also a first reference to the principle of origin that will apply to VAT in the post-1996 era.

\textsuperscript{156} Council Regulation 218/92 on the administrative cooperation in the field of indirect taxation (OJ 1992, L24/1).
mentioned that in the field of excise duties two tobacco Directives were adopted in the 70’s\textsuperscript{157} but there is a great deal of work to be done in order to transform the political agreement reached in the ECOFIN into legally binding measures.\textsuperscript{158} Community legislation also has been introduced in respect of capital duties\textsuperscript{159} and proposed with regard to stamp duties on transactions in securities.\textsuperscript{160}

In contrast to the successful evolution of harmonisation in the field of indirect taxation the respective developments in the field of direct taxation were not so promising at least until recently. The theoretical origins of tax harmonisation with respect


\textsuperscript{160} Proposed Directive on stamp duties on Transactions in Securities, COM(87) 139 final (OJ 1987, C115).
to direct taxes can be identified in the Neumark Report\textsuperscript{161} which advocated the introduction of a similar type of global income tax with a similar bracket structure (but not similar rates) and the adoption of a split-rate system\textsuperscript{162} for the integration of corporate with personal taxation. Furthermore, the influence of direct and especially corporate taxes on the proper functioning of the Common Market was clearly described in the Segré Report\textsuperscript{163} which concluded that tax considerations should not be allowed to affect capital mobility.

In the light of those two Reports the Commission of the EC published the "Programme for the Harmonization of Direct Taxes"\textsuperscript{164} in which it supported the introduction of a single corporate tax system with similar rates and base and the adoption of a comprehensive income tax. In its attempt to implement that Programme the Commission adopted a Regulation on cross-border workers,\textsuperscript{165} set up a Committee of Experts with the task to recommend the most appropriate

\begin{description}
\item[\textsuperscript{161}] International Bureau of Fiscal Documentation, \textit{The EEC Reports on Tax Harmonization}, Amsterdam 1963.
\item[\textsuperscript{162}] Further information on this system will be provided in Chapter 2.
\item[\textsuperscript{163}] European Taxation 1967, p.212.
\item[\textsuperscript{164}] EC Bulletin Supplement, 8/1967.
\item[\textsuperscript{165}] Regulation 1612/68 (JO 1968, L257); Not a pure direct tax harmonisation measure since it was based on Articles 48 and 49 of the EC Treaty.
\end{description}
corporate tax system\textsuperscript{166} and proposed a series of Directives,\textsuperscript{167} of which only four were adopted, one in 1977\textsuperscript{168} and the other three 21 years after their proposal (one of them not as a Directive but as a Convention).\textsuperscript{169}

The 80's started with the release of another Programme under the title "Report on the Convergence of Tax Systems"\textsuperscript{170} in which the Commission reinforced its commitment to the proposals it had drafted and particularly stressed the importance of the 1975 Proposed Directive. In 1984 the Commission proposed a Directive on the Carry-Over of Losses\textsuperscript{171} and in 1988 it presented a preliminary Draft

\textsuperscript{166} Van Den Tempel Report, \textit{Corporation Tax and Individual Income Tax in the European Communities}, Amsterdam, 1970; The Report recommended the adoption of the classical system (further discussion on this will take place in Chapter 2).


\textsuperscript{168} Directive 77/799 (OJ 1977, L336/15) on the Mutual Assistance by the Competent Authorities of the Member States in the field of direct taxation, later extended to VAT.


\textsuperscript{170} EC Bulletin, Supplement 1/80.

\textsuperscript{171} COM(84) 404 final (OJ 1984, C253/5) and COM(85) 319 final (OJ 1985,
Directive on the Harmonisation of Corporate Tax Base.\textsuperscript{172}

The crucial turning point was in 1990 when the Commission rearranged its priorities and altered its strategy in the field of direct taxation in its Communication to the Council and the European Parliament.\textsuperscript{173} With this document the Commission abandoned the 1975 Proposed Directive and expressed its commitment to deal with the tax problems relating to cross-border operations. It also announced its intention to set up a Committee of experts which would report on the distortions caused to the Internal Market by different corporate tax laws and in the light of the recommendations of the Committee the Commission would set out its long-term objectives. As a result of the Communication, the Council adopted two Directives and one Convention in July 1990,\textsuperscript{174} two Directives were proposed\textsuperscript{175} and the Committee (Ruding Committee) was set up by the end of 1990 and after several meetings between January 1991 and February 1992 it reported its recommendations in early 1992.\textsuperscript{176} What is apparent from all these

\textsuperscript{172} XV/2788-EN.
\textsuperscript{174} See Note 167.
\textsuperscript{176} The recommendations were published on 18 March 1992 (Commission of the EC, Conclusions and Recommendations of the Committee of
facts is that harmonisation in the field of direct taxation, at least for the time being, has taken the meaning of corporate tax harmonisation.¹⁷⁷

1.5. The Significance of Corporate Tax Harmonisation

Corporate taxation is one of the factors that influence investment decisions, capital mobility and competition in a market,¹⁷⁸ especially when that market comprises of several tax jurisdictions. The post-1993 European Market offers a great deal of opportunities to enterprises which are not orientated towards domestic markets, but the existence of twelve different corporate tax laws is a serious impediment to the creation of the appropriate environment for efficient competition between companies. Thus, the issue of corporate taxation within the Common Market has been put at the centre of interest as the crucial date of 1/1/1993 is approaching.

Four aspects of corporate taxation are worth being examined in the context of the Common Market, namely the tax base, the tax rates, Independent Experts on Company Taxation. Brussels, March 1992—hereafter called Ruding Committee’s Recommendations), whereas the full text of the Ruding Report is expected to be published later in 1992.

¹⁷⁷ Indeed proposals concerning other issues direct taxation do not progress at all, as for instance the Proposal for a Directive on a Common System of Withholding Tax on Interest Income (OJ 1989, C141).

¹⁷⁸ Other reasons are economic and political stability, infrastructure, labour costs, etc.
the cross-border operations (including double taxation problems) and
the integration of corporate with personal taxation. In view of
this, harmonisation of corporate tax law means the process within the
EC destined to eliminate the obstacles to the establishment and the
distortions to the proper functioning of the Common Market caused by
the disparities of national corporate tax laws in a way that produces
similar, or in exceptional cases identical, rules throughout the EC.

At this point it must be clarified that the purpose of this
research is to focus on corporate income tax which is the most
important tax provided in corporate tax law and any future reference
to corporate taxation or to corporate tax law should be construed in
this context. In view of this clarification, the question that must
be answered concerns the "essentialness" of the process of corporate
tax harmonisation in the EC or, in other words, the problem that
corporate tax harmonisation is intended to tackle.
CHAPTER 2

THE PROBLEM

2.1. Introduction

The purpose of this Chapter is to describe the existing disparities between the corporate tax laws of the Member States and to prove that these disparities cause serious distortions to the establishment and the proper functioning of the Common Market. It is exactly these tax distortions which create the problem in the field of corporate taxation in the EC and offer corporate tax harmonisation the justification for its existence.

2.2. Principal Differences Between the Twelve Corporate Tax Laws

The disparities between the twelve corporate tax laws will be allocated into five categories four of which correspond to the four aspects of European corporate taxation (cross-border operations, tax base, tax rates, tax system) mentioned in the previous Chapter. The analysis of the disparities will be facilitated to a great extent by commenting on the Tables included in the Appendix to this Chapter.

---

1 Chapter 1 (1.5.); The fifth will include all those issues which cannot be classified into any of the four categories.

2.2.1. Cross-Border Operations

a) Withholding Taxes

Withholding taxes are taxes imposed on the payment of dividends, interest and royalty and have dual function. First, at domestic level, they are used as an instrument of combating tax evasion by tracing the recipient of the payment and for this reason they are credited against the recipient's income tax liability (See Table 1 of the Appendix). Secondly, at international level, withholding taxes are imposed on cross-border payments by the State from which the payment of the dividend, interest or royalty originates and in this case these taxes remain unrelieved constituting an additional tax burden for the recipient (company or individual).

Given that the rates of withholding taxes differ among Member States it is obvious that with regard to an investment in the same Member State companies and individuals of the other 11 Member States do not compete on equal terms due to different withholding taxes. For example, an Italian subsidiary in Germany will pay 10% when distributing dividends to the parent company, whereas a British subsidiary in Germany has to pay 15%. This implies that investing in Germany is more expensive for a British company than for its Italian competitor due to taxation. Such cases violate the fundamental ideological principles of the Single Market which is a market of free

---

3 In other words they operate as a partial prepayment of the income tax.
4 See Table 1 of the Appendix.
and, above all not distorted, competition.

However, the Parent-Subsidiary Directive together with the Proposed Directive on the Cross-Border payments of Interest and Royalties have removed the tax distortion to a great extent but not completely, since distortions will remain in relation to payments between companies not qualifying for the beneficial treatment provided in those measures and to payments to individuals.

b) Double Taxation of Foreign Source Income

The income a parent company derives from its subsidiaries and branches is subject to taxation in the Member State of the subsidiary or the branch as well as in the Member State in which that parent is located. Such double taxation is avoided completely or reduced significantly by the means of two methods which are applied by the Member State of the parent either unilaterally or pursuant to the respective provision of the Double tax treaty that may exist between the Member State of the parent and that of the branch or subsidiary.

According to the first method (exemption method) the foreign source income is exempted for domestic corporate income tax purposes and it is not subject to taxation. This method is simple and secures

---


6 This issue could be also included in the tax base but its importance for cross-border operations is greater.

7 See Table 2 of the Appendix.
the avoidance of tax distortions to investment-making induced by the Member State of the parent. The disadvantage lies in the fact that the tax authorities of the Member State of the parent have to accept the calculation of the profits of the foreign income as such calculation was made by the tax authorities of the State of the subsidiary (or branch) in accordance with the rules of the tax law of the latter.

As regards the second method (credit method), the tax paid in the Member State of the subsidiary (or branch) is credited against the corporate income tax liability of the parent company and in order for this liability to be determined the foreign income is taken into account. If the credit for the foreign tax is limited to the amount that would have been paid had the profits been generated domestically the credit method is called "partial credit method". Conversely, when, in cases where the foreign tax exceeds the domestic tax liability, the State of the parent company reimburses that company the amount by which foreign taxes exceed domestic tax liability "full credit" is given.

The advantage of the credit method, in particular of the "full

---

8 The so-called Capital Import Neutrality which will be discussed in Chapters 4 and 5.

9 This version is the one applied by those Member States which use the credit method; See Table 2 of the Appendix.

10 Such cases are hypothetical because States always apply the partial credit method.
is that a company investing in the Single Market knows in advance that the amount of tax it will pay for its foreign activities will be the same as it would have been had the activities taken place domestically. As a result, it does not matter if there are differences between the tax regimes of the Member States where an investment will be made (through the establishment of a subsidiary), since the tax burden, due to the credit offered in the State of the parent, will be the same. However, the administrative complexities accompanying this method in combination with the cases where domestic tax liability is lower than the foreign taxes already paid constitute the most important disadvantages of the method in question.

It becomes obvious from Table 2 that Member States are divided into two almost equal groups each of which applies one of the foregoing methods. Such division is not welcomed and does not help in the creation of tax environment which will help companies to plan their expansion in the Single Market. Finally, as it will be explained in Chapters 5 and 6 the solution given by the Parent-Subsidiary Directive is not perfect, since it does not cover all the cases.

c) Tax Discrimination Against Companies of Other Member States

The conclusion that can be drawn from Table 3 of the Appendix is that most Member States (Denmark, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, U.K.) do not discriminate

\[\text{And of the partial credit method insofar as the domestic income tax liability is equal to or exceeds the foreign tax already paid.}\]
against branches of companies residing in other Member States in contrast to Belgium and France which do so. Such discrimination is not in accordance with Article 52 of the EC Treaty and with the principle of free competition that is destined to characterise the Single Market.

d) Group Taxation - Consolidation of Taxable Profits and Losses

Three Member States (Belgium, Greece, Italy) have not included in their corporate tax laws provisions on group taxation, that is the taxation of associated companies as a whole by permitting the offsetting of losses between them. Conversely, six Member States (Denmark, Germany, Luxembourg, Netherlands, Portugal and Spain) permit group taxation but only with regard to resident companies and under different requirements. Furthermore, two Member States (Ireland, U.K.) permit group taxation to some extent and only one Member State may permit on certain conditions the extension of group taxation to subsidiaries in other Member States.

The lack of measures which would permit parent companies situated in a Member State to offset the losses incurred by their subsidiaries and branches located in other Member States as well as the offsetting of losses between subsidiaries or branches belonging to the same group is a serious impediment to the cross-border movement of capital in the Single Market. Such situation prevents Europe-wide groups from having a clear overall picture of their

---

12 See Note 6.
13 See Table 4 of the Appendix.
performance, penalizes enterprises for doing business in more than one tax jurisdiction, which after all are within the Single Market, and may result in unrelieved losses. Finally, it is worth noting that the Proposed Directive on the Offsetting of Losses is a step towards the elimination of the distortion mentioned above, though not enough.

e) Tax Treaty Network

As it is shown in Table 5 of the Appendix there are Member States which have not concluded tax treaties yet (e.g. Greece-Denmark, Ireland-Spain, Netherlands-Portugal, etc.). Such gap in the treaty network causes serious problems with emphasis on the issue of tax discrimination, which constitutes one of the gravest threats to the Single Market. More specifically, if due to the lack of treaties or due to the existence of two tiers of treaties companies or individuals from certain Member States enjoy a preferential treatment in comparison to their competitors from other Member States this will result in the undermining of the Single Market.

Finally, attention must be given to the conclusion of tax

---

14 Where the parent has losses a subsidiary has profits and another subsidiary has losses.

15 COM(90) 595 final (OJ 1991, C53/30); The Proposed Directive will be further discussed in Chapters 5 and 6.

16 For example a Member State may have concluded some treaties with certain Member States which offer more benefits compared with the treaties concluded with the other Member States.
treaties between Member States and non-EC States and especially the
capital exporting states of Japan and USA, because if a Member State
offers those states tax advantages through the conclusion of tax
treaties there is a danger of capital concentration in that Member
State at the expense of its Community partners. Such development
would undermine economic cooperation between Member States and would
endanger the merits of a Single Market.

2.2.2. The Corporate Tax Base

The tax base is perhaps the most important element of every
type of taxation, because it defines the physical or legal person
having a tax liability and provides the rules for the assessment of
that tax. In the case of corporate taxation the tax base consists of
a number of components which need to be discussed separately.

a) Definition of the Taxpayer and of the Taxable Income

As shown in Table 6 of the Appendix there is unanimity among
Member States on the taxpayer of corporate tax, since in all the
twelve countries tax liability is levied on resident companies.
However, there are differences in relation to the criteria employed
for the determination of the tax residence\footnote{\textsuperscript{17}} and there are also
differences on the concept of company.\footnote{\textsuperscript{18}} Moreover, all Member States

\footnote{\textsuperscript{17} For example Place of Incorporation, Place of Effective Management,
Statutory Place, etc.}

\footnote{\textsuperscript{18} Differences resulting from the field of Company law. Nevertheless,
in all Member States public companies (sociétés anonymes) are subject}
but France impose corporate taxation on the worldwide income of companies: France taxes only the income arising within France (territoriality principle).

As regards the concept of income there are not significant differences\(^1\) in the sense that all Member States regard profits as income. In particular, all Member States but Ireland and the United Kingdom consider as corporate income the profits and the capital gains of companies without distinguishing between the two, whereas Ireland and the United Kingdom treat profits and gains separately.\(^2\) Conversely, greater differences exist in respect of what the corporate tax law of each Member State excludes from the corporate tax base as it is indicated in Table 7 of the Appendix.

Finally, a serious problem results from the fact that Member States are divided into two schools in relation to the accounting methods for the determination of taxable profits.\(^3\) More specifically, in eight Member States (Belgium, France, Germany, Greece, Italy, Luxembourg, Portugal, Spain) the linkage between the taxable profits and the profits reported for commercial purposes is very close to the extent that in certain cases the former are

\(1\) If there were any attempt to achieve harmonisation would be condemned to failure "a priori".

\(2\) Due to the fact that these two countries apply the rules and the rate of corporate tax on gains the practical difference is minor and is restricted to cases where capital losses cannot be offset against profits but have to be set off against capital gains.

\(3\) See Table 6 of the Appendix.
identical with the latter. On the other hand, in four Member States (Denmark, Ireland, Netherlands, United Kingdom) such linkage is not close at all with the rules for determining the commercial profits being stricter.

In conclusion, it is very encouraging that a minimum convergence exists as regards the fundamental concepts of the corporate tax base (income, subjects to taxation) but such convergence has not been extended to the other components of the tax base as the analysis that follows will prove. However, the existence of different accounting methods poses a great threat for companies operating in Member States belonging to different schools of accounting, since such companies have to meet different accounting standards at the expense of their efficiency.

b) Allocation of the Tax Base Between Tax Jurisdictions and Transfer Pricing

The problem of dividing the corporate tax base among different states arises with regard to multinational companies involved in business in more than one Member State. As a result, the Member State in which a subsidiary operates will subject the profits of that subsidiary to corporate taxation and when the profits are repatriated the Member State of the parent will exercise its own tax right as well. The danger of double taxation is reduced by tax treaties and

22 The issue is also related to cross-border operations, but its importance for the determination of the tax base is so great that it has to be considered in this part.
the measures taken at Community level but the problem of fair revenue sharing between the State of source and the State of residence still remains.

The problem has also another aspect, that of income tracing on the part of the tax authorities of the Member State in which the parent company is situated. In particular, if these authorities wish to examine whether the foreign source income declared by a parent company is true or whether there is foreign source income undeclared they are faced with a huge administrative burden. Furthermore, the "transfer pricing" techniques employed by associated companies in a multinational group constitute an additional obstacle to the task of tax authorities.

The term "transfer pricing" is used to describe the pricing of transfers of goods, services, know-how and patents between the companies which form a group (affiliated companies). In some cases the prices charged for the aforementioned transactions between affiliated companies diverge considerably from the prices which would have been agreed upon between unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market. Any future reference to "transfer pricing" in this thesis should be construed as meaning this type of transfer pricing whose effect is the transfer of profits from a high tax jurisdiction

23 e.g. the Parent-Subsidiary which will be discussed in Chapter 5.
24 The so-called internation or interjurisdictional equity which will be further analysed in Chapter 4.
25 The so-called arm's length prices.
CHAPTER 2

to a low tax jurisdiction.

For example, a parent company in Germany producing machines can start producing only the different parts comprising the machines and establish a subsidiary company in Ireland which would be the assembly factory. Given that the tax rate in Germany is 50% and in Ireland for manufacturing companies 10% the German parent may sell its products to the Irish subsidiary at cost prices without profits and without being liable to corporate tax. Then the Irish subsidiary can charge the products as much as it is considered profitable to the group since it will pay only 10% corporate tax (in contrast to 50% in Germany) and finance the parent by loans whose interests will be deductible expenses in relation to the parent's corporate tax liability.26

As shown in Table 8 of the Appendix, all Member States apply the "separate accounting" method according to which each enterprise in a group of associated companies is treated as a separate entity from the taxation point of view, a theory that could be regarded as a fiscal myth in the real world of modern multinational groups. Such approach facilitates transfer pricing since tax authorities are not in a position and above all are not entitled to have an overall picture of the activities of the group. In addition, the application of the "arm's length" principle together with the readjustment of profits27 in cases where transfer pricing occurs does not always

26 Such financing is called "thin capitalisation" and will be discussed in another part of this Chapter.

27 This method is followed by all Member States as indicated in Table
produce satisfactory results, especially when there is strong economic interdependence between the companies forming the group or there are no market prices to be used for comparison.

Finally, it has to be mentioned that the establishment of the Internal Market from 1/1/1993 has already encouraged the formation of Europe-wide groups\textsuperscript{28} which means that the application of "separate accounting" based on the "arm's length" principle will become more difficult. The adoption of the "Arbitration Convention"\textsuperscript{29} for reasons explained in Chapter 5 will not deal with the substance of the problem whose the exact dimensions will be fully realised after the establishment of the Single Market.

c) Depreciation

The term "depreciation" denotes a capital allowance offered for certain assets (tangible and intangible) and deductible partly from the profits of the accounting year within which the expenditure for the acquisition of the assets took place and partly from the profits of the subsequent accounting years until the value of that asset has been written off. With regard to the methods of depreciation it has to be noted that these are mainly two, namely the "straight line" method and the "declining balance" method. According to the former the cost of acquisition of an asset is written-off in

\footnote{8 of the Appendix.}

\textsuperscript{28} This trend has been confirmed by the 1991 records of the management consulting firm KPMG and by the daily announcement of take-over bids.

\textsuperscript{29} 90/463 (OJ 1990, L225/10); It will be discussed in Chapter 5.
equal amounts over a period of years,\textsuperscript{30} whereas under the latter a constant rate is applied first on the cost of acquisition and then to the remaining cost (in some cases the rate is periodically reduced) over a period of years which results in a decline of the amount written off each year. In cases where a high initial (first year) allowance or in particular where very high rates of depreciation are provided the depreciation is called "accelerated depreciation".

In view of these conceptual clarifications, the conclusion that can be drawn from Table 9 of the Appendix is that the differences between Member States as regards depreciation rules are significant. Nine Member States permit only the application of the straight line method in respect of buildings\textsuperscript{31}, whereas three (Belgium, Germany, Netherlands) allow corporations to choose between the two methods.\textsuperscript{32} As regards depreciation of machinery in three Member States (Belgium, Greece, UK)\textsuperscript{33} only the declining balance method is available, in two Member States (Ireland, Italy)\textsuperscript{34} the opposite happens and in the remaining Member States both methods are acceptable.\textsuperscript{35}

\textsuperscript{30} For example 10\% of the cost each year.

\textsuperscript{31} The rates range from 2 to 7\%.

\textsuperscript{32} The rates for declining balance method are not permitted to exceed twice or three times the rates of straight line method.

\textsuperscript{33} Rates varying from 10 to 25\%.

\textsuperscript{34} Rates 10-25\%.

\textsuperscript{35} Rates for straight line from 8 to 25\% and for declining balance method from 1.5 to 3XSL rates.
CHAPTER 2

Turning to intangible assets there is a great variety in the way national corporate tax laws deal with the issue. For example, the depreciation of intangible assets is not permissible in Denmark and Luxembourg fully permissible in Belgium, Greece and Netherlands and partially permissible in the other Member States. In addition, "accelerated depreciation" is used by all Member States, but in some of them (France, Germany, Luxembourg, Netherlands and to some extent UK) the tendency to limit it with a view to abolishing it has become apparent in the recent years in contrast to the other Member States (Belgium, Denmark, Greece, Ireland, Italy, Portugal and Spain) which use it as a tax incentive.

In conclusion, the discrepancies that exist between Member States with regard to depreciation rules undermine the simplicity of the corporate tax base and to a great extent lead to a tax distorted competition due to the advantages that are offered to companies investing in Member States which apply accelerated depreciation or having a more attractive system of depreciation rules. The offer of tax incentives through the tax base does not conform to the current trends of corporate tax philosophy and endangers the attempt to simplify corporate taxation.

d) Deductible Expenses

The corporate tax laws of all Member States provide for the

---

36 This means that some Member States permit the depreciation of goodwill others the depreciation of patents, trademarks and others a combination of the intangibles; See Table 9 of the Appendix.
deduction of certain expenses incurred by companies from their profits. The justification of such deductibility lies in the fact that corporate taxation in its present form is oriented towards the genuine profits and not the receipts of companies. Moreover, it is apparent that the allowance of expenses on a large scale has a declining effect on the corporate tax base and on the amount of corporate tax liability.

The conclusion that can be drawn from Table 10 of the Appendix is that there has been a convergence of the twelve corporate tax laws in relation to the general definition of the concept of "deductible expenses". As a result, all Member States regard the deductible expenses as expenses closely related to the operation of a business and especially to the acquisition and maintenance of business income. Some very common expenses which are deductible for corporate income tax purposes in all Member States include wages, royalties, payment of interest, travelling expenses advertising expenses, indirect and local taxes, social security payments.

Notwithstanding these similarities, significant disparities still exist between the twelve corporate tax laws with regard to company cars, entertainment expenses, payment of commissions, payment of penal or criminal fines, payment of damages, executive remuneration and headquarters expenses. These disparities cause problems to companies involved in business in more than one Member States, and complicate the determination of the tax base for Europe-wide groups.
e) Reserves and Provisions

It is clearly shown in Table 11 of the Appendix that the twelve corporate tax laws have included rules on provisions and reserves. These rules vary widely from one Member State to another resulting in a complication of the tax base and in the distortion of competition. The latter is attributed to the fact that companies located in those Member States which permit a wide range of provisions and reserves gain an advantage from the resources point of view over their competitors situated in Member States which restrict the use of provisions and reserves.

f) Stock Valuation

The valuation of stock is very important for the determination of the corporate tax base and for the corporate tax liability of companies. The word "stock" as it is used in the twelve corporate tax laws means trading stock comprising raw materials, finished but not sold products and work in progress. The basis for the assessment of stock is the historic cost (cost of acquisition or cost of production) which is acceptable by all Member States or the market value. As regards the methods for the valuation these are mainly three. Under the first method (First In First Out) the first items

---

37 = Existence of an amount of money that remains untaxed and destined to meet payments or losses which are likely to be incurred but uncertain as to the exact amount or the exact date on which they will arise.

38 See Table 12 of the Appendix.
purchased are assumed to be disposed first, whereas according to the 
second method (Last In First Out) the last obtained items are assumed 
to have been disposed first. The significant difference between 
these two methods is that where FIFO is applied increases induced by 
inflation are taxed. Under the third method (Weighted Average) 
calculations are based on the average price of the items comprising 
the stock.39

Turning to the conclusions from Table 12 of the Appendix, it 
is worth mentioning that one Member State applies only the LIFO 
method (Germany), two others only the FIFO method (Ireland, UK) four 
Member States both methods (Belgium, Greece, Italy, Portugal), three 
the FIFO and Weighted Average methods (Denmark, France, Spain) and 
two all the three methods (Luxembourg, Netherlands). Such diversity 
in the application of methods for the valuation of stock and 
especially the fact that methods permissible in one Member State are 
not permissible in others causes a great deal of confusion and 
results in tax induced distortions to competition. This happens with 
companies which are not allowed to choose from the variety of methods 
and which are placed in a disadvantageous competitive position 
vis-à-vis those companies located in Member States permitting such 
choice.40

39 For example if 20 items were purchased at a price of 40 GBP and 20 
items were purchased at the price of 50 GBP the average cost of each 
item will be: (20x40) + (20x50) = 800 + 1,000 = 1,800 : 40 = 45 GBP.

40 Such choice is important because a company will apply the method 
that suits its needs and corresponds to the economic environment at a 
given time.
g) Carry-Over of Losses

Companies often have losses due to reasons linked with the economic climate (e.g. recessions) or with their own individual position (losses due to expansion). If such losses are not relieved the future of companies that have suffered losses will be undermined with numerous sideeffects (redundancies, insolvencies, etc.) and corporate taxation will result in subjecting non genuine profits to taxation (since there will not be any offset of losses against profits). Thus, corporate tax laws worldwide provide for the carry-over of companies' losses and for their offsetting against previous or future profits.

The situation in the EC as it is shown in Table 13 of the Appendix is characterised by diversity. In particular, the carry-back method is not acceptable by the majority of Member States (Belgium, Denmark, Greece, Italy, Luxembourg, Portugal and Spain), whereas there is a significant difference between Member States in respect of the duration of application of the carry-forward method. As regards the distortions caused by the existence of such a variety of national provisions, these are identical with those mentioned in the cases of deductible expenses, reserves and provisions and valuation of stock.

41 5 years in Denmark, France, Greece, Italy, Luxembourg, Portugal, Spain, 8 years in the Netherlands and indefinitely in Belgium, Germany, Ireland, and UK.
h) Capital Gains

The taxation of gains from the sale of tangible and intangible business assets\(^4^2\) plays a very important role in the determination of the corporate tax base insofar as such gains are treated as income.\(^4^3\) Indeed, in all Member States except Ireland and the UK gains from the disposal of business assets are regarded as taxable profits and are included in companies' annual income.\(^4^4\) This means that they can be offset against losses and the opposite, that is capital losses can be deducted from taxable profits.

However, the separation of taxable profits from capital gains that exists in Ireland and the UK, despite the fact that gains are subjected to corporate tax rates, in combination with the different exemptions and special treatment of certain gains provided by the twelve corporate tax laws result in considerable differences with regard to the tax burden of European companies. This has inevitably serious repercussions on the competitiveness of companies inducing tax distortions to competition.

i) Thin Capitalisation

The term "thin capitalisation" describes that situation in which a parent company lends its foreign subsidiary (or vice versa)

\(^{42}\) Or from compensation related to the involuntary removal of business assets (loss, theft, damage).

\(^{43}\) Or in the case of capital losses they are treated as ordinary business losses.

\(^{44}\) See Table 14 of the Appendix.
greater amounts of money than those which would be lent by an unconnected party and on terms which would not normally have been agreed by unrelated parties (arm's length principle). Such loan financing is in fact a long-term equity finance and affects the corporate tax base insofar as it diverts profits from a country with high taxation\footnote{The diversion takes place through the payment of interest which is considered as a deductible expense.} to a country with lower taxation.

The increase in the acquisitions of companies in Europe and in the formations of Europe-wide groups within the Internal Market will provide a friendly environment for thin capitalisation. In addition, the lack of specific provisions dealing with the issue in the majority of Member States (Belgium, Denmark, Greece, Italy, Luxembourg, Netherlands, Portugal and Spain)\footnote{See Table 15 of the Appendix.} facilitates the carrying-out of thin capitalisation schemes. The application of the arm's length principle will be difficult in the Internal Market for the same reasons which were mentioned in the case of transfer pricing. Finally, assuming that a potential adoption of a certain debt/equity ratio runs the risk to be regarded as arbitrary the solution of the problem posed by thin capitalisation must be sought outside the framework of "separate accounting".

2.2.3. Tax Rates

Before discussing the differences that exist between the Member States with regard to tax rates it is worth drawing a
distinction between "statutory or nominal" tax rates and "effective or actual" tax rates. The former are provided in the corporate tax law of each Member State and determine the amount of corporate tax liability when they are applied to the taxable profits of companies. The latter are the result of economic analysis and represent "the percentage by which taxation reduces net capital income defined as total receipts minus total costs". In other words, an effective tax rate takes into account not only the statutory tax rate but also all the other elements determining the tax liability such as the tax base and the system of integration of corporate with personal taxation. As a result, effective tax rates can estimate the pre-tax rate of return that is required in order for the investment to be profitable.

The conclusion that can be drawn from Table 16 of the Appendix in respect of the statutory tax rates Member States apply is that a convergence of these rates has been achieved. The convergence was initiated by the corporate tax changes implemented in the United Kingdom in 1984 and the trend was followed by almost all western countries. With the exception of Germany in relation to retained


48 Effective tax rates can give a clear picture of the tax distortions caused to capital movements in the Internal Market and for this reason they will be discussed in 2.3. where reference to the distortions caused by the disparities of national corporate tax laws will be made.
profits and of Ireland in respect of manufacturing companies the statutory corporate tax rates of Member States have converged around the 35% with a 3% divergence downwards and 5% upwards. Moreover, many Member States apply a reduced corporate tax rate on small companies or companies of vital importance for their economies (e.g. Belgium, Ireland, Luxembourg, Portugal, Spain, UK).

What is really significant about the corporate tax rates of the twelve is that they have been brought into alignment to a great extent and that the process of convergence is continuous.49 In contrast to the differences concerning the rules for the determination of the corporate tax base the differences relating to corporate tax rates, although they are not eliminated, are constantly reduced.

2.2.4. The Corporate Tax System50

The integration of corporate income tax with personal income tax is one of the oldest and most controversial problems in the field of corporate taxation. The aim of integration is to mitigate or to eliminate the double taxation of dividends which are subject to corporate tax as taxable profits at the corporate level and to personal income tax at the shareholder level. In the attempt to

49 Denmark has enacted a 4% reduction from 38% to 34% and Greece is cutting its corporate tax rate from 46 and 40% to 35%.

50 This term is used for the system of integration of corporate with personal taxation.
review the existing systems of integration Figure 1\textsuperscript{51} will be quite helpful.

\textbf{INTEGRATION OF TAXES}

\textbf{(FIGURE 1)}

\textbf{NO INTEGRATION} \hspace{1cm} \textbf{FULL INTEGRATION}

\textbf{(Classical System)} \hspace{1cm} \textbf{(Partnership Method)}

\textbf{PARTIAL INTEGRATION}

\textbf{CORPORATE LEVEL} \hspace{1cm} \textbf{SHAREHOLDER LEVEL}

\textbf{Dividend Split Rate}

\textbf{Dividend Deduction} \hspace{1cm} \textbf{Dividend Exemption}

\textbf{(Shareholder Relief Scheme)}

\textbf{Imputation} \hspace{1cm} \textbf{Full} \hspace{1cm} \textbf{Partial}

\textbf{Full Exemption} \hspace{1cm} \textbf{Partial Exemption}

\textsuperscript{51} This figure has been developed from a similar one in S. Cnossen, 'Corporation Taxes in OECD Member Countries', (1984) 38 Bulletin of the International Bureau of Fiscal Documentation, 483 at 484.
Double taxation of dividends exists under the classical system which does not offer any relief for the tax paid at the corporate level. 52 This system favours the retention of profits by companies (since distribution will give rise to further taxation) and discriminates between equity and loan finance giving preference to the latter (dividends unlike interest are not deductible). However, it has also significant advantages namely its administrative simplicity and its neutrality with respect to cross-border payment of dividends. 53

The opposite of the classical system is the partnership method under which the profits of a company are allocated to its shareholders according to their shareholding and as a result only personal income tax is imposed. This method which practically abolishes corporate tax though much discussed has not been accepted by any Member State.

The system laying in the middle is that of partial integration which aims at integrating corporate tax paid in respect of distributed profits with personal income tax and can take place either at the corporate level or at the shareholder level. In the former case, corporate tax is levied on what remains from the

52 This system is applied by Luxembourg, the Netherlands and partially by Belgium; See Table 17 of the Appendix.

53 Resident shareholders do not have a more advantageous position compared to non-resident as it happens with the credits accompanying the imputation systems.
CHAPTER 2

deduction of dividends from taxable profits\textsuperscript{54} or two different corporate tax rates apply one to retained profits and another one (reduced) to distributed profits.\textsuperscript{55} In the latter case, either income derived from dividends is not subject to personal income tax (or is partially subject)\textsuperscript{56} or corporate tax paid at the corporate level on dividends is partially or fully imputed against shareholders' income tax liability.\textsuperscript{57}

The conclusion that can be drawn from Table 17 of the Appendix is that eight Member States apply a form of the imputation system (Belgium, France, Germany, Ireland, Italy, Portugal, Spain and UK) although some of them apply the imputation method concurrently with other methods (Belgium-classical, Germany-split rate). The advantages of the imputation system lie in the mitigation of the discrimination between retained and distributed profits and of the discrimination between equity and debt finance. Nevertheless, it is not an easily administered system (since it involves tax crediting of the corporate tax paid and application of the credit to personal

\textsuperscript{54} This system is applied by Greece; See Table 17 of the Appendix.

\textsuperscript{55} This method has been adopted by Germany; See Table 17 of the Appendix.

\textsuperscript{56} Partial exemption (or Partial Shareholder Relief Scheme) is the system applied by Denmark; See Table 17 of the Appendix.

\textsuperscript{57} Full imputation is applied by Belgium with respect to permanent participations, Germany and Italy. Partial imputation is applied by Belgium with respect to non-permanent participations, Ireland, Portugal, Spain, UK and France (the system in France is practically a full imputation system); See Table 17 of the Appendix.
income tax liability) and poses two problems with regard to cross-border situations.

The first problem refers to the tax credit accompanying the dividend and destined to be imputed against the tax liability of the recipient. Such credit is not available to non-residents in certain Member States (Germany, Italy, Portugal and Spain), whereas in others the availability of the credit is contingent upon certain conditions. Given that the concept of non-residents coincides to a great extent with the concept of non-nationals, a discrimination problem arises with regard to those non-residents who are nationals of one of the Member States.

The second problem concerns Advance Corporation Tax (ACT) imposed by Ireland and the UK and précompte levied by France. The imposition of these taxes takes place each time a company distributes its profits and the payment is set-off against the corporate tax liability of the company. As a result, if a company receives its income from foreign sources and does not have domestic corporate tax liability such offsetting cannot happen and if it does not have even in the future any carrying-forward of the surplus ACT will prove to be meaningless.

In conclusion, the imputation system as it stands induces tax

---

58 In Ireland and the UK upon the existence of a relevant provision in the Double tax treaty; in France upon the payment by the distributing company of a précompte mobilier.

59 The French précompte and the Irish surplus ACT may be refundable subject to the existence of relevant provisions in tax treaties.
distortions to cross-border investment flows and contributes to the continuation of the fragmentation of the capital markets in the European Community. On the other hand, the classical system is responsible for the economic double taxation of dividends which causes economic distortions as was mentioned above. Finally, the differences between Member States on corporate tax system will be another reason for the existence of distortions to capital flow\textsuperscript{60} in the Single Market.

2.2.5. Local and Other Specific Income Taxes on Companies

Six Member States (France, Germany, Italy, Luxembourg, Portugal and Spain)\textsuperscript{61} levy local income taxes which are deductible for corporate income tax purposes (except in Portugal) but not imputed against corporate tax liability.\textsuperscript{62} In some cases (France, Germany, Luxembourg) the corporate tax base is not identical with the local business tax base due to the existence of different rules. In contrast to these six Member States three Member States (Belgium, Greece, Netherlands) do not subject companies to any other kind of income taxation (except for corporate taxation), whereas five Member States (Denmark, France, Ireland, Spain and UK) provide for special

\begin{footnotesize}
\begin{enumerate}
\item Classical system is less attractive than an imputation system which extends the tax credit to non-resident shareholders.
\item See Table 18 of the Appendix.
\item Treatment of local taxes as deductible expenses for corporate tax purposes does not achieve full integration as it is achieved in cases where corporate tax liability is reduced by the amount of local taxes paid.
\end{enumerate}
\end{footnotesize}
CHAPTER 2

income taxation on specific companies.

Local and other specific income taxes constitute an additional tax burden on companies and the differences existing between Member States on this issue introduce tax distortions to free competition, since companies established in certain Member States are faced with additional costs due to this extra-form of income taxation. In addition, the different rules applying to the corporate tax base and the tax base of the other income taxes cause administrative complexities and impede any attempt to simplify the tax base which is essential for the effectiveness of corporate taxation.

2.2.6. Tax Incentives

The term "tax incentive" is construed as "a special tax measure which is a deliberate departure from the regular provisions of the income tax system prevailing in a country and is designed to encourage some activity". Tax incentives are offered by means of reduced tax rates or through the corporate tax base or even

---

63 Given that the income taxes in question are partially and not fully integrated with corporate tax, as was mentioned above.
64 M. Dominic, Income Taxation and Foreign Investment in Developing Countries, Amsterdam, 1990, p.231.
65 See Table 16 of the Appendix.
66 Investment reductions, investment reserves, investment credits, accelerated depreciation.

106
through tax holidays67 and special tax regimes68 (See Table 19 of the Appendix).

All Member States more or less have included tax incentives in their corporate tax laws and it is worth noting that these incentives differ from one Member State to another.69 There is no doubt that by virtue of their functioning tax incentives cause tax distortions to capital flows, since the adoption of such incentives purports to attract investments and divert the flow of capital from economically efficient investing schemes to less efficient but more profitable (due to the mitigation of tax liability resulting from the incentives) schemes. Furthermore, the existence of tax incentives and especially of those offered through the tax base contributes to the complication of corporate taxation and violates the principle of free competition which is one of the fundamental principles upon which the functioning of the Single Market is based.

2.3. Distortions Caused by the Tax Differences to the Single Market

Before discussing the distortions caused by the tax differences it should be mentioned that corporate taxation is not the

67 Partial or full exemption from corporate taxation for some years.

68 Special corporate tax regimes applying to certain categories of companies, mainly holding companies and coordination centres.

69 The Dutch corporate tax law after its 1989 offers less tax incentives compared to the other 11 and since 1989 the Netherlands has become a strong opponent to tax incentives.
only factor that causes distortions. In fact, there are other factors which may cause equally (or more) serious distortions, such as the economic climate (interest rates-inflation rates), infrastructure, labour costs, political stability, non-tax obstacles to cross-border operations, etc. Assuming that some of the non tax induced distortions will be eliminated within the Internal Market\textsuperscript{70} and other factors being equal the interest is focused on the corporate tax factor.

2.3.1. Tax Distortions to Capital Flows

Different rules on the treatment of foreign source income, different rules concerning the corporate tax base, different (though converging) statutory tax rates, different corporate tax systems and different local corporate taxes and incentives play a decisive role in the flow of capital in the EC and in investment-making. Projects which in the absence of so grave corporate tax differences would not attract investors' interest can materialise due to their profitability resulting from the disparities between the twelve corporate tax laws.

The distortions to capital flows in the EC can be clearly identified from the consideration of the effective tax rates which as has already been mentioned\textsuperscript{71} indicate the minimum inflation adjusted pre-tax rate of return that is required for a project to be

\textsuperscript{70} Non tax obstacles to cross-border operations, economic convergence through the EMU.

\textsuperscript{71} See 2.2.3.
profitable. The method for the calculation of the effective tax rates is attributed to two prominent economists (M. A. King – D. Fullerton)\textsuperscript{72} and measures the corporate tax component of the cost of capital. It is worth noting at this point that due to the fact that the method in question is the product of considerations based on the economic science the present thesis as a legal one will not enter the debate on the method "per se" but it will make use of its results which are understandable by non-economists.

The effective tax rates for purely domestic investments in each Member State are shown in Table 20 of the Appendix, whereas the respective rates for intra-Community investments through subsidiaries are included in Tables 21, 22 and 23. These Tables have been copied from a 1991 OECD Report\textsuperscript{73} and are based on the corporate tax regimes of the Member States as at January 1991\textsuperscript{74} and on certain assumptions.\textsuperscript{75}

The first conclusion that can be drawn from the Tables is that the differences between corporate tax laws have an impact on the

\textsuperscript{72} M. A. King-D. Fullerton, The Taxation of Income From Capital: A Comparative Study of the US, the UK, Sweden and West Germany, 1984 University of Chicago Press.

\textsuperscript{73} OECD, Taxing Profits in a Global Economy; Domestic and International Issues, Paris, 1991.

\textsuperscript{74} The corporate tax regimes have been subjected to minor changes compared to the situation as it stands this year and as it was described in 2.1 and therefore the results of the economic analysis are not outdated.

\textsuperscript{75} 5\% required post-tax return, 4.5\% inflation everywhere, 5\% real interest rate, fixed exchanged rates; It is worth noting that the economic parameters do not differ from the EMU scenario.
corporate tax component of the cost of capital with regard to purely domestic investments (Table 20 of the Appendix). In particular, such cost varies from 0.0 (Greece) to 1.3 and the effective tax rates range between 5.0 (Greece) and 6.3 (Luxembourg). If a comparison is made between the domestic effective tax rates and the effective tax rates applying to intra-Community investments (Tables 21,22,23 of the Appendix) the latter are higher.\textsuperscript{76}

The implication from this comparison is that by virtue of corporate taxation (all the other factors being equal, which seldom happens) domestic investments have an advantage over intra-Community investments. Furthermore, the differences between the twelve corporate tax laws on dealing with cross-border issues proves to cause serious tax distortions to the Internal Market by contributing to a great extent to the increase of the tax burden of companies involved in business in more than one Member State compared to the tax burden faced by purely domestic companies. As a result of it, the European Market will remain a fragmented market unless an alignment of domestic and intra-Community effective tax rates takes place by reducing the disparities between the twelve corporate tax laws and by abolishing the hidden disincentives that exist with respect to intra-Community investments.

The second obvious conclusion is that if a company located in a Member State intends to invest in another Member State by setting

\textsuperscript{76} There are very few exceptions which do not change the average since there are also very high effective tax rates; e.g in Table 22 Ireland (residence) Portugal (source) 22.2.
up a subsidiary the investment will be more profitable if it is made in certain Member States due to corporate tax reasons. For example, if a UK parent decides to finance a subsidiary by new equity the ideal location from the taxation point of view for setting up the subsidiary would be Italy (effective tax rate 4.8%) or Denmark (5.7%) and certainly not France or Ireland (8.2%). If the other factors affecting an investment become similar due to the process of EMU (convergence of interest and inflation rates, exchange rates stability or even single currency) and to the elimination of other obstacles hindering intra-Community distortions as the era of the Internal Market is approaching such tax distortions to investment decisions will become more apparent leading to a misallocation of resources.\footnote{Resulting from investing not in the most efficient project but in a less efficient project which due to corporate tax reasons is more profitable than the former.}

The possible appearance of such trend is confirmed by the fact that even nowadays when the other factors affecting an investment are not equal the tax factor is seriously taken into account by investors. For example, according to a survey carried out on behalf of the Ruding Committee\footnote{Ruding Report Chapter 5, Ruding Committee's Recommendations p.22.} the tax factor is always or usually a major factor in decisions concerning the location of a production plant for the 48% of the respondents whereas the percentage is 38% with regard to sales outlets, 41% for research and development centres, 57% for coordination centres and 78% for financial centres. Another survey
carried out by the Institute for Fiscal Studies among UK companies\textsuperscript{79} showed that 47.8\% of the respondents always give relevant consideration to corporate taxation before investing whereas 18.9\% always regard the tax factor as a major factor. In view of this, it can be supported that if the other factors are assimilated the tax factor will play an even more decisive role in investment-making.

The third conclusion is derived from the high effective tax rates that exist in respect of capital flows between certain Member States. For example, for cross-border capital flows (Subsidiary financed by equity from the Parent, Table 22 of the Appendix) between Greece (residence) and Denmark the rate is 13.8, between Greece and Portugal 11.6 and between Greece and Spain 11.8. As regards capital flows concerning the financing of subsidiaries by loans from their parent companies (Table 23 of the Appendix) the effective tax rates are 11.7 in the case of flows between Portugal (residence) and Ireland (source) 16.9 between Ireland and Spain and 15.7 between Ireland and Greece. In view of these, it has to be mentioned that cross-border flow of capital between Member States without a double tax treaty becomes very expensive and is seriously impeded.

Given the convergence of statutory corporate tax rates\textsuperscript{80} the distortion to capital flows in the Internal Market must be attributed primarily to the differences between the twelve corporate tax laws on the regulation of cross-border operations and on the rules for the

\begin{footnotesize}

\textsuperscript{80} See Table 15 of the Appendix, and 2.2.3. of this Chapter.
\end{footnotesize}
determination of the corporate tax base. Of equal importance are the distortions caused by the surplus Advance Corporate Tax or précompte and the imputation tax credits restricted to residents only.\textsuperscript{81}

2.3.2. Tax Distortions to Free Competition

The principle of free competition is one of the fundamental principles upon which the functioning of the Single Market is based.\textsuperscript{82} Thus, any distortions caused by the differences of the twelve corporate tax laws to that principle are in fact tax induced distortions to the Single Market.

The first distortion can be identified in the corporate tax component cost of capital which varies considerably from one Member State to another (See Table 20 of the Appendix). In Member States where the cost of capital is high the companies located in these States are faced with higher overall costs due to corporate taxation than their competitors situated in Member States where the corporate tax component of the cost of capital is low. As a result, the competitiveness of the former is reduced compared to the latter with distorting effects on the principle of free competition.

The second distortion is caused by different rules on cross-border operations and in particular by rules concerning consolidation of accounts and treatment of foreign source income. Parent companies located in Member States where consolidation of

\textsuperscript{81} See 2.2.4.

\textsuperscript{82} See Article 102a of the EC Treaty as amended by Article G(25) of the Treaty on European Union.
accounts and group taxation\textsuperscript{83} are permissible gain an advantage (by reducing their corporate tax liability and therefore their costs) over their competitors situated in Member States where such provisions do not exist. Furthermore, the competitiveness of companies located in Member States applying the exemption method\textsuperscript{84} to foreign source income are in a better position from the competitiveness point of view than those companies situated in Member States permitting the credit method with respect to foreign source income derived from a low tax Member State.\textsuperscript{85} 

Free competition is also distorted by the different rules concerning the tax base and this is obvious since such rules determine the amount of corporate tax liability of each company. If the result of the application of these rules is a high tax burden for a company, the overall costs of this company will be high in contrast to other companies located in other Member States where the respective rules will produce a lower amount of corporate tax liability.\textsuperscript{86} Similar distortions are also caused by different

\textsuperscript{83} See Table 4 of the Appendix and 2.2.1 d.  
\textsuperscript{84} See Table 2 of the Appendix and 2.2.1. b.  
\textsuperscript{85} This is so because the company deriving income from a low tax Member State will not pay tax on this income if it resides in a Member State which permits the exemption method whereas another company deriving income from the same Member State will pay if it is resident in a Member State where the credit method applies.  
\textsuperscript{86} e.g different provisions on deductible expenses, depreciation, stock valuation, reserves, carry-over of losses result in different amounts of corporate tax liability and therefore in different overall
statutory corporate tax rates (although the convergence of rates which has taken place in the 80's and 90's has reduced such distortions), by the application or not of local business taxes and by the adoption or not of tax incentives.

In conclusion, the disparities between the twelve corporate tax laws force European companies to compete on unequal terms.\textsuperscript{87} Conversely, the theory of free competition on which the Internal Market is based requires that companies should compete on equal terms and no advantages strengthening the competitiveness of companies should be offered to them. Such a view that favours the economic survival of the most efficient companies cannot be put into practice unless the tax induced distortions caused by the disparities to free competition are removed.

2.3.3. Distortions to Economic Efficiency

Tax distortions to capital flows resulting from the differences between the twelve corporate tax laws undermine economic efficiency in the European Community and cause a misallocation of resources. It is beyond doubt that when companies invest not in the most efficient project but in the most profitable from the taxation point of view or when projects are not taken by the most efficient companies because these companies make less attractive bids than their less efficient competitors due to tax reasons economic costs affecting competitiveness.

\textsuperscript{87} Other factors may lead to such a kind of competition, but the present thesis is interested only in the corporate tax factor.
efficiency is distorted.

In addition, distortions to free competition in the Internal Market have an impact on economic efficiency in the sense that tax advantages offered to companies\(^8^8\) cover up their inefficiencies and close the gap between efficient and inefficient companies created by those inefficiencies. Such an equalisation of efficient and inefficient companies is contrary to the principle of an open market, as the Internal Market purports to be, and induces a waste of resources in the European Community.\(^8^9\)

Finally, the waste of resources within the European Community caused by the existing tax differences between Member States will have a negative impact on the standards of productivity. This in turn will reduce the Community's overall competitiveness vis-à-vis the non-EC countries and especially its major competitors (USA, Japan).\(^9^0\)

2.3.4. Discriminations

The principal corporate tax differences between the twelve Member States are held responsible for numerous cases of various forms of discrimination. As it has been described in the first part of this Chapter (2.2.e) the corporate tax law of each Member State

\(^8^8\) Due to the disparities of national tax laws.

\(^8^9\) See also the reference to the "efficient allocation of resources" in Article 102a of the EC Treaty as amended by Article G(25) of the Treaty on European Union.

\(^9^0\) Ruding Committee's Recommendations, p.22.
treats foreign income acquired in other Member States and domestic income earned by companies located in other Member States in accordance with the provisions of the bilateral treaty that exists between the States involved in each case. Given that tax treaties are not identical in all cases there is not equal treatment applying to all Member States and this is confirmed by the different effective tax rates in Tables 21, 22 and 23 of the Appendix.

Discriminations resulting from the corporate tax system\(^91\) and from the adoption of tax incentives concerning specific companies\(^92\) together with discriminations originating from the rules relating to the corporate tax base\(^93\) will lead to a fragmentation of the Single Market unless measures are taken for their elimination.

2.3.5. Administrative and Compliance Problems

The existence of so many differences between the twelve corporate tax laws poses serious obstacles to the work of national tax authorities which attempt to trace the income of companies earning that income in other Member States. Even the application of the credit or the exemption method with regard to foreign source

\(^{91}\) Surplus Advance Corporate tax or précompte and imputation credits restricted to residents only in the case of imputation systems or discrimination against distribution of profits and equity finance in the case of classical systems.

\(^{92}\) Companies involved in certain activities (e.g. financial, manufacturing) or established in certain locations.

\(^{93}\) E.g. depreciation rules and exclusions from the tax base favouring companies in certain sectors of the economy.
income can be thrown into doubt if the calculation of the tax paid abroad was made in accordance with rules which are not acceptable by the tax authorities of the Member State in which the company with the foreign source income is located. Furthermore, the formation of Europe-wide groups of companies which has increased due to the prospect of the establishment of the Internal Market will add more complexities to the task of national tax authorities.

Turning to compliance costs it is worth noting that the "greater the difference in tax rules between Member States, the higher the overall costs of compliance" which is absolutely right in relation to companies doing business in more than one Member State. Such companies must comply with different and in some cases conflicting corporate tax rules and must set up different tax planning schemes suitable for the jurisdictions involved in each case.

Finally, frequent changes of tax legislation, inconsistent rulings within a tax administration and, above all, the uncertainty caused by the different and sometimes conflicting corporate tax rules of the twelve constitute a serious impediment to cross-border operations and undermine the unity of the Single Market.

2.4. The Urgent Need for Measures Dealing with the Problem

The disparities between the corporate tax laws of the Member States described in the first part of this Chapter and the serious

---

distortions they cause to the proper functioning of the Single Market in combination with the fact that spontaneous action by national governments can only eliminate a small fraction of these disparities dictate the adoption of measures at the Community level. Such measures will constitute the core of the corporate tax harmonisation process and together with the convergence of the twelve corporate tax laws that takes place with respect to certain elements of corporate taxation (e.g. statutory tax rates, gradual abolition of incentives offered through the tax base, etc.) will provide the formula for the solution of the problem.

However, any attempt to harmonise the corporate tax laws of the Member States will fail unless it corresponds to the political and economic developments taking place in the European Community. Such view stems from the sensitive political aspects of the problem the discussion of which will constitute the subject-matter of the following Chapter.
APPENDIX TO CHAPTER 2

1 Tables 1-19 of the Appendix are based on data from the periodicals Supplementary Service to European Taxation and Tax News Service edited by the International Bureau of Fiscal Documentation.
Tables 20-23 have been copied from: OECD, Taxing Profits in a Global Economy: Domestic and International Issues, Paris 1991.

120
### Table 1

<table>
<thead>
<tr>
<th>RESIDENCE SOURCE</th>
<th>BELGIUM</th>
<th>DENMARK</th>
<th>FRANCE</th>
<th>GERMANY</th>
<th>GREECE</th>
<th>IRELAND</th>
</tr>
</thead>
<tbody>
<tr>
<td>DENMARK</td>
<td>15-0-0</td>
<td>30-0-0²</td>
<td>0-0-0</td>
<td>10-15-0</td>
<td>30-30-30</td>
<td>0-0-0</td>
</tr>
<tr>
<td>FRANCE</td>
<td>15/10-15/10-0</td>
<td>0-0-0</td>
<td>0-35-0</td>
<td>15/0-0-0</td>
<td>25-10/0-5</td>
<td>15/10-0</td>
</tr>
<tr>
<td>GERMANY</td>
<td>15-0-0</td>
<td>10-0-0</td>
<td>10-0-0</td>
<td>25-0-0³</td>
<td>25-10-0</td>
<td>15-0-0</td>
</tr>
<tr>
<td>GREECE</td>
<td>25-15-5</td>
<td>42-46-0</td>
<td>42-10-5</td>
<td>25-10-0</td>
<td>42-25-0</td>
<td>42-46-0</td>
</tr>
<tr>
<td>IRELAND</td>
<td>0-15-0</td>
<td>0-0-0</td>
<td>0-0-0</td>
<td>0-0-0</td>
<td>0-29-29</td>
<td>0-29-29</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>15/10-0-0</td>
<td>15/5-0-0</td>
<td>15/5-0-0</td>
<td>15/10-0-5</td>
<td>15-0-10/12</td>
<td>15/5-0-0</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>15/5-0-0</td>
<td>15/0-0-0</td>
<td>15/5-0-0</td>
<td>15/10-0-0</td>
<td>15/5-0-0</td>
<td>15/0-0-0</td>
</tr>
<tr>
<td>UK</td>
<td>0-0-0</td>
<td>0-0-0</td>
<td>0-0-0</td>
<td>0-0-0</td>
<td>0-0-0</td>
<td>0-0-0</td>
</tr>
</tbody>
</table>

The first figure refers to dividends the second to interest and the third to royalty. Where / this symbolizes the existence of a second rate applied under certain conditions.
TABLE 1 cont.

<table>
<thead>
<tr>
<th>RESIDENCE</th>
<th>ITALY</th>
<th>LUXEMBOURG</th>
<th>NETHERLANDS</th>
<th>PORTUGAL</th>
<th>SPAIN</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>FRANCE</td>
<td>15-15/10-0</td>
<td>15/5-10/0-0</td>
<td>15/5-10/0-0</td>
<td>15-10/12-5</td>
<td>15/10-10-5</td>
<td>15/5-0-0</td>
</tr>
<tr>
<td>GERMANY</td>
<td>10-10-5</td>
<td>10-0-5</td>
<td>15-0-0</td>
<td>15-10-10</td>
<td>15-10-5</td>
<td>15-0-0</td>
</tr>
<tr>
<td>GREECE</td>
<td>35/25-10-5</td>
<td>42-46-0</td>
<td>35-10-7</td>
<td>42-46-0</td>
<td>42-46-0</td>
<td>42-0-0</td>
</tr>
<tr>
<td>IRELAND</td>
<td>0-10-0</td>
<td>0-0-0</td>
<td>0-0-0</td>
<td>0-29-29</td>
<td>0-29-29</td>
<td>0-0-0</td>
</tr>
<tr>
<td>ITALY</td>
<td>-----</td>
<td>15-10-10</td>
<td>32.4/0-15/12.5/25-0</td>
<td>15-15-12</td>
<td>15-12-4/8</td>
<td>5/15-10/0-8</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>15-0-10</td>
<td>15-0-0 (^6)</td>
<td>15/25-0-0</td>
<td>15-0-10/12</td>
<td>15/5-0-10</td>
<td>15/5-0-5</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>0-0-0</td>
<td>15/2.5-0-0 (^7)</td>
<td>25-0-0</td>
<td>25-0-0</td>
<td>15/5-0-0</td>
<td>15/5-0-0</td>
</tr>
<tr>
<td>SPAIN</td>
<td>15-12-8/4</td>
<td>15/10-10-10</td>
<td>15/10/5-10-6</td>
<td>15/10-15-5</td>
<td>25-25-25</td>
<td>15/10-12-10</td>
</tr>
<tr>
<td>UK</td>
<td>0-10-8</td>
<td>0-0-5</td>
<td>0-0-0</td>
<td>0-10-5</td>
<td>0-12-10</td>
<td>0-25-25</td>
</tr>
</tbody>
</table>

\(^1,3,6,7,8,9\) Creditable against domestic income tax liability.
\(^2\) Final tax if the resident recipient receives 30,000 Dkr, 15% in excess.
\(^4\) Due to the dividend deduction system Greece applies withholding tax as a final tax and no corporate income tax is levied on this income.
\(^5,10\) No withholding tax if the recipient is a 51% parent.
<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>DIVIDENDS FROM FOREIGN SUBSIDIARY</th>
<th>INCOME FROM FOREIGN BRANCH</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>UNILATERAL</td>
<td>BY TREATY</td>
</tr>
<tr>
<td>BELGIUM</td>
<td>EXEMPTION / CREDIT</td>
<td>EXEMPTION / CREDIT</td>
</tr>
<tr>
<td>DENMARK</td>
<td>50% EXEMPTION / CREDIT</td>
<td>EXEMPTION / CREDIT</td>
</tr>
<tr>
<td>FRANCE</td>
<td>EXEMPTION</td>
<td>EXEMPTION</td>
</tr>
<tr>
<td>GERMANY</td>
<td>CREDIT</td>
<td>EXEMPTION</td>
</tr>
<tr>
<td>GREECE</td>
<td>CREDIT</td>
<td>CREDIT</td>
</tr>
<tr>
<td>IRELAND</td>
<td>DEDUCTION</td>
<td>CREDIT</td>
</tr>
<tr>
<td>ITALY</td>
<td>60% EXEMPTION / CREDIT</td>
<td>60% EXEMPTION / CREDIT</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>CREDIT</td>
<td>EXEMPTION</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>EXEMPTION</td>
<td>EXEMPTION</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>DEDUCTION</td>
<td>CREDIT</td>
</tr>
<tr>
<td>SPAIN</td>
<td>CREDIT</td>
<td>CREDIT</td>
</tr>
<tr>
<td>UK</td>
<td>CREDIT</td>
<td>CREDIT</td>
</tr>
</tbody>
</table>
**TABLE 3**

**TAX TREATMENT OF FOREIGN BRANCHES**

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>TAX TREATMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>BELGIUM</td>
<td>HIGHER TAX RATE (42.05%) FOR DUTCH, FRENCH AND LUXEMBURGER BRANCHES.</td>
</tr>
<tr>
<td>DENMARK</td>
<td>EQUAL TREATMENT</td>
</tr>
<tr>
<td>FRANCE</td>
<td>NORMAL TAX RATE (34%) + 8%</td>
</tr>
<tr>
<td>GERMANY</td>
<td>PREFERENTIAL TREATMENT (LOWER TAX RATE 46%)</td>
</tr>
<tr>
<td>GREECE</td>
<td>EQUAL TREATMENT</td>
</tr>
<tr>
<td>IRELAND</td>
<td>EQUAL TREATMENT</td>
</tr>
<tr>
<td>ITALY</td>
<td>EQUAL TREATMENT</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>EQUAL TREATMENT</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>EQUAL OR PREFERENTIAL TREATMENT</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>EQUAL TREATMENT</td>
</tr>
<tr>
<td>SPAIN</td>
<td>EQUAL TREATMENT</td>
</tr>
<tr>
<td>UK</td>
<td>EQUAL TREATMENT</td>
</tr>
</tbody>
</table>
# Table 4: Group Taxation

<table>
<thead>
<tr>
<th>Member State</th>
<th>Group Taxation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>No Provision</td>
</tr>
<tr>
<td>Denmark</td>
<td>For resident corporations only. 100% ownership is needed.</td>
</tr>
<tr>
<td>France</td>
<td>For resident corporations. 95% ownership is needed, for foreign subsidiaries subject to approval by the authorities</td>
</tr>
<tr>
<td>Germany</td>
<td>For resident corporations only on certain conditions</td>
</tr>
<tr>
<td>Greece</td>
<td>No provision</td>
</tr>
<tr>
<td>Ireland</td>
<td>Not group taxation but transfer of losses and gains permissible on certain conditions for resident only</td>
</tr>
<tr>
<td>Italy</td>
<td>No provision</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>Only for resident corporations (75% ownership), subject to approval by the authorities</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Only for resident (99% ownership)</td>
</tr>
<tr>
<td>Portugal</td>
<td>Only for resident (90% ownership), subject to approval</td>
</tr>
<tr>
<td>Spain</td>
<td>Only for resident (90% ownership)</td>
</tr>
<tr>
<td>UK</td>
<td>Transfer of losses and gains on certain conditions and only for resident corporations</td>
</tr>
<tr>
<td>MEMBER STATE</td>
<td>MEMBER STATES WITH WHICH THERE IS A TAX TREATY</td>
</tr>
<tr>
<td>--------------</td>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td>BELGIUM</td>
<td>DEN, FRA, GER, GRE, IRE, ITA, LUX, NET, POR, SPA, UK</td>
</tr>
<tr>
<td>DENMARK</td>
<td>BEL, FRA, GER, IRE, ITA, LUX, NET, POR, SPA, UK</td>
</tr>
<tr>
<td>FRANCE</td>
<td>BEL, DEN, GER, GRE, IRE, ITA, LUX, NET, POR, SPA, UK</td>
</tr>
<tr>
<td>GERMANY</td>
<td>BEL, DEN, FRA, GRE, IRE, ITA, LUX, NET, POR, SPA, UK</td>
</tr>
<tr>
<td>GREECE</td>
<td>BEL, FRA, GER, ITA, NET, UK</td>
</tr>
<tr>
<td>IRELAND</td>
<td>BEL, DEN, FRA, GER, ITA, LUX, NET, UK</td>
</tr>
<tr>
<td>ITALY</td>
<td>BEL, DEN, FRA, GER, GRE, IRE, LUX, NET, POR, SPA, UK</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>BEL, DEN, FRA, GER, IRE, ITA, NET, SPA, UK</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>BEL, DEN, FRA, GER, GRE, IRE, ITA, LUX, SPA, UK</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>BEL, DEN, FRA, GER, ITA, SPA, UK</td>
</tr>
<tr>
<td>SPAIN</td>
<td>BEL, DEN, FRA, GER, ITA, LUX, NET, POR, UK</td>
</tr>
<tr>
<td>UK</td>
<td>BEL, DEN, FRA, GER, GRE, IRE, ITA, LUX, NET, POR, SPA</td>
</tr>
</tbody>
</table>
## Table 6
### Definition of the Corporate Tax Base

<table>
<thead>
<tr>
<th>Member State</th>
<th>Definition of the Base and Accounting Methods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>Worldwide income of resident companies (Registered Office, Main Establishment or Place of Management). Commercial ~ Tax Accounting.</td>
</tr>
<tr>
<td>Denmark</td>
<td>Worldwide income of resident companies (Entry in the Danish Registry). Commercial different from tax accounting.</td>
</tr>
<tr>
<td>France</td>
<td>Domestic source income of resident companies (Effective Management in France). Commercial ~ Tax Accounting.</td>
</tr>
<tr>
<td>Germany</td>
<td>Worldwide income of resident companies (Legal Seat, Place of Management). Commercial ~ Tax Accounting.</td>
</tr>
<tr>
<td>Greece</td>
<td>Worldwide income of resident companies (Legal Seat, Incorporation in Greece, Place of Management). Commercial ~ Tax Accounting.</td>
</tr>
<tr>
<td>Ireland</td>
<td>Worldwide income of resident companies (Central Management and Control). Commercial different from tax accounting.</td>
</tr>
<tr>
<td>Italy</td>
<td>Worldwide income of resident companies (Legal Seat, Administrative Office, Main Purpose of Business in Italy). Commercial ~ Tax Accounting.</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>Worldwide income of resident companies (Statutory Place, Place of Day to Day Management). Commercial ~ Tax Accounting.</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Worldwide income of resident companies (Place of Incorporation, Statutory Seat, Place of Effective Management). Commercial different from tax accounting.</td>
</tr>
</tbody>
</table>
TABLE 6 cont.

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>DEFINITION OF THE BASE AND ACCOUNTING METHODS</th>
</tr>
</thead>
<tbody>
<tr>
<td>PORTUGAL</td>
<td>WORLDWIDE INCOME OF RESIDENT COMPANIES (Head Office, Place of Effective Management). COMMERCIAL ≈ TAX ACCOUNTING</td>
</tr>
<tr>
<td>SPAIN</td>
<td>WORLDWIDE INCOME OF RESIDENT COMPANIES (Formation in Accordance with Spanish law, Head Office, Place of Effective Management). COMMERCIAL ≈ TAX ACCOUNTING</td>
</tr>
<tr>
<td>UK</td>
<td>WORLDWIDE INCOME OF RESIDENT COMPANIES (Incorporation in the UK, Central Management and Control) COMMERCIAL DIFFERENT FROM TAX ACCOUNTING</td>
</tr>
</tbody>
</table>

¹ ≈ means very similar or even identical.
### TABLE 7

**PRINCIPAL EXCLUSIONS FROM THE TAX BASE**

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>EXCLUSIONS FROM THE TAX BASE</th>
</tr>
</thead>
<tbody>
<tr>
<td>BELGIUM</td>
<td>DIVIDENDS, INVESTMENT ALLOWANCES, EXEMPTED CAPITAL GAINS</td>
</tr>
<tr>
<td>DENMARK</td>
<td>CONTRIBUTIONS TO CAPITAL, DIVIDENDS, CERTAIN CAPITAL GAINS, CERTAIN FINANCIAL SUPPORT TO SPECIFIC FIELDS OF BUSINESS OR GEOGRAPHICAL AREAS</td>
</tr>
<tr>
<td>FRANCE</td>
<td>DIVIDENDS, CERTAIN INCOME FROM ACTIVITIES ABROAD</td>
</tr>
<tr>
<td>GERMANY</td>
<td>CONTRIBUTION TO THE CAPITAL, PREMIUMS RECEIVED ON CORPORATE SHARES, REHABILITATION GAINS</td>
</tr>
<tr>
<td>GREECE</td>
<td>DIVIDENDS TO SHAREHOLDERS, INTEREST FROM DEPOSITS IN BANKS, PROFITS FROM PUBLISHING NEWSPAPERS AND PERIODICALS (Special Tax Status), PROFITS FROM THE EXPLOITATION OF SHIPS AND PLANES REGISTERED UNDER FOREIGN FLAG AND BELONGING TO FOREIGN ENTERPRISES, PROFITS FROM SALE OF PROPERTY, PROFITS FROM SALE OF SHIPS UNDER THE GREEK FLAG, etc.</td>
</tr>
<tr>
<td>IRELAND</td>
<td>CERTAIN PROFITS (Patents, Woodlands), PROFITS FROM THE SALE OF FIXED ASSETS ARISING FROM OVER-DEPRECIATION, DIVIDENDS FROM COMPANIES LIABLE TO CORPORATE TAX</td>
</tr>
<tr>
<td>ITALY</td>
<td>60% OF DIVIDENDS, INTEREST ON PUBLIC BONDS ISSUED BEFORE 20/9/1986, INCOME FROM BONDS OF INTERNATIONAL ORGANISATIONS</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>CONTRIBUTIONS TO CAPITAL, DIVIDENDS FROM QUALIFYING PARTICIPATIONS, REHABILITATION AND RESTRUCTURING GAINS</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>GAINS FROM THE TRANSFER OF ENTERPRISES, FROM THE INCREASE IN THE VALUE OF LAND, PROFITS FROM FORESTRY, DIVIDENDS FROM PARTICIPATION IN COMPANIES, CONTRIBUTION TO CAPITAL</td>
</tr>
</tbody>
</table>
## APPENDIX TO CHAPTER 2

**TABLE 7 cont.**

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>EXCLUSIONS FROM THE TAX BASE</th>
</tr>
</thead>
<tbody>
<tr>
<td>PORTUGAL</td>
<td>CONTRIBUTIONS TO CAPITAL</td>
</tr>
<tr>
<td>SPAIN</td>
<td>CONTRIBUTIONS TO CAPITAL, REINVESTED CAPITAL GAINS, STOCK DIVIDENDS</td>
</tr>
<tr>
<td>UK</td>
<td>DIVIDENDS AND DISTRIBUTIONS FROM RESIDENT COMPANIES (FRANKED INVESTMENT INCOME)</td>
</tr>
</tbody>
</table>
TABLE 8
TRANSFER PRICING

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>TREATMENT OF TRANSFER PRICING</th>
</tr>
</thead>
<tbody>
<tr>
<td>BELGIUM</td>
<td>SEPARATE ACCOUNTING-ARM'S LENGTH PRINCIPLE</td>
</tr>
<tr>
<td>DENMARK</td>
<td>SEPARATE ACCOUNTING-ARM'S LENGTH PRINCIPLE</td>
</tr>
<tr>
<td>FRANCE</td>
<td>SEPARATE ACCOUNTING-ARM'S LENGTH PRINCIPLE</td>
</tr>
<tr>
<td>GERMANY</td>
<td>SEPARATE ACCOUNTING-ARM'S LENGTH PRINCIPLE</td>
</tr>
<tr>
<td>GREECE</td>
<td>SEPARATE ACCOUNTING-ARM'S LENGTH PRINCIPLE</td>
</tr>
<tr>
<td>IRELAND</td>
<td>SEPARATE ACCOUNTING-NO SPECIFIC LEGISLATION BUT PRACTICALLY ARM'S LENGTH PRINCIPLE</td>
</tr>
<tr>
<td>ITALY</td>
<td>SEPARATE ACCOUNTING-ARM'S LENGTH PRINCIPLE</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>SEPARATE ACCOUNTING-ARM'S LENGTH PRINCIPLE</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>SEPARATE ACCOUNTING-NO SPECIFIC PROVISIONS, PRACTICALLY ARM'S LENGTH PRINCIPLE</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>SEPARATE ACCOUNTING-ARM'S LENGTH PRINCIPLE</td>
</tr>
<tr>
<td>SPAIN</td>
<td>SEPARATE ACCOUNTING-ARM'S LENGTH PRINCIPLE</td>
</tr>
<tr>
<td>UK</td>
<td>SEPARATE ACCOUNTING-ARM'S LENGTH PRINCIPLE</td>
</tr>
</tbody>
</table>
### TABLE 9

#### DEPRECIATION RULES

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>TANGIBLE ASSETS</th>
<th>INTANGIBLE</th>
<th>ACCELERATED</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>BUILDINGS</td>
<td>MACHINERY</td>
<td></td>
</tr>
<tr>
<td>BELGIUM</td>
<td>SL(^1)= 3-5%</td>
<td>SL = 10%</td>
<td>YES, SL</td>
</tr>
<tr>
<td></td>
<td>DB(^2)= 2xSL</td>
<td>DB = 2xSL</td>
<td>YES: SHIPS,</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>ASSETS FOR</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>RESEARCH</td>
</tr>
<tr>
<td>DENMARK</td>
<td>SL= 6% x 10</td>
<td>DB maximum = 30% NO after 1/1/ 1987</td>
<td>YES: SHIPS,</td>
</tr>
<tr>
<td></td>
<td>YEARS AND 4%</td>
<td></td>
<td>MACHINERY</td>
</tr>
<tr>
<td></td>
<td>then or in SOME CASES: 4% x 10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FRANCE</td>
<td>SL = 5%</td>
<td>SL = 10-20%</td>
<td>NO for GOOD-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>DB = 1.5/2.5/2.5 x SL</td>
<td>WILL, TRADE-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>MARKS</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>YES for SOFT-</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>WARE PATENTS</td>
</tr>
<tr>
<td>GERMANY</td>
<td>SL = 4%</td>
<td>SL = 10%</td>
<td>GOODWILL IN 15 YEARS SL</td>
</tr>
<tr>
<td></td>
<td>DB = 10% x4 +</td>
<td>DB = 3xSL maximum 30%</td>
<td>VERY LIMITED</td>
</tr>
<tr>
<td></td>
<td>5% x3 + 2.5% x18</td>
<td></td>
<td>CASES, TREND TO ABOLISH</td>
</tr>
<tr>
<td>GREECE(^4)</td>
<td>SL</td>
<td>DB</td>
<td>GOODWILL, KNOW HOW, PATENTS IN SOME AREAS</td>
</tr>
<tr>
<td>IRELAND</td>
<td>SL = 4%</td>
<td>SL = 10-25%</td>
<td>PATENTS SHIPS, PLANT</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>MACHINERY</td>
</tr>
<tr>
<td>ITALY</td>
<td>SL = 3-7%</td>
<td>SL = 10-25%</td>
<td>GOODWILL TANGIBLES</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>SL = 2-5%</td>
<td>SL = 10-20%</td>
<td>NO ASSETS CONTRIBUTING TO</td>
</tr>
<tr>
<td></td>
<td></td>
<td>DB = 3xSL maximum 30%</td>
<td>ENVIRONMENTAL</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>PROTECTION</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>SL = 3.3%</td>
<td>SL = 10-15%</td>
<td>YES AS LUXEMBOURG</td>
</tr>
<tr>
<td></td>
<td>DB = 2xSL</td>
<td>DB = 2xSL</td>
<td></td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>SL = 2-5%</td>
<td>SL = 12.5-25%</td>
<td>PATENTS, TRADE</td>
</tr>
<tr>
<td></td>
<td></td>
<td>DB = 1.5/2.5xSL</td>
<td>MARKS, MANUF.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>LICENCES NOT GOODWILL</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>FORMATION EXPENSES</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>RESEARCH COST INTENSIVELY</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>USED ASSETS</td>
</tr>
</tbody>
</table>

---

\(^1\) SL = Straight Line depreciation.
\(^2\) DB = Double Declining.
\(^3\) SL and DB calculated on the cost less any salvage.

\(^4\) For goodwill in some areas.
### TABLE 9 cont.

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>TANGIBLE ASSETS</th>
<th>INTANGIBLE</th>
<th>ACCELERATED</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>BUILDINGS</td>
<td>MACHINERY</td>
<td></td>
</tr>
<tr>
<td>SPAIN</td>
<td>SL = 2–3%</td>
<td>SL = 8%</td>
<td>YES EXCEPT FOR GOODWILL</td>
</tr>
<tr>
<td></td>
<td></td>
<td>DB = 2xSL</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>SL = 4%</td>
<td>DB = 25%</td>
<td>PATENTS, KNOW HOW RIGHTS DB</td>
</tr>
</tbody>
</table>

1. **SL** = Straight Line method.
2. **DB** = Declining Balance method.
3. **2xSL** = Up to twice the rate of Straight Line method.
4. Greek tax law is under reform (the relevant tax bill is before the Parliament–June 1992). The Methods mentioned are derived from the Bill.
TABLE 10  

DEDUCTIBLE EXPENSES

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>DEDUCTIBLE EXPENSES</th>
</tr>
</thead>
<tbody>
<tr>
<td>BELGIUM</td>
<td>EXPENSES AND CHARGES DIRECTLY OR CLOSELY CONNECTED WITH THE CONDUCT OF A BUSINESS</td>
</tr>
<tr>
<td>DENMARK</td>
<td>EXPENSES INCURRED IN THE ACQUISITION SECURING AND MAINTENANCE OF BUSINESS INCOME</td>
</tr>
<tr>
<td>FRANCE</td>
<td>EXPENSES RELATED TO OPERATION OF THE BUSINESS</td>
</tr>
<tr>
<td>GERMANY</td>
<td>EXPENSES DIRECTLY CONNECTED WITH TAXABLE INCOME</td>
</tr>
<tr>
<td>GREECE</td>
<td>EXPENSES INCURRED IN THE NORMAL COURSE OF THE BUSINESS</td>
</tr>
<tr>
<td>IRELAND</td>
<td>NO GENERAL PROVISION— INSTEAD SPECIFIC DIRECTIONS</td>
</tr>
<tr>
<td>ITALY</td>
<td>EXPENDITURE AND CHARGES TO THE EXTENT THEY RELATE TO THE PRODUCTION OF TAXABLE INCOME</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>EXPENDITURES ARISING FROM THE OPERATION OF THE BUSINESS</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>EXPENSES DIRECTLY OR CLOSELY CONNECTED WITH THE CONDUCT OF A BUSINESS</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>EXPENSES NECESSARY FOR THE PRODUCTION OF TAXABLE INCOME OR TO MAINTAIN THE PRODUCTIVE ASSETS</td>
</tr>
<tr>
<td>SPAIN</td>
<td>EXPENSES NECESSARY FOR THE PURPOSE OF PRODUCING INCOME</td>
</tr>
<tr>
<td>UK</td>
<td>THE EXPENDITURE MUST HAVE BEEN INCURRED WHOLLY AND EXCLUSIVELY FOR THE PURPOSES OF THE TRADE</td>
</tr>
</tbody>
</table>
### TABLE 11
**RESERVES AND PROVISIONS**

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>RESERVES AND PROVISIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>BELGIUM</td>
<td>PROVISION FOR PROBABLE LOSSES, FOR PROBABLE CHARGES</td>
</tr>
<tr>
<td>DENMARK</td>
<td>RESERVE FOR BAD DEBTS</td>
</tr>
<tr>
<td>FRANCE</td>
<td>RESERVE FOR INVESTMENT ABROAD, COMPULSORY PROFIT-SHARING PLAN PROVISION, RESERVE FOR COMMODITY MARKET FLUCTUATIONS, RESERVE FOR CREDIT RISKS, RESERVE FOR OIL GAS AND MINERAL DEPLETION, RESERVE FOR PUBLICATIONS, LONG-TERM CAPITAL GAINS RESERVE, BAD DEBTS</td>
</tr>
<tr>
<td>GERMANY</td>
<td>PROVISIONS FOR CERTAIN LIABILITIES OR ANTICIPATED LOSSES (WARRANTIES, DAMAGE CLAIMS, LITIGATION EXPENSES)</td>
</tr>
<tr>
<td>GREECE</td>
<td>REPLACEMENT &amp; REINVESTMENT RES. CAPITAL GAINS-LOSSES RES</td>
</tr>
<tr>
<td>IRELAND</td>
<td>SPECIFIC DOUBTFUL DEBTS, SPECIFIC LIABILITIES</td>
</tr>
<tr>
<td>ITALY</td>
<td>RESERVE FOR BAD DEBTS, RESERVE FOR LOSSES RESULTING FROM REEVALUATION OF ASSETS</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>PROVISIONS FOR WARRANTIES, DAMAGE CLAIMS, LITIGATION EXPENSES, FUTURE PENSION SCHEMES</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>PROVISIONS FOR PENSIONS, BAD DEBTS, REPLACEMENT RESERVES</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>PROVISION FOR DOUBTFUL COSTS, PROVISION FOR DEVALUATION OF STOCK, PROVISION FOR LITIGATION COSTS, COMPULSORY PROVISIONS FOR FINANCE AND INSURANCE COMPANIES, PROVISION FOR DEPLETION FOR OIL COMPANIES</td>
</tr>
<tr>
<td>SPAIN</td>
<td>PROVISIONS FOR DOUBTFUL DEBTS, DEVALUATION OF STOCK, MARKETABLE SECURITIES, PROVISION FOR LIABILITIES, PROVISION FOR OVERHAULS AND REPAIRS OF SHIPS AND PLANES, PROVISION FOR MINING AND HYDROCARBON ENTERPRISES</td>
</tr>
<tr>
<td>UK</td>
<td>PROVISIONS FOR SPECIFIC DOUBTFUL DEBTS</td>
</tr>
</tbody>
</table>

135
TABLE 12

VALUATION OF STOCK

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>BASIS OF VALUATION</th>
<th>METHOD OF VALUATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>BELGIUM</td>
<td>ACQUISITION COST-REPLACEMENT VALUE</td>
<td>LIFO/FIFO</td>
</tr>
<tr>
<td>DENMARK</td>
<td>ACQUISITION COST-MARKET VALUE</td>
<td>FIFO/WEIGHTED AVERAGE</td>
</tr>
<tr>
<td>FRANCE</td>
<td>ACQUISITION COST-MARKET VALUE</td>
<td>FIFO/WEIGHTED AVERAGE</td>
</tr>
<tr>
<td>GERMANY</td>
<td>ACQUISITION COST-MARKET VALUE</td>
<td>LIFO</td>
</tr>
<tr>
<td>GREECE</td>
<td>ACQUISITION COST-MARKET VALUE</td>
<td>LIFO/FIFO</td>
</tr>
<tr>
<td>IRELAND</td>
<td>ACQUISITION COST-MARKET VALUE</td>
<td>FIFO</td>
</tr>
<tr>
<td>ITALY</td>
<td>ACQUISITION COST-MARKET VALUE</td>
<td>LIFO/FIFO²</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>ACQUISITION COST-MARKET VALUE</td>
<td>LIFO/FIFO/WEIGHTED AVER.</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>ACQUISITION COST-MARKET VALUE</td>
<td>LIFO/FIFO/WEIGHTED AVER.</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>ACQUISITION COST</td>
<td>LIFO/FIFO</td>
</tr>
<tr>
<td>SPAIN</td>
<td>ACQUISITION COST-MARKET VALUE</td>
<td>FIFO/WEIGHTED AVERAGE</td>
</tr>
<tr>
<td>UK</td>
<td>ACQUISITION COST-MARKET VALUE</td>
<td>FIFO</td>
</tr>
</tbody>
</table>

1 Whichever is lower.
2 The result from the application of FIFO should not exceed the one produced by LIFO.
### TABLE 13
**CARRY-OVER OF LOSSES**

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>CARRY-BACK</th>
<th>CARRY-FORWARD</th>
</tr>
</thead>
<tbody>
<tr>
<td>BELGIUM</td>
<td>NO</td>
<td>INDEFINITELY</td>
</tr>
<tr>
<td>DENMARK</td>
<td>NO</td>
<td>5 YEARS</td>
</tr>
<tr>
<td>FRANCE</td>
<td>3 YEARS</td>
<td>5 YEARS</td>
</tr>
<tr>
<td>GERMANY</td>
<td>2 YEARS</td>
<td>INDEFINITELY</td>
</tr>
<tr>
<td>GREECE</td>
<td>NO</td>
<td>5 YEARS</td>
</tr>
<tr>
<td>IRELAND</td>
<td>1 YEAR¹</td>
<td>INDEFINITELY</td>
</tr>
<tr>
<td>ITALY</td>
<td>NO</td>
<td>5 YEARS</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>NO</td>
<td>5 YEARS</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>3 YEARS</td>
<td>8 YEARS</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>NO</td>
<td>5 YEARS</td>
</tr>
<tr>
<td>SPAIN</td>
<td>NO</td>
<td>5 YEARS</td>
</tr>
<tr>
<td>UK</td>
<td>3 YEARS</td>
<td>INDEFINITELY</td>
</tr>
</tbody>
</table>

¹ In cases where loss is offset against other income.
### TABLE 14

**CAPITAL GAINS**

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>CAPITAL GAINS</th>
</tr>
</thead>
<tbody>
<tr>
<td>BELGIUM</td>
<td>REGARDED AS BUSINESS INCOME&lt;sup&gt;1&lt;/sup&gt;</td>
</tr>
<tr>
<td>DENMARK</td>
<td>REGARDED AS BUSINESS INCOME&lt;sup&gt;2&lt;/sup&gt;</td>
</tr>
<tr>
<td>FRANCE</td>
<td>REGARDED AS BUSINESS INCOME&lt;sup&gt;3&lt;/sup&gt;</td>
</tr>
<tr>
<td>GERMANY</td>
<td>REGARDED AS BUSINESS INCOME&lt;sup&gt;4&lt;/sup&gt;</td>
</tr>
<tr>
<td>GREECE</td>
<td>REGARDED AS BUSINESS INCOME&lt;sup&gt;5&lt;/sup&gt;</td>
</tr>
<tr>
<td>IRELAND</td>
<td>SUBJECT TO THE RULES AND RATES OF CORPORATE TAX BUT NOT TREATED AS BUSINESS INCOME&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>ITALY</td>
<td>REGARDED AS BUSINESS INCOME&lt;sup&gt;7&lt;/sup&gt;</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>REGARDED AS BUSINESS INCOME&lt;sup&gt;8&lt;/sup&gt;</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>REGARDED AS BUSINESS INCOME&lt;sup&gt;9&lt;/sup&gt;</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>REGARDED AS BUSINESS INCOME&lt;sup&gt;10&lt;/sup&gt;</td>
</tr>
<tr>
<td>SPAIN</td>
<td>REGARDED AS BUSINESS INCOME&lt;sup&gt;11&lt;/sup&gt;</td>
</tr>
<tr>
<td>UK</td>
<td>CORPORATE TAX RATE APPLIED - NOT INCLUDED IN THE TAXABLE PROFITS&lt;sup&gt;12&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

---

<sup>1</sup> Certain Exemptions; Gains from sale of shares if not reinvested subject to tax rate equal to the half of the corporate tax rate.

<sup>2</sup> Gains from the sale of shares exempted if sale within 3 years from acquisition.

<sup>3</sup> 25% rate if gains from the sale of portfolio elements.

<sup>4, 10, 11</sup> Exemption if reinvested (Roll-Over Relief).

<sup>5</sup> Certain exemptions apply; Gains from the sale of shares exempted if used for future loss relief.

<sup>6, 7</sup> Reduced rates on gains of shares: 30% in Ireland, 25% in Italy.

<sup>8, 9</sup> On certain conditions gains from the sale of shares is exempted.

<sup>12</sup> Roll-Over relief for reinvestment on land, buildings, plant and machinery, ships, aircrafts and goodwill.
<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>THIN CAPITALISATION RULES</th>
</tr>
</thead>
<tbody>
<tr>
<td>BELGIUM</td>
<td>NO PROVISION</td>
</tr>
<tr>
<td>DENMARK</td>
<td>NO PROVISION</td>
</tr>
<tr>
<td>FRANCE</td>
<td>INTEREST PAID BY FRENCH SUBSIDIARIES TO FOREIGN CORPORATIONS IS DEDUCTIBLE PROVIDED THE LOAN DOES NOT EXCEED 150% OF THE SHARE CAPITAL</td>
</tr>
<tr>
<td>GERMANY</td>
<td>ADMINISTRATIVE PRACTICE = LOANS GIVEN BY NON-RESIDENTS ARE CONSIDERED AS HIDDEN CAPITAL IF THE COMPANY CAPITAL IS LESS THAN 10% OF THE GROSS ASSETS</td>
</tr>
<tr>
<td>GREECE</td>
<td>NO PROVISION</td>
</tr>
<tr>
<td>IRELAND</td>
<td>NO SPECIFIC PROVISION, BUT INTEREST PAID TO 75% PARENT COMPANIES IS CONSIDERED AS DIVIDEND</td>
</tr>
<tr>
<td>ITALY</td>
<td>NO PROVISION</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>NO PROVISION</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>NO PROVISION</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>NO PROVISION</td>
</tr>
<tr>
<td>SPAIN</td>
<td>NO PROVISION</td>
</tr>
<tr>
<td>UK</td>
<td>NO SPECIFIC PROVISION BUT THE INLAND REVENUE DOES NOT ACCEPT A DEBT/EQUITY RATIO IN EXCESS OF ONE TO ONE. ALSO DEEMED DIVIDEND PROVISION: TA Sec 209 (2) (e)(iv) AND EXCESSIVE INTEREST PAYMENT TO NON-RESIDENT: TA Sec 74(n)</td>
</tr>
</tbody>
</table>
TABLE 16
STATUTORY CORPORATE TAX RATES

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>TAX RATES</th>
</tr>
</thead>
<tbody>
<tr>
<td>BELGIUM</td>
<td>39%¹</td>
</tr>
<tr>
<td>DENMARK</td>
<td>34%²</td>
</tr>
<tr>
<td>FRANCE</td>
<td>34%</td>
</tr>
<tr>
<td>GERMANY</td>
<td>50/36%³</td>
</tr>
<tr>
<td>GREECE</td>
<td>35%⁴</td>
</tr>
<tr>
<td>IRELAND</td>
<td>40/10%⁵</td>
</tr>
<tr>
<td>ITALY</td>
<td>36%</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>33%⁶</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>35%⁷</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>36%⁸</td>
</tr>
<tr>
<td>SPAIN</td>
<td>35%⁹</td>
</tr>
<tr>
<td>UK</td>
<td>33%¹⁰</td>
</tr>
</tbody>
</table>

¹ 28-35% for small companies.
³ The former applies to retained profits and the latter to distributed.
⁴ This rate is the one provided in the Tax Amendment Bill discussed by the Parliament.
⁵ The former is the standard rate, the latter applies to manufacturing companies.
⁶ Reduced rates for smaller companies apply.
⁷ 40% for the first 250,000 Gld.
⁸,⁹ Reduced rates apply to certain companies.
¹⁰ 25% for companies with profits up to 250,000GBP.
## TABLE 17

**CORPORATE TAX SYSTEMS**

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>CORPORATE TAX SYSTEM</th>
</tr>
</thead>
</table>
| BELGIUM      | FULL IMPUTATION FOR PERMANENT PARTICIPATIONS  
               PARTIAL IMPUTATION FOR NON-PERMANENT  
               CLASSICAL SYSTEM FOR THE OTHERS |
| DENMARK      | PARTIAL SHAREHOLDER RELIEF SCHEME<sup>1</sup> |
| FRANCE       | PARTIAL IMPUTATION SYSTEM<sup>2</sup> |
| GERMANY      | SPLIT RATE SYSTEM AT CORPORATE LEVEL<sup>3</sup>  
               FULL IMPUTATION AT SHAREHOLDER LEVEL |
| GREECE       | DIVIDEND DEDUCTION SYSTEM |
| IRELAND      | PARTIAL IMPUTATION SYSTEM |
| ITALY        | FULL IMPUTATION SYSTEM |
| LUXEMBOURG   | CLASSICAL SYSTEM |
| NETHERLANDS  | CLASSICAL SYSTEM |
| PORTUGAL     | PARTIAL IMPUTATION SYSTEM |
| SPAIN        | PARTIAL IMPUTATION SYSTEM |
| UK           | PARTIAL IMPUTATION SYSTEM |

<sup>1</sup> Tax liability for shareholders with respect to dividends is restricted to 30% on the first 30,000 Dkr. and 45% on the excess.

<sup>2</sup> The rate of tax credit is 50%, higher than the rate of Corporate tax, which results in full imputation.

<sup>3</sup> 50% for retained profits and 36% for distributed.
<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>LOCAL AND OTHER SPECIFIC INCOME TAXES ON COMPANIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>BELGIUM</td>
<td>NONE</td>
</tr>
<tr>
<td>DENMARK</td>
<td>HYDROCARBON TAX ON INCOME DERIVED FROM SURVEYS, EXPLORATION AND EXPLOITATION OF HYDROCARBONS (IMPOSED AFTER THE DEDUCTION OF CORPORATE TAX)</td>
</tr>
<tr>
<td>FRANCE</td>
<td>LOCAL CORPORATE TAX (DEDUCTIBLE FOR CORPORATE TAX PURPOSES), OIL TAX ON OIL COMPANIES (NON-DEDUCTIBLE), FINANCIAL INSTITUTIONS TAX (NON-DEDUCTIBLE).</td>
</tr>
<tr>
<td>GERMANY</td>
<td>LOCAL BUSINESS TAX (DEDUCTIBLE FOR CORPORATE TAX PURPOSES)</td>
</tr>
<tr>
<td>GREECE</td>
<td>NONE</td>
</tr>
<tr>
<td>IRELAND</td>
<td>CLOSELY CONTROLLED COMPANIES ARE LIABLE TO A 20% SURCHARGE ON AFTER TAX INVESTMENT, RENTAL AND INCORPORATED PROFESSIONAL OR EMPLOYMENT INCOME WHICH IS NOT DISTRIBUTED WITHIN 18 MONTHS OF THE END OF THE ACCOUNTING PERIOD</td>
</tr>
<tr>
<td>ITALY</td>
<td>LOCAL INCOME TAX (DEDUCTIBLE FOR CORPORATE TAX PURPOSES)</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>LOCAL BUSINESS TAX (DEDUCTIBLE FOR CORPORATE TAX PURPOSES)</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>NONE</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>MUNICIPAL SURCHARGE (10%) ON THE BASIC CORPORATE TAX (NON-DEDUCTIBLE)</td>
</tr>
<tr>
<td>SPAIN</td>
<td>LOCAL SURCHARGE (1.5%) OF THE CHAMBER OF COMMERCE (DEDUCTIBLE FOR CORPORATE TAX PURPOSES), LOCAL BUSINESS/PROFESSIONAL LICENCE TAX, HYDROCARBON TAX.</td>
</tr>
<tr>
<td>UK</td>
<td>PETROLEUM REVENUE TAX (DEDUCTIBLE FOR CORP. TAX PURP.)</td>
</tr>
<tr>
<td>MEMBER STATE</td>
<td>TAX BASE INCENTIVES</td>
</tr>
<tr>
<td>--------------</td>
<td>---------------------</td>
</tr>
<tr>
<td>BELGIUM</td>
<td>IA&lt;sup&gt;1&lt;/sup&gt;, AD&lt;sup&gt;2&lt;/sup&gt;</td>
</tr>
<tr>
<td>DENMARK</td>
<td>AD</td>
</tr>
<tr>
<td>FRANCE</td>
<td>RESEARCH CREDITS LIMITED AD</td>
</tr>
<tr>
<td>GERMANY</td>
<td>AD</td>
</tr>
<tr>
<td>GREECE</td>
<td>IA, AD REINVESTMENT RES.</td>
</tr>
<tr>
<td>IRELAND</td>
<td>IA, AD</td>
</tr>
<tr>
<td>ITALY</td>
<td>AD, REVALUATION SCHEMES OF ASSETS</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>ITC&lt;sup&gt;4&lt;/sup&gt;, AD</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>INVESTMENT DEDUCTIONS, AD</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>ROLL-OVER RELIEF FOR GAINS, AD</td>
</tr>
<tr>
<td>SPAIN</td>
<td>ITC, AD</td>
</tr>
<tr>
<td>UK</td>
<td>IA, AD</td>
</tr>
</tbody>
</table>

1 Investment Allowance. 
2 Accelerated Depreciation. 
3 Reductions of tax liability for companies located in West Berlin; Gradually abolished by 1995. 
4 Investment tax credit.
### Table 20

**EFFECTIVE TAX RATES FOR PURELY DOMESTIC INVESTMENTS**

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>EFFECTIVE TAX RATE(^1)</th>
<th>CORPORATE TAX WEDGES(^2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BELGIUM</td>
<td>5.4</td>
<td>0.4</td>
</tr>
<tr>
<td>DENMARK</td>
<td>5.9</td>
<td>0.9</td>
</tr>
<tr>
<td>FRANCE</td>
<td>5.4</td>
<td>0.4</td>
</tr>
<tr>
<td>GERMANY</td>
<td>5.6</td>
<td>0.6</td>
</tr>
<tr>
<td>GREECE</td>
<td>5.0</td>
<td>0.0</td>
</tr>
<tr>
<td>IRELAND</td>
<td>5.1</td>
<td>0.1</td>
</tr>
<tr>
<td>ITALY</td>
<td>5.9</td>
<td>0.9</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>6.3</td>
<td>1.3</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>5.6</td>
<td>0.6</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>5.7</td>
<td>0.7</td>
</tr>
<tr>
<td>SPAIN</td>
<td>6.2</td>
<td>1.2</td>
</tr>
<tr>
<td>UK</td>
<td>5.9</td>
<td>0.9</td>
</tr>
</tbody>
</table>


\(^2\) For a 5% post-tax real return, assuming that average inflation is at 4.5%, real interest rate at 5% and in the absence of personal taxes.

\(^3\) This column indicates the corporate tax component of the cost of capital.
### TABLE 21

**EFFECTIVE TAX RATES WHEN THE SUBSIDIARY IS FINANCED BY RETAINED EARNINGS**

| Member State of Residence | BE | ER | RO | C | A | Y | B | E | M | K | M | N | A | R | M | Y | L | X | T | U | E | P | S | H | R | I | K |
| Belgium                   | 7.1| 7.5| 7.3| 9.5| 7.3| 5.5| 9.1| 8.1| 7.1| 7.5| 7.8| 7.7|
| Denmark                   | 7.1| 7.5| 6.8| 8.7| 7.3| 5.2| 8.4| 7.5| 6.7| 7.0| 7.3| 7.2|
| France                    | 7.1| 7.5| 7.3| 9.5| 7.3| 5.5| 9.1| 8.1| 7.1| 7.5| 7.8| 7.7|
| Germany                   | 7.1| 7.5| 7.3| 9.5| 7.3| 5.5| 9.1| 8.1| 7.1| 7.5| 7.8| 7.7|
| Greece                    | 7.1| 7.5| 7.3| 9.5| 7.3| 5.5| 9.1| 8.1| 7.1| 7.5| 7.8| 7.7|
| Ireland                   | 7.1| 7.5| 7.3| 9.5| 7.3| 5.5| 9.1| 8.1| 7.1| 7.5| 7.8| 7.7|
| Italy                     | 7.1| 7.5| 7.3| 9.5| 7.3| 5.5| 9.1| 8.1| 7.1| 7.5| 7.8| 7.7|
| Luxembourg                | 7.1| 7.5| 7.3| 9.5| 7.3| 5.5| 9.1| 8.1| 7.1| 7.5| 7.8| 7.7|
| Netherlands               | 7.1| 7.5| 7.3| 9.5| 7.3| 5.5| 9.1| 8.1| 7.1| 7.5| 7.8| 7.7|
| Portugal                  | 7.1| 7.5| 7.3| 9.5| 7.3| 5.5| 9.1| 8.1| 7.1| 7.5| 7.8| 7.7|
| Spain                     | 7.1| 7.5| 7.3| 9.5| 7.3| 5.5| 9.1| 8.1| 7.1| 7.5| 7.8| 7.7|
| UK                        | 7.1| 7.5| 7.3| 9.5| 7.3| 5.5| 9.1| 8.1| 7.1| 7.5| 7.8| 7.7|

1. Source and variables same as in the previous Table.
**TABLE 22**

**EFFECTIVE TAX RATES WHEN THE SUBSIDIARY IS FINANCED**

**BY NEW EQUITY FROM THE PARENT**

<table>
<thead>
<tr>
<th>MEMBER STATE OF RESIDENCE</th>
<th>B</th>
<th>E</th>
<th>L</th>
<th>G</th>
<th>M</th>
<th>A</th>
<th>C</th>
<th>N</th>
<th>E</th>
<th>M</th>
<th>D</th>
<th>B</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>BELGIUM</td>
<td>5.4</td>
<td>8.2</td>
<td>9.0</td>
<td>6.7</td>
<td>3.7</td>
<td>4.5</td>
<td>7.0</td>
<td>6.8</td>
<td>6.5</td>
<td>8.2</td>
<td>8.6</td>
<td>5.3</td>
<td></td>
</tr>
<tr>
<td>DENMARK</td>
<td>7.3</td>
<td>5.9</td>
<td>6.6</td>
<td>6.0</td>
<td>6.0</td>
<td>4.0</td>
<td>6.2</td>
<td>5.9</td>
<td>5.1</td>
<td>7.3</td>
<td>6.8</td>
<td>4.6</td>
<td></td>
</tr>
<tr>
<td>FRANCE</td>
<td>6.9</td>
<td>5.8</td>
<td>5.4</td>
<td>3.8</td>
<td>6.1</td>
<td>4.0</td>
<td>6.4</td>
<td>6.4</td>
<td>6.1</td>
<td>7.3</td>
<td>8.6</td>
<td>6.0</td>
<td></td>
</tr>
<tr>
<td>GERMANY</td>
<td>7.4</td>
<td>6.5</td>
<td>6.8</td>
<td>5.6</td>
<td>1.3</td>
<td>3.1</td>
<td>10.3</td>
<td>4.9</td>
<td>6.1</td>
<td>7.9</td>
<td>6.7</td>
<td>4.6</td>
<td></td>
</tr>
<tr>
<td>GREECE</td>
<td>7.7</td>
<td>13.8</td>
<td>15.8</td>
<td>7.5</td>
<td>5.0</td>
<td>11.9</td>
<td>8.0</td>
<td>6.0</td>
<td>6.2</td>
<td>11.8</td>
<td>11.8</td>
<td>7.1</td>
<td></td>
</tr>
<tr>
<td>IRELAND</td>
<td>7.1</td>
<td>6.5</td>
<td>8.3</td>
<td>5.9</td>
<td>15.9</td>
<td>5.1</td>
<td>5.6</td>
<td>6.8</td>
<td>6.7</td>
<td>22.2</td>
<td>22.1</td>
<td>7.5</td>
<td></td>
</tr>
<tr>
<td>ITALY</td>
<td>7.7</td>
<td>8.4</td>
<td>12.1</td>
<td>3.6</td>
<td>7.4</td>
<td>11.1</td>
<td>5.9</td>
<td>8.4</td>
<td>9.4</td>
<td>8.2</td>
<td>9.7</td>
<td>10.5</td>
<td></td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>6.6</td>
<td>6.4</td>
<td>7.7</td>
<td>6.2</td>
<td>5.9</td>
<td>4.1</td>
<td>6.5</td>
<td>6.3</td>
<td>5.8</td>
<td>9.5</td>
<td>7.3</td>
<td>4.9</td>
<td></td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>6.2</td>
<td>6.0</td>
<td>7.9</td>
<td>6.4</td>
<td>4.8</td>
<td>4.3</td>
<td>4.8</td>
<td>6.5</td>
<td>5.6</td>
<td>9.7</td>
<td>7.5</td>
<td>5.1</td>
<td></td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>7.3</td>
<td>7.0</td>
<td>9.2</td>
<td>6.2</td>
<td>13.6</td>
<td>9.7</td>
<td>6.5</td>
<td>13.8</td>
<td>18.7</td>
<td>5.7</td>
<td>7.3</td>
<td>7.0</td>
<td></td>
</tr>
<tr>
<td>SPAIN</td>
<td>7.4</td>
<td>7.2</td>
<td>8.6</td>
<td>6.3</td>
<td>6.1</td>
<td>7.8</td>
<td>6.7</td>
<td>6.5</td>
<td>6.1</td>
<td>7.9</td>
<td>6.2</td>
<td>6.5</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>6.0</td>
<td>5.7</td>
<td>8.2</td>
<td>5.9</td>
<td>5.9</td>
<td>8.2</td>
<td>4.8</td>
<td>6.2</td>
<td>6.0</td>
<td>7.5</td>
<td>7.5</td>
<td>5.9</td>
<td></td>
</tr>
</tbody>
</table>

1 Source and variables same as in Tables 20, 21.
TABLE 23

EFFECTIVE TAX RATES WHEN THE SUBSIDIARY IS FINANCED

BY A LOAN FROM THE PARENT

| MEMBER OF RESIDENCE | B | E | N | L | G | M | A | K | M | B | T | U | E | O | P | S |
|---------------------|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| BELGIUM             | 5.4| 5.0| 5.5| 2.7| 4.9| 7.1| 5.7| 5.0| 4.8| 6.4| 7.2| 6.4|   |   |   |   |
| DENMARK             | 5.9| 5.9| 6.6| 4.1| 6.5| 6.9| 5.5| 6.2| 5.9| 2.6| 2.8| 6.3|   |   |   |   |
| FRANCE              | 4.9| 5.1| 5.4| 2.3| 4.6| 6.8| 4.3| 5.4| 5.3| 5.0| 6.2| 5.9|   |   |   |   |
| GERMANY             | 9.6| 9.4| 10.3| 5.6| 5.7| 10.2| 8.4| 9.6| 10.1| 10.2| 9.1|   |   |   |   |   |
| GREECE              | 6.0| 8.5| 10.1| 3.2| 5.0| 11.9| 5.2| 6.0| 6.2| 7.3| 8.4| 7.1|   |   |   |   |
| IRELAND             | 6.3| 6.5| 7.5| 4.4| 15.7| 5.1| 5.6| 6.8| 6.7| 16.1| 16.9| 7.5|   |   |   |   |
| ITALY               | 7.6| 8.4| 11.1| 3.2| 7.4| 14.6| 5.9| 8.5| 9.4| 7.9| 9.7| 10.5|   |   |   |   |
| LUXEMBOURG          | 5.8| 6.1| 6.9| 4.2| 6.4| 7.0| 5.6| 6.3| 6.1| 6.8| 6.9| 6.4|   |   |   |   |
| NETHERLANDS         | 5.3| 5.6| 6.5| 3.8| 4.8| 6.8| 4.7| 6.0| 5.6| 9.1| 6.5| 6.0|   |   |   |   |
| PORTUGAL            | 6.0| 6.3| 7.4| 4.3| 14.2| 11.7| 5.6| 8.6| 9.9| 5.7| 6.9| 7.0|   |   |   |   |
| SPAIN               | 5.7| 6.0| 6.8| 3.9| 6.6| 7.8| 5.3| 6.0| 5.8| 2.7| 6.2| 6.5|   |   |   |   |
| UK                  | 4.8| 5.1| 6.2| 2.7| 4.6| 8.2| 4.0| 5.4| 5.4| 5.2| 6.1| 6.8|   |   |   |   |

1 Source and variables same as in Tables 20, 21 and 22.
CHAPTER 3
THE POLITICAL ASPECTS OF THE PROBLEM

3.1. Introduction

Having said that the harmonisation of corporate tax law is so essential for the proper functioning of the Common Market, one could expect that the process of corporate tax harmonisation, due to its importance for the Common Market, would be effective and fast. Unfortunately, this is not the case due to some factors which either are purely political or, if not purely political, attribute their existence to political decisions and circumstances, hindering the successful completion of the process. Furthermore, the interaction between the economic-political developments in the EC and the process of corporate tax harmonisation is so great that it must be closely examined.

3.2. The Great Obstacles

3.2.1. The Correlation Between National Sovereignty and Corporate Tax Harmonisation

The concept of national sovereignty presupposes the existence of an independent State whose government has exclusive competence within the territorial frontiers of the State. In other words, the sovereignty of a State is established when there is a territory with

\[^{1}\text{See Chapter 2.}\]
its borders and a government having authority over the people who reside in that territory. In addition to this, the degree of national sovereignty depends upon the extent to which the decisions of a national government are influenced by pressures coming from abroad. The more a country is dependent on other countries in economic and political terms the less national sovereignty it retains. For example, if a country has borrowed a great deal of money from foreign creditors its economic policy is affected by the conditions included in those loans and this, in turn, means that the national government's authority has been limited not only in relation to economic policy but also with regard to other policies and in particular with regard to foreign policy.

Two questions arise at this point. The first is whether a State can retain its national sovereignty even when it puts it under serious restrictions. The second concerns the exact relationship between the harmonisation of corporate tax law in the European Community and the national sovereignty of the twelve Member States.

With regard to the first question, it must be noted that the theory of nationalism, which gained ground in the 19th century, played a significant role in the formation and the strengthening of

---

2 A recent example is the 1991 loan between the EC (lender) and Greece (borrower) which limits the Greek government's choices in the planning of the economic policy. Another example is the influence the International Monetary Fund exerted on the planning of economic policy during the last Labour government in the UK.

3 Economic dependence has consequences on the planning of foreign policy.
the dogma of the indivisibility of national sovereignty. According to the old approach to sovereignty, only one single sovereignty can be exercised on a specific territory and states can only cooperate or coordinate with each other. A rival theory, the so called "auto-limitation" theory, has developed in the 20th century and its main idea is that a State can retain its sovereignty even if it surrenders part of that sovereignty, provided that the surrender in question takes place for the attainment of a specific objective.

The "auto-limitation" theory holds a key position within the European Community law and it has repeatedly been confirmed by the European Court of Justice in *Van Gend en Loos*, *Costa v. ENEL* and *Neumann*. It is also worth noting that the limitation of a State's sovereign rights in a specific sector may go as far as the total abolition of that State's right to deal with issues relating to the respective sector, or may take the form of "shared competence". In

---


5 *Costa v. ENEL*, Case 6/64, [1964] ECR 585, [1964] CMLR 425: "...by creating a Community of unlimited duration....having its own....real powers stemming from a limitation of competence or a transfer of powers from the States to the Community the Member States, albeit within limited spheres, have restricted their sovereign rights...".


7 Which means that in a given field some issues are decided by
the first case the State surrenders its sovereignty by transferring its competence in a specific sector to an international organization, whereas in the second the State has transferred some, but not all, of its sovereign rights in a sector to the international organization.

The conclusion that can be drawn from the application of the "auto-limitation" theory is that, if Member States decide that a transfer of competence from national to Community level is needed for issues of corporate tax law, the theory in question provides the legal justification. In other words, the shrinking of national sovereignty in relation to corporate taxation may be permissible, essential, inevitable and justified, although such a view is almost certain not to receive a warm welcome from the governments of the Member States.

Turning to the second question, the consideration of which may explain why Member States are not very happy with the aforementioned theory, it has to be said from the beginning that income taxation lies at the core of the concept of sovereignty, because levying a tax on the income of a physical or legal person indicates a direct authoritative relationship between the tax non-national authorities and all the other issues related to this field are within the competence of national authorities.

\footnote{e.g. the twelve States of the EC have completely surrendered their rights to the Community in areas such as customs duties, conclusion of Commercial and Association agreements with third countries.}

\footnote{The so-called "shared or concurrent competence" = e.g. competition and agricultural policy in the European Community.}
legislator-collector and the taxpayer. In democratic societies this authoritative relationship has been placed under a democratic control which operates as a safeguard against arbitrary trends and secures people's assent. Thus, the imposition of income taxes has been linked with the right of representation and for this reason the enactment of Income Tax Acts rests with national Parliaments.

The right of a State to impose taxes within its territory constitutes the core of fiscal sovereignty which, in its turn, is undoubtedly one of the most important areas of national sovereignty. Therefore, the imposition of corporate tax, a tax on the income of enterprises, is an act of fiscal sovereignty and a crucial issue of national sovereignty. In view of this, any attempt to harmonise corporate tax law implies a certain degree of transfer of the national authorities' competence on corporate taxation to a supranational authority.

There is also another reason explaining why Member States are so reluctant to surrender part of their sovereignty in the area of corporate tax law. They consider such a surrender as a prelude to further developments in the field of direct taxation which could result in the transfer of competence with regard to personal income

---

10 "No taxation without representation", Magna Charta 1215.
11 Even when harmonisation is carried out by the means of Directives the decisions are taken at Community level by a Community institution, namely the Council of Ministers of Economic Affairs (ECOFIN).
12 Especially, if the "functional spillover theory" developed by the Neo-Functionalists proves to be correct.
taxes from the national to Community level. This inevitably implies that Member States would be stripped of their sovereign rights in the very sensitive sphere of direct taxation and given that the sovereignty of the twelve has already diminished in the field of indirect taxation Member States will in practice lose their fiscal sovereignty.

Indeed, it is the Community that has exclusive jurisdiction over customs duties and brings under its control VAT and excise duties. Indeed, the tax base of VAT has been defined at Community level by several Directives and progress has also been made as regards the common rates of VAT and the imposition of common excise duties. As a result of it, the only area of taxation, in which the Community has not reduced its Member States' sovereign rights yet, is that of direct taxation. Thus, taking into account that the Commission has renewed its interest in corporate tax law, corporate tax harmonisation will prove to be the test case or the battleground for another attempt by the Community to extend its jurisdiction at the expense of Member States' sovereignty.

---

13 EC Treaty Articles 12-29.
14 For more details see Chapter 1 (1.4.).
15 Two Directives were adopted in 1990, one Convention was concluded in the same year, two proposed Directives are tabled before the Council, and a Committee (Committee of Independent Experts on Company Taxation, known as the Ruding Committee) was set up in 1991 and produced a Report in 1992 (the full text will be published later in 1992).
3.2.2. Different Approaches to Corporate Taxation Among Member States.

From the discussion of the differences between the corporate tax laws of the twelve Member States in Chapter 2 and from the detailed juxtaposition of the main corporate tax law provisions of each Member State in the Appendix to Chapter 2 it has become obvious that the differences in question are not restricted only to rules but reflect the existence of different tax policies. Such differences which make the progress of corporate tax harmonisation quite difficult result from the way Member States approach the issue of corporate taxation.

As has rightly been suggested, the corporate tax structures of certain Member States (Netherlands, U.K.) can be regarded as "international" in the sense that they favour multinational enterprises by reducing discrimination between domestic and foreign companies to the minimum. On the contrary, the tax structures of the other ten Member States have been designed to the advantage of home based enterprises and more or less to the disadvantage of non resident companies doing business in their territories (national structures).  

---


17 Such corporate tax structures can be labelled as "open corporate tax systems" because of their international orientation.

18 Such systems can be labelled as "closed tax systems" because of
As a result, international corporate tax systems are likely to conflict with national tax systems during the harmonisation process which is a give and take process. If the corporate tax structures of all Member States had an international orientation agreements could be reached because there could be a negotiation on the same basis. In such a case the abolition of advantages the corporate tax system of a Member State offers to multinationals could be exchanged for the abolition of the respective advantages of the corporate tax systems of the other Member States. But this cannot happen when the majority of corporate tax systems in the EC do not have such advantages which would be the object of bargaining.

The existence of the two schools of tax law within the EC and the adherence of Member States to the one or the other is one of the major obstacles posed to the progress of corporate tax harmonisation. It is very difficult for Member States belonging to one of the two schools of tax law to make concessions which do not conform to the theoretical framework of their tax system with the intention to reach an agreement with Member States belonging to the other school of corporate taxation.

3.2.3. Problems Arising From the EC Treaty

The EC Treaty in its present form does not provide the appropriate framework for the harmonisation of corporate tax law. This can be attributed, first, to the fact that there is no specific provision concerning the harmonisation of direct taxes in the Treaty, their orientation towards the needs of the domestic market.
unlike the one on indirect taxes. The Member States, namely the governments of the Member States, either underestimating the real needs of the Internal Market or considering that the introduction of a provision dealing with direct taxation would seem as a step towards fiscal federalism, did not include such provision either in the original text of the Treaty or in its subsequent amendments. As a result of it, the harmonisation of corporate tax law lacks a provision in the EC Treaty, a provision that would set out the objectives of the process and clarify its meaning.

The second reason for the inadequacy of the EC Treaty with regard to corporate taxation is that the existing legal basis for the harmonisation of corporate tax law (EC Treaty Article 100) is susceptible to controversy. First, this Article, being very general, may not be interpreted by Member States uniformly. Indeed, the wording of Article 100 depends the application of the Article on considerations which are mainly political. For example, the Article in question sets a prerequisite for the harmonisation to take place, namely that the provisions of corporate tax law under harmonisation must "directly affect the establishment or functioning of the Common Market."

Two comments must be made in relation to the aforementioned phrase. First, it has to be mentioned that a verdict can be reached

---

19 EC Treaty Art.99, as it was amended by Article 17 of the Single European Act.
21 See Chapter 1 (1.3.2.).
on the way certain legal provisions affect the Common Market, only if consideration is given to the economic impact of those provisions on the Common Market. But economic considerations are not independent of political influences. Secondly, under the present circumstances, it is the Council of Ministers or perhaps the European Council that will decide: i) whether a provision of corporate tax law affects or not the Common Market, and ii) whether it affects the Market directly or indirectly. But the Council is an organ consisting of the representatives of the national governments and these representatives rely heavily on political criteria in order to reach a decision.

The second problem emanating from Article 100 is the unanimity clause it contains. Such a requirement initiated long and complex negotiations which sometimes result in complete deadlocks. In addition, issues decided under the procedure that requires unanimity, are offered for political bargaining, as the Member State which blocks the adoption of a decision may drop its reservations if it secures sufficient concessions from the other Member States.\textsuperscript{22} This happened in the adoption of the Directive concerning tax issues resulting from mergers of companies.\textsuperscript{23}

Indeed, the Directive in question was presented to the Council in 1969, but it was strongly rejected by the Germans and the Dutch. Since every Directive in the field of corporate taxation needs unanimity in order to be adopted, the adoption of the aforementioned Directive took 21 years (1969-1990). In those 21 years a great deal

\textsuperscript{22} Even support on another issue.

\textsuperscript{23} Directive 90/434 (OJ 1990, L 225/1).
of pressure was exerted on Germany and Holland and considerable concessions were made to those two Member States so as to be persuaded to drop their objections.\textsuperscript{24}

The concept of a free and efficiently operating market, as the Single Market is destined to be, presupposes that the authority which is responsible for the efficient functioning of that market will intervene when and where such intervention is absolutely essential for the proper functioning of the market. Furthermore, it is obvious that such interventions take place in exceptional circumstances when the rules of the free market do not operate and there is a need for rules which will eliminate the distortions of the free market as soon as possible.

Therefore, if the Single Market is to be established in 1993, it is almost sure that some legislative measures will be necessary at Community level to deal with the distortions caused to the Single Market by the different corporate tax laws.\textsuperscript{25} If these measures need as many years as the "Mergers" Directive needed, because of the requirement of unanimity, the Single Market will be seriously undermined. Finally, these considerations bring forward a very important question, that is, whether the concept of the Internal Market is compatible with the requirement of unanimity.

Even if harmonisation of corporate tax law manages to proceed without the requirement of unanimity\textsuperscript{26} there is always the danger that

\textsuperscript{24} Further discussion of this issue will take place in Chapter 5.

\textsuperscript{25} See Chapter 2.

\textsuperscript{26} In case that in future Article 100 is amended or a new Article
unanimity may return by the backdoor which is the Luxembourg Accords. The Luxembourg Accords is a political agreement concluded in Luxembourg in 1966 which provides that when decisions are taken by majority voting and very important interests of one or more partners are at stake, then unanimity must be sought. When the Single European Act was adopted in 1987 the French and the British governments during the ratification debates in the respective national parliaments made clear that the validity of the Luxembourg Accords were not affected by the Single European Act and other governments shared this view (Denmark, Greece, Ireland).

Although the Luxembourg Compromise is an act of the representatives of the Member States which is not legally binding and without legal effects and which does not constitute part of the Community legal system, its influence on decision-making has been very important so far.\textsuperscript{27} In conclusion, the Luxembourg Accords have proved that the requirement for unanimity has a strong political basis and it is not enough if the provisions of the EC Treaty providing for unanimity are amended. Perhaps, Member States may have concerning direct taxation is introduced.

\textsuperscript{27} "As a last resort the Luxembourg compromise remains in place untouched and unaffected by the Single European Act", The Foreign Secretary, House of Commons Parliamentary Debate, Vol.96, col.320, 23/4/1986.

\textsuperscript{28} In 1982 the UK unsuccessfully invoked the Luxembourg Compromise whereas in 1985 Germany in 1986 Ireland and in 1988 Greece blocked Council's decisions on agricultural issues. In June 1992 Italy posed a threat on Common Agricultural Policy.
to reexamine the compatibility of unanimity with proper functioning of the Single Market.

3.2.4. The Lack of a Widely Accepted Strategy on the Part of the Commission

One of the reasons to which the delay of the harmonisation of corporate tax law is attributed lies in the way each party that plays a role in the process of harmonisation approaches the concept of corporate tax harmonisation. Those approaches, or in other words strategies, are defined by the following three criteria:

a) The object of harmonisation (WHAT should be harmonized),

b) The procedure and the means of harmonisation (HOW should harmonisation take place) and

c) The appropriate time for harmonisation (WHEN -HOW LONG).

Each of the aforementioned criteria can constitute the field of deep disagreements which usually need a great deal of time to be settled.

Starting from the first criterion, it is worth noting that in theory the harmonisation of corporate tax law includes the definition of a common tax base, the alignment of tax rates, the establishment of a common system of integration of corporate tax with personal taxation and the removal of the tax barriers to cross-border operations. In practice though, the proper functioning of the Internal Market may need one of, or some of, or even all the components mentioned above.

For example, there are four trends as regards the subject matter of corporate tax harmonisation. The first favours the removal
of tax barriers to cross-border operations\textsuperscript{29} and suggests that everything else should be left to market forces.\textsuperscript{30} The second is identical with the first as regards the removal of tax barriers but it is differentiated to the extent it favours legislative intervention when problems arise.\textsuperscript{31} The third one calls for the harmonisation of the tax base, the removal of tax barriers to cross-border operations and the abolition of discrimination in the integration of corporate tax with personal taxation.\textsuperscript{32} Finally, the fourth trend supports the idea of total harmonisation (base, rates, tax barriers, system of integration).

The decision on what should be harmonised is a political one, because it has to be taken by the Council (ECOFIN) which consists of the representatives of the governments of the Member States. Whichever of the four strategies the Commission chooses, it is the Council's choice that matters. In doing so the Council will examine closely the needs of the Single Market taking into account economic and political factors. One of them, perhaps the most significant, will be the degree of political and economic integration which will

\textsuperscript{29} Double taxation and other problems which occur when a parent company residing in one Member State sets up a subsidiary in another Member State.

\textsuperscript{30} Competitive or market-led harmonisation. It will be examined separately.

\textsuperscript{31} Wait and See how the Internal Market functions after the removal of tax barriers and if the result is not satisfactory, then intervention (ex-post).

\textsuperscript{32} See Chapter 2 (2.2.4.).
CHAPTER 3

dictate the kind of corporate tax harmonisation.\footnote{33} 

Turning to the second criterion (HOW should corporate tax harmonisation take place?), it must be stated from the beginning that the criterion at issue concerns the type and the means of corporate tax harmonisation.\footnote{34} As regards the type, the debate is focused mainly on two competing types, competitive and imposed, which represent different schools of tax philosophy. The former favours the removal of tax obstacles to cross-border operations and calls for any other issue to be left to market forces. As a result, the Community's intervention will be restricted to a deregulatory role and the solution of any problems which may concern the taxation of business in the Single Market will rest upon the market forces. In other words, competitive harmonisation will bring the convergence of national corporate tax laws, since the Member State with the most flexible and attractive corporate tax law will set an example which will be followed by the other Member States (the so-called bottom up approach), if the latter do not want to lose investments.\footnote{35}

The advantages of this approach are significant. First, any future changes to corporate tax laws of the Member States will be

\footnote{33} An analysis of the interaction between the harmonisation of corporate tax law and European integration will follow in this Chapter.

\footnote{34} See Chapter 1 (1.2.5. and 1.3.3.).

\footnote{35} This theory has been put into practice when the UK in 1984 and the US in 1986 reformed their corporate tax laws. As a result, Western European countries adopted similar changes into their tax laws.
almost simultaneous, quick\textsuperscript{36} and, above all, without negotiations and deadlocks. Secondly, since such changes will be decided by the government of each Member State there will be no restriction of national sovereignty with all its side effects.

On the other hand, it has to be underlined that tax competition has achieved a convergence of nominal tax rates but not a respective convergence of the tax bases (and therefore of the effective tax rates) and that competition between enterprises is quite different from competition between Member States. The former is justified to force the weakest businesses out of the market, whereas the latter must not be allowed to force the weakest Member States out of the Internal Market, simply because their revenues cannot afford such tax changes.

In addition, the concept of competition presupposes a certain degree of similarity of the competing parts which means that competition cannot take place between completely different things (e.g. there cannot be competition between a car manufacturing company and a bank). Thus, one may wonder whether the twelve corporate tax laws have that minimum degree of similarity which will enable them to enter into competition with each other. If not, the disparities between the twelve tax laws will not lead to a state of competition but they will cause serious distortions to the free flow of capital and to the Internal Market. Finally, competitive tax harmonisation due to the fact that it does not follow a prefixed formula but it may concern any aspect of corporate taxation and may take place every

\textsuperscript{36} As the trends in income taxation in the 80's have proved.
time a Member State introduces some important tax amendments does not offer certainty which is crucial for businesses.\textsuperscript{37}

However, competitive corporate tax harmonisation is regarded as unlikely to take place by the Ruding Committee which stated in Chapter 10, Part II of its Report that "...the Committee found no convincing evidence that independent action by national governments is likely to provoke unbridled tax competition among Member States".\textsuperscript{38} The Committee reached this conclusion relying on the consideration of data in Chapters 7 and 8 of the Report. What the Committee misjudged was that the data used for drawing this conclusion were taken from 12 different domestic markets in which corporate taxation was not the only factor that distorted investment-making and not from the post-1993 Internal Market which will produce different data and in which some distorting factors will have been eliminated and the importance of the factor of corporate taxation will have been upgraded.\textsuperscript{39} For example, Member States may compete for offering the

\textsuperscript{37} According to a research which was carried out in the European business community on behalf of the Ruding Committee and will be included in the Report 74\% of businessmen are in favour of Community action whereas only 24\% favour Competitive harmonisation. This information was provided by Prof. Vanistandel in his speech at the Conference organized by the Institute for Fiscal Studies in London on 27/3/1992.

\textsuperscript{38} Ruding Committee's Recommendations, p.25.

\textsuperscript{39} In order to safeguard its conclusion against developments leading to the opposite direction the Committee has stated in Chapter 10 that "...past experience may not be reliable guide to the amount of tax competition that might eventually materialize in a single market,
best tax environment to investments from non-EC countries.

The opposite of competitive harmonisation is imposed harmonisation which favours the idea of centrally initiated legislative action aimed at creating similar corporate tax rules in all Member States. In other words, this type of harmonisation calls for a "top-down" imposition of corporate tax structures and deadlines leaving little discretion to Member States. Nevertheless, imposed harmonisation has the advantage that it clarifies the tax framework (legal certainty) within which the European companies will compete (it makes the rules of the "game" known "ex-ante"). Furthermore, it achieves a great degree of uniformity with respect to corporate tax rules and this is very important for the Single Market which is destined to be a unified market.

Though important, the advantages of imposed harmonisation are accompanied by some grave disadvantages. First, such type of harmonisation involves many and long rounds of negotiation and this will not be in conformity with the need of the Internal Market for "on the spot" response to the problems which cause distortions. Secondly, problems may arise from the fact that imposed harmonisation reduces the role of national governments and restricts their sovereignty by imposing a common tax structure. But the different tax structures of the Member States reflect differing economies and different social and political priorities. Consequently, would not since establishment of the latter is likely to increase sensitivity of investment to tax differences among Member States", Ruding Committee's Recommendations pp.25-26.
it be fair if Member States were given more discretion to decide their tax systems according to their needs and priorities?

A satisfactory answer to the question mentioned above is offered by another type of harmonisation which is a hybrid solution, a combination of the other two types. Indeed, this third type opts for the minimum harmonisation, that is the removal of tax barriers to cross-border operations accompanied by the harmonisation of those elements of national corporate tax laws which undermine the application of the principle of competition. On the one hand, the hybrid solution gathers all the advantages of the two types of harmonisation without having their disadvantages, but on the other it poses a difficult question which has to be faced by the governments of the Member States. The question is: What should the minimum harmonisation include, or, in other words, which are the elements of national corporate tax laws that undermine the concept of competition and, therefore, need harmonisation? 40

Whatever the answer is, or whichever type of harmonisation prevails, the decision on the choice of a specific type of corporate harmonisation will be based on economic and political elements. In fact, such choice is closely connected with the way one approaches the concept of competition, that of the free market, as well as with the way one considers the effects of each of the types of harmonisation on tax revenue and on public spending. In addition, for the reasons explained in Chapter 1 41 the instrument by which

40 This question will be answered in Chapter 6.
41 See 1.3.3. at c.
corporate tax harmonisation should be carried out is Directives.

With regard to the timing of corporate tax harmonisation (WHEN) it is worth mentioning that this issue is closely related to the selection of a specific type of harmonisation. For example, if competitive harmonisation prevails there is no need for a decision on which stage of the Internal Market the harmonisation will take place, since the latter is decided by market forces "on the spot". Conversely, in the case of imposed and hybrid type of harmonisation certain questions arise in relation to the appropriate time which will be chosen by the Community to intervene and regulate some issues of corporate taxation.

The first question could be whether the harmonisation of corporate tax law must take place before the establishment of the Internal Market or after and if after at which stage. The second could be whether each problem arising from the lack of corporate tax harmonisation should be dealt with separately, or whether each attempt of harmonisation should deal with a band of different problems. The third and final question concerns the speed of harmonisation (How quickly should the process of corporate tax harmonisation respond to the needs of the Internal Market?). The Ruding Report has included some recommendations on the timing of corporate tax harmonisation. In particular, it has proposed the allocation of Corporate tax harmonisation measures to three phases the first of which will end in 1994 the second will coincide with the

---

42 This question is related to distinction between gradual and single-phased harmonisation: See Chapter 1 (1.2.5.).
second phase of Economic and Monetary Union and the third will start when full Economic and Monetary Union has been achieved.  

A final point is worth making about the Commission's share of responsibility for the non-adoption of a widely accepted strategy. Looking back one can find the answer on the question why the adoption of a strategy for the harmonisation of corporate tax law has not been well-prepared. Although the Neumark Report and the Segré Report resulted in the setting up of a "Programme for the Harmonisation of Direct Taxes" in which the Commission clearly opted for a total and imposed harmonisation of corporate tax, the strategy the Commission adopted in that Programme did not produce results.

Moreover, the Commission reaffirmed its commitment to Impose harmonisation in the "Report on the Convergence of Direct Taxes" presented in 1980. Between 1967 and 1989 the Commission proposed some Directives but it failed to persuade the Council to adopt them.

---

43 Ruding Committee's Recommendations, p.28.


47 The harmonisation of corporate tax law faced a deadlock.


49 The three Directives on the removal of tax obstacles to cross-border cooperation in 1969, the Directive on the system of integration of corporate with personal taxation in 1975 and its 1978 version concerning Collective Investment Institutions, the 1984
This is attributed to the fact that the Commission did not succeed in persuading the other Community institutions of the significance and the benefits of its strategy. And the most disappointing is that the Commission wasted precious time, in fact 23 years, adhering to a strategy which was rejected by the Council and the European Parliament (The European Parliament considered that the Commission should rearrange its priorities and to deal with the most important things such as the tax base in the first place).\textsuperscript{50} In addition, the Commission did not attempt to take advantage of the judgment given by the European Court of Justice in \textit{Commission v. France} on tax discrimination between resident and non-resident companies in respect of tax credits.\textsuperscript{51} If the Commission had brought similar cases of tax discrimination before the Court many more tax obstacles to cross-border operations may have been removed by now.

The lack of successes in the field of corporate tax harmonisation forced the Commission to change its tactics and to adopt a new strategy\textsuperscript{52} in 1990 which has two stages. During the first one tax barriers to cross-border operations will be abolished and a detailed study of the problems arising from the existence of twelve Directive on the carry-over of losses and the 1988 preliminary draft directive on tax base (See Chapter 1, 1.4.).

\textsuperscript{50} a) Fredesdorf Report, Doc.CEJ 846/78, Brussels 12/7/1978.
   b) Interim Nyborg Report, Doc.104/79.


different corporate tax laws will be carried out by the Ruding Committee (short term approach).\textsuperscript{53} The Report of that Committee will constitute the basis for the Commission's proposals on the harmonisation of corporate tax law (long term approach).

The guidelines of this approach were announced by the Commission on 24/6/1992\textsuperscript{54} and according to them the Commission will attempt to ensure: i) the adoption of the Proposed Directives on cross-border operations,\textsuperscript{55} ii) the implementation of the already adopted measures,\textsuperscript{56} iii) the avoidance of unfair situations resulting from the fact that the double tax agreements with non-EC countries differ from Member State to Member State and iv) that most of the Ruding Committee's recommendations are put into effect through consultation and agreement, rather than legislation.\textsuperscript{57} Although this new strategy has already produced some results\textsuperscript{58} its success will be

\textsuperscript{53} The Committee finished its work in March 1992 when it published its Recommendations (Chapter 10 of the Report); the full text of the Report of the Committee will be published later in 1992.


\textsuperscript{55} These Proposals will be discussed in Chapter 5.

\textsuperscript{56} The Mergers Directive, the Parent-Subsidiary Directive and the Arbitration Convention.

\textsuperscript{57} Such preference to tax coordination rather than tax harmonisation is not justified by the reality of the Single Market which is an advanced stage of economic integration that cannot be served by solely coordination measures destined to deal with less advanced forms of integration.

\textsuperscript{58} The adoption of 2 Directives and the conclusion of a Convention on 23/7/1990.
judged by the following two criteria: a) Whether the strategy will gain ground in the Council and the European Parliament and b) Whether it will secure that corporate taxation will not cause distortions to the Internal Market. However, the fact that the term of the present Commissioners expires by the end of 1992 and the likely replacement of the current Tax Commissioner constitute a serious drawback to the newly adopted strategy.

3.2.5. The Conflict of Interests in the Process of Corporate Tax Harmonisation

The process of harmonisation, when it is conducted from Brussels, has the characteristics of a national law-making procedure, the only exception being the number of interested parties (at national level is smaller than at Community level). Indeed, "participants in making law on important issues include not only a broad range of European Community institutions but also a wide variety of individuals, governments, groupings and interest groups". 59 All these parties express their views in the several stages of European Community lawmaking which are public and extremely open at the beginning, but become secret as they approach the final agreement. 60

59 F. G. Snyder, New Directions in European Community Law, London, 1990, p.35.
At this point, it is worth mentioning that the participants in the lawmaking process act in accordance with the interests they want to protect or serve. Interests could be defined as "policy preferences, the fulfillment of needs.... based on hypothesised ex post facto choices". Furthermore, interests can be classified as objective (=interests not necessarily reducible to or independent on individual consciousness) or as subjective (consciously expressed interests).

Three sources of interests can be identified in the process of Corporate tax harmonisation. First, Member States have to secure their "national interests" which are defined as interests resulting from the policies each Member State has adopted. Secondly, there are the interests of the companies which operate in the Internal Market, and such interests stem from the economic orientations of each company (e.g. if it is interested in exports or in establishing subsidiaries in other Member States). Thirdly, there are the interests of the Community's institutions that take part in the process of harmonisation.

Starting from national interests, the crucial question that needs an answer refers to the factors which form these interests in the process of corporate tax harmonisation. One of the most decisive factors is the revenue obtained from corporate tax which means that, if the revenue is high in a Member State, changes to corporate

---

62 F. G. Snyder, op.cit., p.49.
taxation proposed by the Community and resulting in a reduction of the revenue will not be welcomed by that Member State. The following table outlines the situation in the twelve Member States:

Table 24*

<table>
<thead>
<tr>
<th>MEMBER STATE</th>
<th>REVENUE FROM CORPORATE TAX AS A PERCENTAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>of Total Tax Revenue</td>
</tr>
<tr>
<td>BELGIUM</td>
<td>6.7</td>
</tr>
<tr>
<td>DENMARK</td>
<td>4.2</td>
</tr>
<tr>
<td>FRANCE</td>
<td>5.5</td>
</tr>
<tr>
<td>GERMANY</td>
<td>5.5</td>
</tr>
<tr>
<td>GREECE</td>
<td>4.6</td>
</tr>
<tr>
<td>IRELAND</td>
<td>3.4</td>
</tr>
<tr>
<td>ITALY</td>
<td>10.1</td>
</tr>
<tr>
<td>LUXEMBOURG</td>
<td>17.7</td>
</tr>
<tr>
<td>NETHERLANDS</td>
<td>7.7</td>
</tr>
<tr>
<td>PORTUGAL</td>
<td>3.9</td>
</tr>
<tr>
<td>SPAIN</td>
<td>8.6</td>
</tr>
<tr>
<td>U.K.</td>
<td>12.3</td>
</tr>
</tbody>
</table>

*The figures in the Table refer to 1989.


It is obvious from Table 24 that corporate tax revenue constitutes a basic source of revenue for some Member States (Luxembourg, U.K., Italy, Spain, Netherlands). In addition, revenue from corporate taxation occupies a significant part of the Gross Domestic Product in certain Member States (Luxembourg, U.K., Italy, Netherlands). Thus, it is unlikely that those Member States would be prepared to accept harmonisation measures which would reduce their
revenue, because if they did so they would have to raise the lost revenue from somewhere else. This can be done either by borrowing, which is not recommended because the European Monetary System as it will apply sets strict rules for borrowing, or by raising the rates of other taxes, which is not politically popular and may have economic side effects.

The danger of losing investments or even driving away the already invested capital is a factor that contributes to the formation of national interests. For example, the Directive on the common system of taxation applicable to mergers needed 21 years to be adopted, because for all those years it was meeting the opposition from the Netherlands and Germany to the Directive. Both were fearing that companies might merge outside their tax jurisdictions, either to secure benefits offered by those Member States which do not apply the classical system (in the case of the Netherlands), or to avoid worker participation schemes (in the case of Germany).

Another decisive factor is whether in the territory of a Member State reside parent companies which have subsidiaries in other Member States. In this case, the Member State with the parent companies is interested in the adoption of measures which harmonise the corporate tax in the European Community, because this will benefit the parent companies, in the sense that it will facilitate their tax planning, their future expansion, as well as the

---

63 See the Protocol on the Excessive Deficit Procedure of the Treaty on European Union.

64 See Chapter 2 (2.2.4.).
repatriation of the profits made by the subsidiaries. This, in turn, will have positive effects on the economic interests of the Member State in which parent companies reside.

The degree of pressure that pressure groups can exert on the national government's policy making is another factor. It is a question of whether such pressure groups can vest their interests with a national dimension and persuade the government to consider these interests as national and to protect them. Usually, national confederations of businesses and industries decide on whether a corporate tax harmonisation measure is for their benefit or not and then press the government to adopt their position. Consequently, if they can exert a great deal of influence on the government, the latter transforms the subjective interests of the group into national interests.

Another factor that defines national interests in the field of corporate tax harmonisation is the way in which the government of a Member State approaches the issue of integration. If it does not believe in the need for a high level of integration, the concept of national interest excludes Community measures that could directly or indirectly lead to such a level of integration. Therefore, if a corporate tax harmonisation measure has some elements of federal tax structure, it is totally in opposition to the "national interests" of the Member State in question.

The second category of interests involved in the process of

\[6^{5}\] As usually happens with national confederations of industry and commerce.

175
corporate tax harmonisation stems from companies residing in a Member State. Such companies are inevitably affected by any harmonisation measure in the field of corporate tax law and their position over such a measure depends upon: i) Their size, ii) The degree of efficiency they have achieved and iii) Whether they do business in a Member State different from that in which they reside.

Considering the first factor, namely the size of companies, it has to be mentioned that corporate tax harmonisation measures are aimed at contributing to the creation of ideal conditions of competition between companies in the Single Market. Given that large firms can perform better than small firms under conditions of competition, because the former have more resources available than the latter, it is inevitable that harmonisation measures, which help the creation of such conditions, will offer more chances to large companies and, consequently, will be in accordance with their interests.

The second factor (degree of efficiency) is closely related to the first one. As previously mentioned, corporate tax harmonisation measures are destined to remove the tax obstacles which block the proper functioning of competition rules. Such rules create an environment which favours the survival of efficient companies, forcing the inefficient companies to closure. As a result, inefficient companies may consider corporate tax harmonisation measures as harmful to their interests.

The fact that a company in a Member State may have, or may have not, extended its activities in another Member State plays a significant role in the formulation of the interests of that company
and determines its position on a series of corporate tax harmonisation measures. Indeed, the harmonisation of corporate tax law includes measures which are aimed at removing the tax obstacles to cross-border operations and counteracting double taxation. The effects of such measures on companies with subsidiaries in other Member States are vital. Conversely, the same measures may be indifferent or even harmful\(^6^6\) to companies with domestic only activities.

The aforementioned arguments are confirmed by three surveys. The first carried out by M. Devereux and M. Pearson\(^6^7\) proved that British companies favour the harmonisation of tax base and tax rates by a massive majority. The companies opposed to any attempt of harmonisation did not do business abroad. Furthermore, the same survey showed that the structure of the investment abroad (branch or subsidiary) as well as the place of investment are influenced by tax. The second survey, under the title "Reshaping Europe", was conducted by the European Round Table of Industrialists, which represents 45 of Europe's largest companies, and showed that these companies were in favour of a high level of economic and political integration.\(^6^8\) Such

---

\(^6^6\) The measures at issue may enable companies from a Member State to enter the domestic market of another Member State and to become more competitive than the domestic companies which will find themselves in a very difficult position.


\(^6^8\) They supported the widening and deepening of the Community as well
an approach inevitably encompasses the harmonisation of corporate tax law. The third survey was carried out for the Ruding Committee and showed that 74% of businesses support the idea of centrally imposed corporate tax harmonisation.\textsuperscript{69}

The last interests that can be identified in the process of corporate tax harmonisation are those of the Community’s institutions which participate in the process, namely the Commission and the European Parliament.\textsuperscript{70} These two institutions have a significant political interest in any harmonisation process and, consequently, in corporate tax harmonisation.

By initiating and supporting the harmonisation process in such important fields of law as corporate tax law is, the Commission\textsuperscript{71} and the European Parliament\textsuperscript{72} try to influence the process of economic and political integration and to upgrade their role within the Community

as the strengthening of Community structures. \textsc{Financial Times} 20/9/1991.

\textsuperscript{69} See Note 37.

\textsuperscript{70} Excluding the Council which has operated so far as an institution in which the national interests of Member States can be protected. See the analysis of the concept of “national interests” above.


structure "de facto" with a view to achieving a "de jure" reallocation of competences through an amendment of the EC Treaty in the long run. This, of course, is in complete opposition to the interests of the Council and especially with the Council's privileged role in decision-making.

The Commission's role in particular seems so central in the entire process of corporate tax harmonisation. It is the Commission by proposing legislation in the field of corporate taxation that shapes the pace of corporate tax harmonisation and given that direct taxation is a very important issue the Commission has not missed the opportunity to play its distinctive role in such a crucial field. By doing so the Commission reaffirms its position as an extremely important policy-making institution whose actual power is not proportional to its role in the harmonisation process.

3.3. The Interaction Between Corporate Tax Harmonisation and European Integration

The process of European Integration, that is the "process leading toward institutionalised regional unity", is a process with legal, economic and political aspects, but, above all, is a process based on policy choices (made by politicians) and involving a great

---

73 For an introduction to the relation between the concept of harmonisation and the concept of integration see Chapter 1 (1.2.).

74 Keohane and Nye, "International Dependence and Integration", (1975) International Politics 363 at 394.
deal of interests. On the other hand, corporate tax harmonisation, as already shown, has a similar strong political element. This element and the fact that both processes take place within the political framework of the European Community raise the question whether any possible link between those processes could be identified.

The attempt to find any possible link between the two concepts has to start from a conceptual analysis of them, and more specifically of the term "integration", since the concept of corporate tax harmonisation has already been clarified. Thus, "integration" can be defined as the process of bringing together different parts and forming a whole. In addition, the concept of integration is divided into three parts and each of them is connected with and influences the others. Economic integration, political integration and legal integration are the three subdivisions of European integration. There is also the concept of fiscal integration which was defined in Chapter 1 and part of which is corporate tax harmonisation. Since the relation between tax harmonisation and legal integration has been examined in the first Chapter, what remains to be considered is the relation between the harmonisation of corporate tax law and the other two parts of European integration.

Economic integration "refers to the closer linking together of

---

75 See Chapter 1 (1.2.6.); fiscal integration can be included in the concept of legal integration and can also be regarded as an important sector of economic integration.
economies in a Free Trade Area, a Customs Union, a Common Market or an Economic Union".\textsuperscript{76} The purpose of economic integration is the achievement of higher living standards, full employment, economic expansion and economic efficiency by linking the economies of the Member States. Free Trade Area, Customs Union, Common Market and Economic Union have been classified as stages of economic integration and the classification, at least its original version, is attributed to B. Balassa's classical work under the title \textit{The Theory of Economic Integration} (London, 1962). Other authors\textsuperscript{77} have further divided those initial four stages and have enriched the debate on the process of economic integration.

Given that economic integration in the European Community is approaching the stage of Common Market, it is worth finding how corporate tax harmonisation is linked with that stage. As has previously been argued,\textsuperscript{78} the harmonisation of corporate tax law is essential for the proper functioning of the Common Market which is one of the stages of economic integration. Furthermore, the harmonisation of corporate taxation is essential to the final stage of economic integration, that is the Economic and Monetary Union.


\textsuperscript{78} See Chapter 2.
This view has been expressed by the Werner Report and has been politically endorsed by a Council Resolution. The Ruding Report has also linked corporate tax harmonisation with the Economic Monetary Union by providing that the phases of the former should coincide with the already fixed stages of the latter. In conclusion, the evolution of the process of European economic integration depends, to a great extent, upon the successful completion of corporate tax harmonisation. However, the dependence seems to be mutual, because corporate tax harmonisation cannot take place, unless there is an economic integration process under way.

Nevertheless, in the relation between corporate tax harmonisation and economic integration the latter prevails in a sense that it is corporate tax harmonisation that serves economic integration and not vice versa. Thus, if the former does not fulfill the needs of the latter, the result is tax distortions to the Common

---


81 Ruding Committee's Recommendations, p.28.

82 At least in its advanced stages, because a State may adopt trends in corporate taxation that already apply in the corporate tax system of another State in order not to be in a disadvantageous position in terms of tax competitiveness. But this type of harmonisation is confined to adoption of trends, something different from corporate tax harmonisation as it has been defined in this thesis.
Market, which is the most crucial stage of European economic integration.

At this point, it is worth answering two final questions on the relation between corporate tax harmonisation and economic integration. The first concerns the authority which shapes, and determines that relation. Bearing in mind that the Council is the Community Institution vested with the power of deciding almost everything, one can easily find the answer. It is the Council or, in more specific terms the governments of the twelve, that shapes the relation at issue, because it has the authority to choose the degree of economic integration the European Community needs, and of taking all those measures which enable the accomplishment of that degree of integration.

The second question refers to the way in which the Council shapes the aforementioned relation. The Council does so by choosing the appropriate policy, that is by determining what type of corporate tax harmonisation (imposed-competitive-hybrid) suits the present status of economic integration and by defining the subject-matter of the harmonisation process (base, rates, etc.).

Admitting that economic integration contributes to and influences the progress of political integration and taking into account that corporate tax harmonisation is connected with economic integration one may wonder whether there is a possible link between the harmonisation of corporate tax law and political integration.

within the European Community. It seems though, that the consideration of that question requires the definition of the concept of "political integration" in the first place.

Consequently, "political integration" can be defined as "the process of uniting distinct groups, communities or regions into a workable and viable political organisation".\[^{84}\] In order to apply this definition to the European Community one needs to replace the phrase "...distinct groups, communities or regions..." with the words "distinct Member States". As far as the stages of political integration are concerned it has to be mentioned that they are in principle three.\[^{85}\]

The first stage is that of formal association or cooperation between two or more States. In this stage, the States which contribute to a formal association cooperate with each other in order to reach the adoption of common positions vis-à-vis issues that fall within the scope of the association (economic, military, etc.). Sometimes, the association is so loose that it takes the form of mutual consultation between the States.

The second stage is the political system of confederation which can be defined as the one "in which the central government derives its original authority from the constituent regional governments and is, therefore, legally and politically subordinate to them, and in which the institutions are composed predominantly of

\[^{84}\] D. Cameron, \textit{loc.cit.}

\[^{85}\] Although each of these stages has been further divided by the political science into sub-stages.
delegates appointed by the constituent regional governments". The European Community after the Treaty on European Union (Maastricht) has departed from the stage of confederation and by becoming a Union has reached an interim stage which lies in the middle between confederation and federation.

The final stage of political integration is the formation of a federation in which "the central and regional governments each possess autonomous authority assigned by a formal constitution, so that neither order of government is legally or politically subordinate to the other and each order of government is elected by and directly acts upon the electorate".87

In view of this political analysis, it is obvious that imposed or hybrid corporate tax harmonisation may enable the creation of a European federal tax structure which corresponds to the third stage of political integration. In other words, these two types of harmonisation involve transfer of competence from the national level to the Community level and are always accompanied by a certain degree of surrender of national sovereignty. Consequently, imposed and, to a large extent, hybrid corporate tax harmonisation contribute to the transformation of the European Community from a confederation to federation.88

Conversely, competitive corporate tax harmonisation seems to

---

86 D. Cameron, op.cit., p.10.
87 Ibid.
88 Although it is quite doubtful whether the federal structure will ever be acceptable by the Member States.
conform to the confederal model and to contribute to the retention of the present stage of political integration in the European Community. In fact, this type of harmonisation does not lead to the creation of a federal tax structure and does not require any transfer of competence from the national to Community level.

Finally, the relation between corporate tax harmonisation and political integration and, especially, the fact that corporate tax harmonisation may or may not cause a reallocation of competences between the Community and the Member States in the field of corporate tax law raises another political issue. This issue concerns the application of the principle of subsidiarity to the process of corporate tax harmonisation.

3.4. Corporate Tax Harmonisation and Subsidiarity

Corporate taxation is one of the so-called "Grey Areas of Policy" in the European Community, because the legislative powers lie with the national governments of the twelve Member States, while there is a strong case for a possible partial transfer of those powers. The dispute between the central authority (at Community level) that adopts rules of corporate tax harmonisation in connection with some specific issues and national authorities (in each Member State) which deal with all the remaining issues (these issues constitute the vast majority) may be set aside or reduced when the principle of subsidiarity is applied to any policy conducted by the Community.

The principle of subsidiarity started as a socio-political
idea whose existence goes as far as the German philosophical school of natural law. However, it was the Catholic Church which put forward the principle of subsidiarity in the 1930's underlining its social dimension. Furthermore, the need for an allocation of powers between the central and regional governments in federal States was the reason that political science turned to subsidiarity searching for an answer. It was exactly that moment when subsidiarity took the meaning it has nowadays (a principle that confines central government's competence to those issues with which regional governments cannot deal effectively). This, in turn, resulted in the inclusion of a subsidiarity clause in the text of federal constitutions, transforming subsidiarity into a legal, constitutional principle.

As regards the European Community, the importance of the principle of subsidiarity emerged from the fact that the safeguards the EC Treaty offers in relation to the distribution of competence between the Community and the national level may not be enough for the needs of the economic and political integration. Indeed, the process of Economic and Political Union in the European Community is likely to increase the fields in which the competence will be shared.

---

89 Pope Pius' XI Encyclical Letter, Quadragesimo Anno (1931) reads that: "...it is injustice, a grave evil and a disturbance of right order for a larger and higher association to arrogate to itself functions which can be performed efficiently by smaller and lower societies."

90 The Tenth Amendment to the US Constitution, Article 30 of the Federal German Grundgesetz.
between the national and the Community level. The inclusion in the EC Treaty of a subsidiarity clause, similar to those included in federal constitutions, which could operate as a political guide to Community’s action in connection with issues falling within the concurrent competence materialized when the Treaty on European Union was agreed. 91

The debate on the application of subsidiarity to Community matters started in the 70's and many written references to the principle were made. 92 In addition, the principle was included in the EC Treaty when the latter was amended by the Single European Act, but that reference (Article 130R) was restricted only to environmental issues. The debate climaxed during the Intergovernmental Conferences concerning the Economic and Political Union and the European Parliament contributed to it. 93 As a result of the debate, the Treaty on European Union inserted a new Article (3b) in the EC Treaty which reads as follows: "The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein. In areas which do not fall within its exclusive competence, the Community shall take action, in accordance

91 Article G(5) of the Treaty on European Union inserted in the EC Treaty Article 3b that is the subsidiarity clause.
93 The European Parliament called for an adoption of such clause with the Resolution Doc. A3-163/90 (1990 OJ, C231/163) and the Commission did so in its opinion delivered on 21/10/1990 COM(90)600 final.
with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community. Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty."

The adherence of the Community to the principle of subsidiarity and the inclusion of the principle in the text of the EC Treaty will have repercussions on the process of corporate tax harmonisation. The latter, in order to comply with the principle of subsidiarity, should deal with those elements of corporate taxation which, because they affect the achievement of the Common Market and therefore transcend the frontiers of the Member States, can be dealt with more sufficiently by the Community than by the Member States acting separately.

Thus, the application of subsidiarity to corporate tax harmonisation would mean, first, that the process of harmonisation must focus not on the twelve corporate tax systems as a whole, but it must isolate those provisions of national tax systems which might affect the establishment and the proper functioning of the Common Market and then examine whether the issues with which these provisions deal would be better regulated by rules adopted at the Community level. Secondly, the attempt of harmonisation must leave most corporate tax issues to be decided by national authorities. Thirdly, any legislative intervention by the Community should be restricted to those cases in which there is a real and absolute need for centrally imposed legislative solutions.
In view of these, it has to be noted that the decision on what needs harmonisation becomes difficult and politically sensitive. Given that the principle of subsidiarity has already been accepted by the Community as a guideline in the field of corporate tax harmonisation\textsuperscript{94} and has already been included in the EC Treaty, the Commission is bound to propose harmonisation measures which conform to the principle of subsidiarity and the Council must adopt such measures only if it has been persuaded that those measures serve the principle in question.

The fact that it is the Council which will finally apply the principle of subsidiarity to corporate tax harmonisation may raise some problems. As previously mentioned, the Council employs, to a great extent, political criteria when it takes decisions, and this can lead to the misuse of the principle. In fact, if one or more Member States want to protect their national interests endangered by a corporate tax harmonisation measure they may invoke that the measure in question contravenes the principle of subsidiarity.

Such reference to the notion of subsidiarity, aimed at hindering the progress of corporate tax harmonisation, formulates the concept of the so-called "artificial subsidiarity".\textsuperscript{95} In this case subsidiarity does not serve the purposes mentioned above, namely the

\textsuperscript{94} Commission of the EC, `Taxation in the Single Market'. (1990/6) European Documentation, at 28.

\textsuperscript{95} See J. Delor's speech on Subsidiarity, delivered at the Institute of Public Administration in Maastricht, 28/3/1991.
fair and efficient distribution of powers between the Community and Member States, and cannot help the conciliation between the concepts of federalism and national sovereignty.\footnote{This role of subsidiarity was underlined in J. Delor's speech delivered at the opening session of the 40th academic year of the College of Europe, Bruges, 17 October 1989.}

In applying the principle of subsidiarity to the field of corporate taxation the Council faces another difficult task. It must decide which parts of corporate taxation are covered by national corporate tax laws efficiently and which need Community's legislative intervention. Such a decision, in order to be fair and serve the real needs of the Common Market, must be taken on the basis of what is beneficial to the Common Market and not on the basis of national interests. Otherwise, if national interests prevail, the Council may find that there are no parts of corporate taxation needing regulation at the Community level, simply because such regulation means a certain degree of surrender of national sovereignty.

Finally, the success in the application of the principle of subsidiarity to corporate taxation will depend upon the role of the European Court of Justice. This means that if subsidiarity becomes an established principle of European Community law through its inclusion in the EC Treaty, the European Court of Justice may be given the chance of deciding whether the regulation of a specific issue should be left with the national authorities or should be transferred to the Community. It is beyond doubt that in such a case the task of the Court would be easier if a provision giving the Court...
such power were adopted.  

3.5. Corporate Tax Harmonisation and Regional Policy

Regional policy in general is defined as all those measures taken by the government of a State and aimed at helping the development of the poorest and most deprived regions of that State. As regards the European Community, such policy can be conducted by the Community (Community's regional policy) or by the government of a Member State (national regional policy). The measures included in the regional policy constitute a deliberate or conscious distortion of the principles of the Single Market, and especially of the principle of free competition.

Among regional policy measures there are tax measures that purport to make the poorest regions attractive with respect to investments. Such measures are called "tax incentives" and by their nature are not compatible with tax neutrality and free competition. Thus, from a theoretical point of view they cannot conform to the concept of Single Market which does not favour distortions to the

---


98 Measures in the course of the regional policy of a Member State may be accepted by the Community even if they cause distortions to the Single Market.

99 For further analysis See Chapter 2 (2.2.6.).

100 This concept will be analysed in Chapter 4.
CHAPTER 3

free market rules.

The problem arising at this point is that without tax incentives and perhaps other forms of economic incentives the poorest and less-competitive regions of the European Community will face a deterioration of their economic status which will lower the living standards of the people residing in those regions.⁹¹ Thus, corporate tax harmonisation must allow for regional policy regardless of whether the latter is conducted by the Community or by each Member State separately.

In more specific terms, whichever type of corporate tax harmonisation prevails (competitive-imposed-hybrid) it must leave enough space for the survival of tax incentives, or, in other words, it must not affect the existence of those tax incentives which try to boost investments in the deprived regions of the Community. In such case, although corporate tax harmonisation will derogate from its principles,⁹² it is beyond doubt that it will serve the objectives of the European Community in the best way.

---

¹⁰² These principles will be the subject-matter of the next Chapter.
CHAPTER 4
THE PRINCIPLES FOR THE SOLUTION OF THE PROBLEM

4.1. Introduction

The aim of the previous two Chapters was to identify the problem caused by the lack of harmonisation in the field of corporate tax law and to reveal the sensitive and complex aspects of that problem. However, the ultimate objective in the study of a problem, if that study is to be regarded as an integrated one, is the search for feasible and rational solutions. Such search is guided by two kinds of rules which due to their characteristics can be regarded as principles.

The first category includes all those general principles which can be derived from philosophy, methodology and logic and help in understanding a problem and in selecting a method of thinking with a view to identifying the causes of the problem and to finding a solution. The second category embraces those principles which are unique for each science and can apply only to problems classified in the same scientific area (e.g. principles of mathematics, physics, law, etc.). These principles are subject to a continuous elaboration in order to meet the needs of the science of which they are part.

In conclusion, having recognized that the disparities of the twelve corporate tax systems cause distortions to the Internal

---

1 Some of the principles discussed in this Chapter have been endorsed by the Ruding Committee.
Market\textsuperscript{2} and that a solution can be given through harmonisation, the purpose of this Chapter is to identify and analyze the principles which should be the guiding principles in the process of corporate tax harmonisation. Most of these principles have resulted from the elaboration of the general principles of tax law.

### 4.2. The Principle of Subsidiarity

As has already been mentioned,\textsuperscript{3} there is a close correlation between corporate tax harmonisation and subsidiarity. The implementation of this principle in the field of corporate tax law means that action can be taken by the Community in order to counteract problems resulting from the lack or the diversity of national corporate tax laws in respect of certain issues when it is considered that those laws do not deal with the issues in question in a way which is regarded as effective for the accomplishment of the aims set out in the EC Treaty.

The principle of subsidiarity after its inclusion in Article 3b of the Treaty on Political Union which was concluded at Maastricht\textsuperscript{4} has become one of the most fundamental principles of European Community law. As a result, a corporate tax harmonisation measure, when it is imposed,\textsuperscript{5} must be in accordance with the

\begin{itemize}
  \item \textsuperscript{2} See Chapter 2.
  \item \textsuperscript{3} Chapter 3 (3.4.).
  \item \textsuperscript{4} 9-11 December 1991.
  \item \textsuperscript{5} This means that it does not concern competitive or market-led
\end{itemize}
principle in question which means that where the tax laws of the twelve deal with corporate tax issues sufficiently intervention by the Community will not be acceptable. Conversely, there are cases in which the needs of the Internal Market or the involvement of more than one tax jurisdiction renders the attempt to deal with corporate tax issues by means of national laws ineffective. In such cases, where the market forces cannot induce a "de facto" harmonisation or they cannot achieve it in a short time so that economic resources are not wasted, there is a demand for corporate tax harmonisation measures that will be taken at Community level and will conform to the principle of subsidiarity.

4.3. Tax Neutrality

Taxes are neutral when they do not induce a certain economic behaviour and, therefore, do not cause any distortion to the "free market". It has been suggested\(^6\) that even when a tax causes a distortion it can be regarded as neutral provided that the distortion is conscious (deliberate). Certain authors\(^7\) have contributed to the


debate on tax neutrality by discussing various aspects of the concept. What remains a problem is to put all these aspects together so as to achieve a synthesis that will correspond to the real meaning of the concept. In view of this, it can be said that the term "tax neutrality" implies five situations.

First, it implies that the decision on the location of an investment must not be influenced by corporate tax laws (locational neutrality). Secondly, tax neutrality occurs when the legal form of enterprises is not influenced by provisions of corporate tax law which favour certain types of enterprises. Thirdly, tax neutrality also exists when the provisions of corporate tax law do not treat direct investments more favourably than indirect investments (neutrality with respect to the type of investment). Fourthly, corporate taxation must not affect the means of financing of an enterprise by giving preference to one of them (neutrality toward the financing of investments), if tax neutrality is the objective.

Finally, there must be neither discrimination between foreign or domestic investment made by a resident of a State nor

---

8 e.g. the corporate tax law of a country may favour public companies against limited partnerships.

9 Direct Investment = when an individual or a company invests. Indirect or Portfolio Investment = when an individual or a company buys shares of a financial institution (e.g. bank, fund, etc.) whose the main activity is to make profitable investments.

10 Companies are financed by three means: a) issue of new shares (equity financing), b) loans (debt financing) and c) retention and reinvestment of profits.
discrimination between domestic investment made by resident or non-resident (international neutrality). Consequently, it must be underlined that total tax neutrality exists when all the aforementioned conditions are met and that corporate tax harmonisation must achieve as much neutrality as possible. If, however, some of, but not all, the five forms of tax neutrality appear in a case the result is the accomplishment of partial tax neutrality.

4.3.1. Locational Neutrality

The concept of locational neutrality is further divided into:

a) Capital Export Neutrality (hereafter CEN) according to which investors bear the same tax burden regardless of the place of investment, or in other words investors' decisions on which country should receive their investment are not influenced by corporate tax systems and b) Capital Import Neutrality (hereafter CIN) which requires that investors investing in a certain country must bear the same tax burden regardless of their tax residence.\(^{11}\)

When CEN exists, the decision on the location of an investment will be affected not by taxation but by other factors.\(^{12}\) In other words, a company will invest in that Member State which offers the best environment from the resources point of view, and this, in turn,

---

\(^{11}\) The concepts of CEN and CIN were first introduced by R. A. Musgrave; See Note 7.

\(^{12}\) e.g. economic and political stability, transport, telecommunications, cheapest production cost, etc.
CHAPTER 4

will not amount to a waste of resources within the European Community. For example, a British manufacturing company wants to expand its business by establishing a subsidiary in another Member State so as to cover the European market in a more efficient way. The most likely location, from the resources point of view, would be a country like Germany or France, but, because of the special tax treatment of manufacturing companies in Ireland (10% Tax Rate), the investment will possibly be made in Ireland, a country poor in resources. Such a waste of resources is not for the benefit of the economic development which is essential for the achievement of the Community's objectives.

The application of CEN to corporate tax harmonisation is accomplished either by the equalization of the effective tax rates or by the full crediting of foreign taxes. According to the first method the effective corporate tax rates will be identical in all Member States and, therefore, European companies will face the same tax burden. This requires the equalization of nominal corporate tax rates and the simultaneous harmonisation of the corporate tax base.

---

13 There is a Treaty reference to the efficient allocation of resources implying the principle of Economic Efficiency in the new version of Article 102A as it was amended by Article G(25) of the Treaty on European Union.

14 Except for those cases in which such a waste is justified by reasons of regional policy.

15 For the meaning of the term See Chapter 2 (2.2.3 and 2.3).
and of the systems which integrate corporate with personal taxation.\textsuperscript{16} Nevertheless, CEN may be achieved, to a large extent, even if equalization of statutory tax rates does not take place, on condition that harmonisation is secured in the other two areas. The alignment of statutory corporate tax rates could be left to market forces (tax competition).

Under the second method each Member State offers companies residing in its territory full credit\textsuperscript{17} for the taxes paid to another Member State. As a result, the credit against domestic tax liability for the taxes paid abroad plays an equalizing role, since a company knows in advance that the amount of tax it will pay for its foreign activities will be the same as it would have been if those activities had taken place in the country of residence. Consequently, it is neutral to companies, from the corporate taxation point of view, whether they will invest in a Member State with low or high corporate taxes, because the final and definite tax burden they will have to bear will be decided by the tax system of the Member State in which those companies reside. Thus, it can be said that the method in

\textsuperscript{16} i) For the integration of personal with corporate taxation See Chapter 2 (2.2.4.), ii) effective rate equalization = total corporate harmonisation (harmonisation of all the elements of corporate tax).

\textsuperscript{17} Full credit means that in the case that foreign tax paid by a company exceeds its domestic tax liability the Member State in which that company resides must reimburse the company the amount in excess or it may allow that company to carry-forward that amount against future domestic tax liability.
question succeeds in subjecting foreign and domestic investments to the same tax treatment.

Nevertheless, there are some problems arising from the implementation of the credit method which may result in rendering the entire method inapplicable. First of all, the method requires that, in certain cases, the Member State of residence has to refund to a company the amount of tax paid to another Member State and exceeding the company's domestic tax liability or to carry-forward that amount and offset it against future domestic tax liability. Consequently, there is a need for some kind of clearing mechanism the purpose of which will be the sorting out of tax differences between Member States. 18

Secondly, the credit method raises difficult administrative problems and presupposes a high degree of cooperation between the tax authorities of Member States. Moreover, even the application of the full credit method relies upon a certain degree of corporate tax harmonisation. More specifically, if Member State A has to refund a company the amount by which the tax paid to Member State B exceeds domestic tax liability 19 it may do so only if it is satisfied by the methods B employ for the determination of taxable profits, since the latter play the most important part in the calculation of the tax

18 If Member State A has refunded ComA a certain amount of the tax paid in Member State B (country of Source) or has allowed ComA to carry-forward that amount of tax paid in B in excess of domestic tax liability, the latter will repay to A that amount through the clearing mechanism.

19 Or to allow the company to carry-forward the amount in excess.
due. This, however, implies a degree of similarity between the corporate tax bases of the two Member States which does not exist for the time being and cannot be achieved without harmonisation measures. Thus CEN has to be attained through the first method which may need more time to be applied but after applied it will secure better results.

Turning to CIN, it is worth noting that this type of neutrality affects competition in a market, because its existence ensures that investments are made by the most efficient investors. Conversely, if the tax system of a Member State does not treat companies from the other Member States equally, it is likely that a certain project in Member State A will not be undertaken by a company established in Member State B (ComB) and making the most efficient offer but it will be undertaken by a company established in Member State C (ComC) and making the cheapest offer. The reason that ComB, though the best company, cannot make the cheapest offer may be attributed to a possible additional tax burden on foreign income imposed by the tax system of Member State B or to the tax treaty between A and B which may contain less advantageous provisions compared with the respective treaty between A and C.

There are two ways to achieve CIN. The first is through effective rate equalization and is identical with that analyzed in the case of CEN. The second method consists of an equal treatment of investors from other Member States by the Member State, where the

---

20 See Chapter 2 (2.2.2.).

21 The same comments apply.
investments take place, plus full exemption of income earned abroad from taxation, an exemption which will be offered by the Member State in which the investing company resides. This means that each Member State must treat companies of other Member States uniformly and that the Member State of residence, when taxing companies in its jurisdiction, must exempt the income those companies have earned in another Member State. Nevertheless, the method at issue is not in accordance with CEN, as companies may face different effective tax rates investing in different Member States with all the above stated side effects.

There is no doubt that the ideal method to achieve both CEN and CIN would be the equalization of effective tax rates. Unfortunately, this is not feasible for the time being, because it requires extensive corporate tax harmonisation which is not welcomed by Member States. The other methods previously mentioned cannot achieve both types of locational neutrality, since CEN and CIN are attached to different poles. CEN is based on the concept of taxation on the basis of residence, whereas CIN relies on taxation based on the source of income. Thus, if both forms of locational neutrality cannot be satisfied priority must be given to one of them.

In view of the fact that corporate taxes in the twelve Member States are based on the principle of residence CEN must be given priority over CIN. In addition, the interrelation between CEN and

---

22 See Appendix to Chapter 2.
the principle of efficiency\textsuperscript{23} gives CEN a lead over CIN\textsuperscript{24} and makes it more important for the proper functioning of the Internal Market.

4.3.2. Neutrality Toward the Legal Form of Undertakings

Tax neutrality ceases to exist, if someone who wants to set up a business chooses a certain legal form for that business as a result of the preferential tax treatment given to that legal form by corporate taxation. In view of this, corporate tax harmonisation measures should not provide for or result in a more favourable tax treatment of certain legal forms of enterprises. For example, they should not restrict benefits only to public companies leaving other types of enterprises (partnerships, other types of companies) in a disadvantageous position.\textsuperscript{25}

The principle in question has already been endorsed by the judgment of the European Court of Justice in Case 270/83.\textsuperscript{26} The facts of that Case may be summarized as follows: The French tax law provided for a tax credit when distribution of dividends was taking place. The tax credit was equal to a fraction of the corporation tax paid at company level and was set off against the tax liability of the person (legal or physical) who was receiving the dividends.

\textsuperscript{23} To be considered later in this Chapter.


\textsuperscript{25} Unfortunately this is the case in some corporate tax Directives as it will be shown in Chapter 5.

However, the tax credit was dependent on one condition, namely that the shareholder who would be entitled to the tax credit should be resident in France except those cases in which the extension of the tax credit to non-residents was provided by a bilateral tax treaty. The problem was of dual nature. First, the tax treaties covered only subsidiaries whose parent companies were situated in Germany, Luxembourg, U.K. and Netherlands and did not provide anything for branches. Secondly, the tax treaties between France and those Member States which were not mentioned previously did not cover even subsidiaries.

As a result, the Commission received some complaints from insurance companies which were established in France and since the pre-litigation procedure did not come into fruition the Commission brought an action against the French government under Article 169 of the EC Treaty. The Commission brought an action before the European Court of Justice against France for the breach of the non-discrimination principle resulting from Article 52\textsuperscript{27} of the EC Treaty and succeeded in this action. In paragraph 22 of the judgment the ECJ establishes the principle of neutrality toward the legal form of undertakings by declaring that: "The second sentence of the first paragraph of Article 52 expressly leaves traders free to choose the appropriate legal form in which to pursue their activities in another Member State and that freedom of choice must not be limited by discriminatory tax provisions".

\textsuperscript{27} Freedom of establishment.
There is no obvious justification for such kind of tax discrimination. Even if the ultimate objective was to force European enterprises to adopt a legal form recognized by the company laws of all Member States (e.g. public companies), this should be done by means of company law harmonisation. Besides, there is no logic in attempting to abolish those legal forms of enterprises which are considered as traditional in some Member States and concern mainly small businesses with market orientations restricted to domestic markets. Hence, corporate tax harmonisation measures should be neutral toward the legal form of enterprises.

4.3.3. Neutrality with Respect to the Type of Investment

This type of neutrality has two aspects. The first concerns the abolition of any discrimination between direct and portfolio (indirect) investments. The second is related to portfolio investments and requires that in a unified market such as the Internal Market the corporate tax laws of Member States "should not influence investors' decisions as to in which European company they buy shares".

As regards the first aspect, it must be said that "the tax system should not influence the saver's choice between making his investment direct or using the services of an intermediary acting as

---

28 For the meaning of the terms "Direct Investment" and "Indirect Investment" See Note 9.

29 This form of neutrality is also called "Shareholder CEN" : M. Devereux-M. Pearson, op.cit., p.24.
a collector of savings". This means that there must be no additional tax burden on that income which is received by a financial intermediary (e.g. Investment Fund) and is subsequently distributed to individual shareholders. Although this rule is often taken into account by the tax systems of Member States, its application is confined only to domestic financial institutions and resident shareholders. Such discriminatory treatment may be attributed to protectionist attitudes national governments often develop and according to which domestic capital should be hindered from crossing borders. Hence, when national tax laws reserve some benefits for domestic financial intermediaries the result is tax induced distortions to the free movement of capital.

The second aspect may be regarded as a supplement to the discussion on CEN and CIN mentioned above. Indeed, buying shares in a less efficient company is sometimes more profitable than investing in an efficient company due to the tax benefits the less efficient company enjoys. But basing investment-making on tax factors and not on pure economic performance constitutes a violation of the principle of tax neutrality.

4.3.4. Neutrality Toward the Means of Financing

This form of tax neutrality is aimed at ensuring that corporate tax harmonisation measures do not favour a particular means of financing an investment and do not discriminate between retained

---

and distributed corporate profits. In other words, "In the ideal corporate taxation system, neutrality in terms of the means of financing should be strived for and in particular non-fiscal consequences should determine decision-making in this respect".  

Taking into account that interest paid on loans is treated by the corporate tax laws of all Member States as a deductible expense, one can conclude that there is a tax induced movement towards the financing of companies by loans. In addition, in those Member States which employ the classical system for the integration of corporate with personal taxation there is a tax induced preference for financing through the retention of profits or through loans. The reason for this trend is that, first, since profits are unlikely to be distributed (because if they are distributed they will bear double taxation) they must be directed to reinvestment and secondly, that new equity is more expensive than new debt, because dividends, unlike interest, are not deductible when corporate tax liability is determined.

Another factor that exerts influence on the financing of investments is the statutory tax rate each Member State applies. If

---

31 There are three means: a) Retention and Reinvestment of Profits, b) Issue and Sale of New Shares, c) Loan.
33 See Chapter 2 (2.2.2. d).
34 See Appendix to Chapter 2, Table 17.
it is high enough companies tend to finance their projects by borrowing money, as the interest paid for that money can be deducted from the taxable profits. As a result, the heavy tax burden is significantly reduced, but such a reduction is not always efficient, from the economic point of view. However, it must be underlined that there is a great deal of factors which, although they are not related to corporate taxation, have an impact on the choice of financing means.  

4.3.5. International Neutrality

As has already been indicated above, the concept of international neutrality can be divided into two forms. According to the first one the tax laws of the Member States should not discriminate between foreign or domestic investments made by their residents. Such discriminatory treatment against foreign source income is the result of high foreign taxes which are not taken into account in the calculation of the amount of domestic corporate tax for which a company is liable.

The Segré Report recommended three formulae for the elimination of double taxation resulting from the imposition of both corporate and withholding tax. Under the first formula foreign

---

35 e.g. inflation, interest rates, etc.

36 See pp.197-198.

37 Foreign Taxes = Foreign Corporate Taxes + Withholding Taxes.

income should be subjected to withholding tax but not to corporate income tax at source. The second formula denies the Member State from which the income originates the right to tax and entitles only the State in which a company resides to levy tax on that company's foreign income. Finally, the third method calls for the crediting of withholding tax at source against domestic corporate tax liability. Nevertheless, the free movement of capital requires the total abolition of withholding taxes within the Internal Market plus either effective tax rate equalization (even without statutory rate equalization) or full crediting of taxes paid at source.\(^\text{39}\)

As regards the second form of international neutrality, it requires that Member States' tax laws should not treat an investment from a resident company in a different way than they treat an investment from a company residing in another Member State. In other words, corporate tax harmonisation must establish a neutral treatment between domestic and foreign investments by introducing the necessary changes in Member States' corporate tax laws.\(^\text{40}\) The principle of international neutrality is implied in the last sentence of paragraph

\(^{39}\) The 1990 Parent-Subsidiary Directive is Community's first attempt to solve the double taxation problem caused by foreign taxes, but this attempt concerns only associated companies. Detailed analysis of the Directive in question takes place in Chapter 5.

\(^{40}\) NEUTRAL TREATMENT = Abolition of tax discriminations in the treatment of domestic and foreign investments.

EQUAL TREATMENT = Not necessarily abolition: e.g. If a tax advantage has been provided for domestic investments the concept of equity calls for the extension of the advantage to foreign investments as well.
18 of the judgment of the ECJ in Case 270/8341 which reads: "Acceptance of the proposition that the Member State in which a company seeks to establish itself may freely apply to it a different treatment solely by reason of the fact that its registered office is situated in another Member State would thus deprive that provision [= Article 52 of the EC Treaty] of all meaning".

The achievement of the second form of international neutrality rests with the successful dealing with the causes of non-neutrality, namely the different statutory tax rates often applying to domestic and foreign companies,42 the imposition of withholding tax when profits are transferred from the Member State of source to the Member State of residence, the amendment of those provisions of national tax laws which discriminate between domestic and foreign companies in so far as companies of other Member States are treated as foreign companies, the removal of the bureaucratic administrative obstacles imposed by the national tax authorities on foreign investments. To conclude, the concept of international neutrality leads corporate tax harmonisation towards the abolition of the distinction between domestic and foreign income within the Internal Market. Such an abolition removes one of the most important obstacles to the free movement of capital which is among the four targets of the Internal Market.43

---

2. See the Appendix to Chapter 2, Table 3.
3. EC Treaty 7a second paragraph.
4.4. Economic Efficiency

The term "economic efficiency" denotes the most productive use of resources at the lowest possible cost. This is one of the most important criteria used to provide a satisfactory answer in the question whether the resources of a country are used in a way that guarantees steady and constant economic development. The application of this principle to investments made by companies can determine whether a project is economically efficient or not. As a result of it, a specific investment is regarded as efficient, from the economic point of view, when the following requirements are met:

a) The investment is made by that company which is the most suitable for the project.

b) The investment is made in the area where the resources which are necessary for the project exist.

c) There is no influence of other factors which can influence the economic climate.

The relevance of corporate tax harmonisation to economic efficiency is attributed to the fact that the former is destined to promote the latter and, therefore, it must not contain elements which

44 It has the meaning of the most qualified.

45 There are cases of deliberate deviations from this rule, for example, for reasons of regional policy. See the reference to regional policy in Chapter 3 (3.5.).

46 e.g. taxation, political circumstances, bureaucracy, lack of infrastructure, etc.
could pose a threat to the accomplishment of economic efficiency. Moreover, it has to be added that Article G(2) of the Treaty on European Union\textsuperscript{47} redefines the aims of the EC by replacing Article 2 of the Treaty of Rome and the most important is that those aims\textsuperscript{48} are to a great extent the benefits from the existence of economic efficiency. In addition, the introduction in the EC Treaty of the concept of "efficient allocation of resources"\textsuperscript{49} makes clear that economic efficiency is one of the criteria in accordance to which the process of economic integration evolves in the Community.

In conclusion, if the aims of the EC are to be achieved then economic efficiency must be achieved and if harmonisation of tax laws is one of the means for the achievement of the aims of the EC\textsuperscript{50} then it is one of the vehicles for the attainment of economic efficiency. Consequently, harmonisation of tax laws and, in particular, harmonisation of corporate tax laws must take into account the elements of economic efficiency, since the latter is one of the aims

\textsuperscript{47} Maastricht 9-11 December 1991.

\textsuperscript{48} "...to promote, throughout the Community, a harmonious and balanced development of economic activities, sustainable and non-inflationary growth respecting the environment, a high degree of convergence of economic performance, a high level of employment and of social protection, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States."

\textsuperscript{49} Article 102A as amended by Article G(25) of the Treaty on European Union.

\textsuperscript{50} Article 3(h) of the EC Treaty.
of the former.

A tax structure (including harmonisation of corporate tax laws) is efficient, from the economic point of view, when the following conditions are met:

a) It does not produce a misallocation of national resources.\(^5\)

b) When national resources are not employed to the most productive uses the tax structure has the task of influencing the reallocation of resources to more productive uses.

c) It benefits the most efficient companies protecting competition from tax induced distortions.

In order to satisfy all the aforementioned conditions a tax structure must be, above all, neutral, which implies the existence of a strong link between tax neutrality, and particularly locational neutrality, and economic efficiency. Indeed, the achievement of the former, which requires that investments should be made in the most efficient country (CEN) by the most efficient company (CIN),\(^6\) results in the establishment of the latter. However, the two principles must not be confused and they must not be considered as identical. Conversely, there is a cause-effect relation between locational neutrality and economic efficiency.\(^7\)

Economic inefficiency, that is the result of the lack of

---

\(^5\) Unless it is required to do so for reasons of regional policy.

\(^6\) See 4.3.1.

\(^7\) It must be noted that CEN is the "sine qua non" element. CIN is important for the achievement of economic efficiency but not as much important as CEN.
economic efficiency, can be measured thanks to a model developed in 1984 and extended later and whose purpose is to calculate the effective tax rates on transnational investments. This model attempts to find what rate of return a company must earn before tax in order to give a shareholder or bank which provides the capital for the company a given rate of return. The difference between the pre-tax return to the company and the post-tax return to a shareholder can provide a clear picture of the distortion of investment induced by the corporate tax regime.

4.5. Equity

The principle of equity requires that a tax system should be fair towards the taxpayers who are subject to its rules. The answer to the question about the fairness of a tax system depends on whether the latter treats equally taxpayers with the same ability to pay (horizontal equity) and differently taxpayers with different abilities to pay (vertical equity). Although this classical approach to equity should characterize any attempt of corporate tax harmonisation, the needs of the Internal Market call for the

---

56 See Chapter 2 (2.3.).
adaptation of the principle to the multi-national element. Thus, the classical approach must be extended in order to include the concept of interindividual equity which concerns the EC nationals (including companies) as well as that of internation (interjurisdictional) equity which refers to the Member States.

4.5.1. Interindividual Equity

It has been suggested\(^{57}\) that interindividual equity is the "equitable treatment among individuals who receive income that is exposed to several tax jurisdictions". This means that each Member State should not subject income accruing to a company from its activities in other Member States to different treatment from that domestic profits of the same company enjoy.\(^{58}\) As a result, residents who invest at home (in a Member State) and residents who invest abroad (in another Member State) should be treated equally. In addition, residents who invest at home (in a Member State) and non-residents who are nationals of other Member States residing in those States and invest in the original Member State should be treated equally. The concept of equal treatment is what distinguishes interindividual equity from international neutrality.

The principle of interindividual equity whose legal basis is Article 52 of the EC Treaty was clearly expressed in paragraph 28 of


\(^{58}\) There should be no distinction between foreign and domestic income when the Internal Market is established.
the judgment of the ECJ in Case 270/83\textsuperscript{59} which reads: "...by not granting to the branches and agencies in France of insurance companies whose registered office is in another Member State on the same term as apply to insurance companies whose registered office is in France the benefit of shareholders' tax credits in respect of dividends paid to such branches or agencies by French companies, the French Republic has failed to fulfil its obligations under Article 52 of the EEC Treaty".

The implementation of interindividual equity has to be left to the Member State of residence, because, usually, the domestic income of companies is higher than their foreign income in most cases. As it has rightly been suggested,\textsuperscript{60} "Taxpayer equity requires that income taxes apply to global income and only the country of residence/citizenship of the income recipient is in a position to tax this comprehensive measure of economic position".

Finally, the question concerning the method leading to the attainment of interindividual equity remains to be answered. The full crediting of taxes paid abroad\textsuperscript{61} (in other Member States) which is offered by the Member State of residence is not likely to receive a warm welcome by Member States, since it involves repayment of taxes


\textsuperscript{60} P. Musgrave, 'Interjurisdictional Coordination of Taxes on Capital Income', in S. Cnossen (ed.), \textit{Tax Coordination in the European Community}, Amsterdam, 1987, p.207.

\textsuperscript{61} As in the case of CEN.
in some cases by the Member State of residence, although that Member State may not have received any part of the taxes in question. Furthermore, such a solution requires the existence of a clearing mechanism whose purpose would be the settlement of disputes concerning the fair distribution of taxes between Member States. Therefore, in the long term the only feasible method would be equalization of effective tax rates (achieved either by imposition or competition) accompanied by the abolition of withholding taxes.

4.5.2. International (Interjurisdictional) Equity

This term is used to suggest a fair distribution of corporate taxes between the Member State in which a company resides and the Member States in which a part or the entire taxable income of the aforementioned company accrues. It is worth noting that the principle in question is linked with the classical dispute between the country of residence and the country of source about the right to tax. The latter is given the chance to tax profits first, whereas the former has the privilege of determining the final tax liability of a company.

As has been proved, a tax levied by the source country causes two types of losses to the country of residence. First, the country of residence suffers a national loss, as the total income of its

---

62 When the foreign tax paid exceeds domestic tax liability.
63 See Chapter 3.
64 This dispute is the cause of double taxation.
nationals (including resident companies) is reduced. Secondly, the tax paid to the source country causes revenue losses to the country of residence. The exact amount of those losses depends on the tax system of the source country and on the method the country of residence employs in order to tax foreign income.

If the country of residence is interested in achieving economic efficiency and interindividual equity only at national level, it will regard foreign taxes as deductible expenses. Conversely, if it is interested in implementing those two principles at international level, it will grant full credit for foreign taxes against the domestic tax liability.

At this point, another issue must be taken into consideration, namely the question on the level of taxation the source Member State should be permitted to levy on income originating within its territory and accruing to investors residing in other Member States. The rule of non discrimination could provide a formula for dealing with the question mentioned above. According to this rule, the Member State of the source has the original right to tax, but since it must not discriminate against the income accruing to investors who reside in other Member States excessive losses to those investors must be avoided.

Another possible solution would be the adoption of unitary taxation, a system suitable for States with two levels of

---

66 EC Treaty, Article 6(1) [former Article 7 which became Article 6 pursuant to Article G8 of the Treaty on European Union].
government. Under this system the taxable profits of companies residing in a Member State but operating in a number of Member States could be apportioned to the several tax jurisdictions according to a predetermined formula based on factors such as property, payroll and sales in each Member State.

Finally, it has been suggested that interjurisdictional equity could be achieved through the European budget. In particular, this method requires that companies with activities in more than one Member States should pay tax to a central tax authority (at Community level) which will have the task of distributing the revenue among the Member States entitled to a share of that revenue. Nevertheless, such a solution involves a great deal of cooperation between national tax authorities and, above all, a substantial surrender of national sovereignty which, in its turn, presupposes an advanced stage of political and economic integration.

4.6. Flexibility

The term "Flexibility" is used to denote that the corporate tax structure which emerges from the harmonisation of national tax laws, regardless of the form of the harmonisation, and is destined to meet the needs of the Single Market, ought to be adaptable to the

---

67 This system has been adopted by the United States of America and will be discussed in the concluding Chapter of this research.

68 P. Snoy, op.cit., p.57.

69 Imposed-competitive-hybrid; See Chapter 3.
developments taking place within and outside the EC. If it fails in doing so, the proper functioning of the Internal Market will run a risk and new distortions, other than those the emergence of the new corporate tax structure purported to counteract, will appear.

4.6.1. Flexibility Towards Developments Outside the EC

Corporate tax harmonisation in the European Community must not produce tax rules which will increase the tax burden on the non-EC companies. This could be caused by tax rules which would place companies from any of Member States in a far better position compared with companies residing outside the Community. As a result, the flow of capital would be diverted to other industrial countries such as the U.S.A. and Japan or to developing countries.

In addition, the European corporate tax system which would result from corporate tax harmonisation should not penalize European companies for investing outside the European Community. This has the meaning that the discriminatory tax treatment of income acquired outside the Community should not exceed certain limits. In view of this, it must be said that the establishment of the Internal Market is not intended to abolish the obstacles to trade within the Community in a way that would raise new obstacles to the trade between the Community and the non-Community States.

Another characteristic of the common corporate tax rules should be the avoidance of protectionism. Indeed, if those rules play the role of an extra protective mechanism of EC companies against the non-EC ones, the former will confine their activities to the "protected market" and will undermine their competitiveness
outside that protected area. Such restoration of protectionism will have damaging repercussions on international competition and will transform the Single Market to a closed market the access to which will be very expensive and, perhaps, practically impossible for non-EC companies.

Finally, corporate tax harmonisation should correspond to corporate tax reforms taking place at international level. The adoption of those reforms started during the 80's and has not stopped yet. Consequently, corporate tax harmonisation has to take into consideration the latest developments in the area of corporate taxation, namely the broadening of the corporate tax base, the reduction of statutory tax rates and the partial or total abolition of tax incentives.

4.6.2. Flexibility Towards Developments Within the EC

As has already been mentioned, corporate tax harmonisation must not be seen as something developing outside the process of economic and political integration that takes place in the European Community. Conversely, harmonisation of corporate tax laws is destined to serve the process of economic and political integration as the latter is shaped in the EC. Besides, the importance of corporate tax harmonisation for the achievement of an economic and Monetary Union has been underlined in the "Report to the Council and the Commission on the Realisation by Stages of Economic and Monetary

---

70 UK 1984, USA 86, Germany 88, 90.

71 See Chapter 3 (3.3.).
Union in the Community"\(^7\)\(^2\) and acknowledged by the Council of Ministers in 1971.\(^7\)\(^3\)

In addition, the strong links between national sovereignty and political integration on one side and corporate tax harmonisation\(^7\)\(^4\) on the other imply that any measures to be taken in the course of harmonisation must correspond with the pace of Political Union. In other words such measures must conform to the achieved stage of political integration, otherwise they will stand no chance to be adopted or, if adopted, they will have no practical effect. If all the aforementioned conditions are to be met, the process of corporate tax harmonisation must be very flexible, given that the progress of economic and political integration is not prefixed.

There is also another reason that dictates the flexibility of corporate tax harmonisation, namely the interrelation and interdependence between company law and corporate tax law. As a result, corporate tax harmonisation measures must provide an immediate response to the developments taking place in the area of European company law. Indeed, the harmonisation of company law in the European Community results in significant changes in the structure and the performance of companies. Such changes,\(^7\)\(^5\) in order to produce results, must be accompanied by respective tax changes

---


\(^7\)\(^3\) Council Resolution of 22 March 1971, OJ 1971, C/28

\(^7\)\(^4\) See Chapter 3.

\(^7\)\(^5\) e.g changes in the accounting methods, in mergers, in the parent-subsidiary relations, etc.
which will be introduced by the process of corporate tax harmonisation. The latter, in some cases, \(^{76}\) might act as a catalyst for the progress of company law harmonisation.

Finally, it is worth noting that corporate tax harmonisation should be adapted to the needs of the liberalization of capital markets, the free flow of capital and the free movement of financial services. The accomplishment of these three objectives which are crucial for the establishment of the Single Market relies on a series of measures \(^{77}\) which give rise to several tax questions. If those measures are to succeed, the relevant tax questions must be effectively dealt by corporate tax harmonisation. For example, the Banking Directives have to be supplemented by the relevant tax framework in order to be effective, because a bank residing in a Member State may be able to expand its activities in other Member States by setting up branches according to the legal framework provided in the Banking Directives, but such expansion raises a great deal of tax problems \(^{78}\) which have to be tackled by corporate tax harmonisation.

\(^{76}\) This comment refers to the Directive on taxation of cross-border mergers that has been adopted before the adoption of the respective company law Directive. For more details See Chapter 5.

\(^{77}\) e.g. the two Banking Directives, the Directives on Insurance, the Directives on the Liberalization of Capital movements.

\(^{78}\) Tax dispute between the Member State in which a bank has its tax residence and the Member State in which the same bank has set up a branch.
4.7. Prevention of Tax Avoidance and Tax Evasion

The prevention of tax avoidance and evasion is one of the most important principles by which corporate tax harmonisation has to abide. Before specifying the content of this principle it would be useful to refer to the meaning of the two terms. The first term, that is tax avoidance, is construed as the reduction or postponement of tax payment by the use of legitimate means.\(^7^9\) Conversely, tax evasion is defined as the reduction or postponement of tax payment by the use of illegitimate means.\(^8^0\)

The ambiguity and the complexity of some tax provisions in tax laws, the existence of loopholes, the ineffectiveness of tax authorities and the absence of carefully planned anti-avoidance and anti-evasion strategy are some factors that facilitate a company's embarkation on tax avoidance or tax evasion schemes. Furthermore, the establishment of a Single Market to which twelve different corporate tax laws apply or, in other words, the creation of a market in which twelve tax jurisdictions coexist without a degree of harmonisation will constitute an additional factor which will operate for the benefit of companies having cross-border activities and intending to set up tax avoidance or evasion plans. Indeed, the exploitation of different corporate tax regimes and of potential

\(^7^9\) Such as transfer pricing, treaty shopping, thin capitalisation. For further details See Chapter 2.

\(^8^0\) Such as the submission to tax authorities of false tax returns, the falsification of the company's accounts and books, etc.
conflicts between national tax authorities boosts the chances of tax avoidance or evasion schemes to succeed.

The successful completion of tax avoidance or evasion schemes causes serious problems and contributes to the creation of conditions which do not conform to the concept of the Internal Market. First, tax avoidance and evasion are responsible for the loss of revenue suffered by Member States. Secondly, the conception and the execution of a tax evasion and, especially, of a tax avoidance scheme cost a great deal of money a part of which is used for the scheme itself, whereas another part is used for the payment of tax consultation fees. This in turn affects economic efficiency in the sense that a less efficient company manages to survive not because its products or services are of high quality, but because it saves money by paying less tax compared with an efficient company faced with higher taxes due to its strict compliance with tax laws.

Thirdly, reducing costs by means of tax avoidance or evasion enables a company to subsidize its prices and, thus, to offer more competitive prices than another company which complies with tax laws. This, however, is nothing else but unfair competition which introduces tax induced distortions to the Internal Market; a market based on the principle of free and fair competition.

In conclusion, corporate tax harmonisation measures must have an anti-avoidance and anti-evasion orientation. The meaning of this phrase is that, first, corporate harmonisation measures must be clear, unambiguous and free from loopholes. Secondly, they must include special provisions aimed at counteracting tax evasion and avoidance. Thirdly, the measures in question should not put
obstacles to the enforcement of anti-avoidance and anti-evasion provisions of national tax laws. Finally, they should promote the cooperation between national tax authorities which will be proved of great importance in the fight against tax evasion and tax avoidance in the post-1993 era.

4.8. Administrative Feasibility

This principle concerns the administration of the measures which will result from the process of corporate tax harmonisation regardless of the way they come about. The criterion that determines whether a tax measure is administratively feasible or not is based on the administrative problems which may or may not arise after that measure has come into effect. The less problems such measure causes or, in other terms, the higher degree of administrative efficiency it achieves the more likely is for this measure to be administratively feasible. But how can a corporate tax measure avoid causing administrative problems or, in other terms, which are the factors that determine the administrative efficiency of that measure?

First, corporate tax harmonisation measures need to be easy to administer. To achieve this, they must contain clear and unambiguous provisions and avoid including complex provisions which are likely to induce disputes about their interpretation. Indeed, the more complex

---

81 Imposed by the Community or adopted by each Member State as a result of tax competition.
a tax measure is the more difficult for the tax authorities is to enforce that measure. In addition, the lack of clarity is a potential cause of dispute and litigation which in their turn will make the enforcement of the specific tax measure more expensive.82

Secondly, the administrative feasibility of a corporate tax measure will be judged upon the administrative costs it will require for its enforcement. An efficient tax measure must be cheap to administer in the sense that it should not need a huge and, therefore, expensive administrative machine to support the process of enforcement.

Thirdly, companies affected by the rules provided in corporate tax harmonisation measures must not be faced with high compliance costs. Such costs may be the result of extensive litigation or of the need to comply with complex bureaucratic procedures. Whatever the cause may be the fact remains that excessive compliance costs constitute a waste of resources that should be avoided.

Finally, the expansion of European companies in the Internal Market will inevitably cause many problems to national tax authorities and it is the job of corporate tax harmonisation to produce the necessary framework that will help them to deal with those problems effectively. Thus, to secure the administrative efficiency of those tax rules which will apply to more than one

82 The lack of clarity is often responsible for the loopholes of a tax measure which are exploited by tax avoidance schemes.
The principle of Certainty is one of the most important principles to which every efficient tax structure adheres. Pursuant to this principle a tax system must not be subject to continuous and consecutive changes and must not raise doubts to the taxpayers as to whether it is enforceable or not. In view of this, the scope and the content of tax rules should be clear and any ineffective or outdated provisions or other problems should be identified by studying the performance of a tax system through years and should be dealt with by appropriate tax reforms. This by no means excludes "on the spot reactions" to very serious problems which are likely to threaten the functioning of a tax system causing losses of revenue.84

The benefits from the existence of certainty in a tax system are significant. First, taxpayers are able to estimate their tax liability and to plan their economic activity accordingly. Secondly, tax authorities become familiar with the provisions of the tax law and this in turn enables them to administer the tax system more easily and more effectively. Thirdly, certainty helps the Treasury

83 Like those rules which will be the outcome of the process of corporate tax harmonisation.
84 For example when a government amends tax provisions aiming at closing loopholes or making those provisions clearer.
of a State to calculate the revenue it expects to raise in a given financial year.

Before applying the principle to corporate harmonisation measures distinction should be made between imposed and competitive measures. As a result, the principle of certainty in respect of imposed corporate tax harmonisation measures requires that the latter: a) should be transposed into national law, b) should be characterized by clarity avoiding the creation of controversies, c) should not offer temporary, off-hand and changeable solutions.

As regards tax measures adopted through the process of competitive harmonisation two points should be made. First, if a tax measure that has already been adopted by a number of Member States and is about to be adopted by the rest of them does not fulfill the principle of certainty it will be soon subjected to amendments which will cause confusion to tax authorities and companies. Secondly, tax competition in its extreme version may lead to the introduction of measures lacking the characteristics of certainty. More specifically, if corporate tax harmonisation is exclusively left to market forces the adoption of a tax measure by a Member State forces the other Member States to follow without wasting time because any delay in the adoption of a similar tax measure may have repercussions on their ability to attract investments. But such forced and hasty actions may jeopardize the principle of certainty.

65 After all there is no guarantee that the amendments will be similar in contrast to the similarity that existed with regard to the original tax measure.
Finally, it is worth clarifying that the application of the principle of certainty does not thwart the application of the principle of flexibility. The latter requires that corporate tax harmonisation should be flexible in order to correspond to certain needs, but being flexible is quite different from being changeable.

4.10. Political Acceptability

Corporate tax harmonisation measures gain political acceptance when they have the support of the governments of Member States. The kind of support depends on whether those measures are the outcome of imposed or market-led (competitive) corporate tax harmonisation. In the first case, political acceptability is confirmed when a proposed corporate tax harmonisation measure is adopted by the ECOFIN after usually long consideration and negotiations. In the second case, political acceptability appears in a different way, that is the government of a Member State introduces a corporate tax measure and the governments of the rest of Member States spontaneously react by introducing similar legislation, simply because they do not wish to worsen their tax competitiveness.

The question arising at this point concerns the factors which make a corporate tax harmonisation measure politically acceptable. Most of them have already been mentioned and discussed in detail in Chapter 3, thus the reference to them has to be short.

\[\text{For more details on this principle See Chapter 3, in which the political dimensions of corporate tax harmonisation are discussed.}\]
The first factor is the timing of a corporate tax harmonisation measure which implies two things. First, the necessity for the adoption of the measure must have become obvious especially with regard to the functioning of the Internal Market. Secondly, the measure in question must correspond to the pace of economic and political integration.  

The second factor is the link between a corporate tax harmonisation measure and the interests that measure affects. If that measure is to have any chance to be welcomed it must not be adverse to a great number of organized interests at the same time. Otherwise, these interests will find the means to prevent the adoption of the specific measure.

The third factor concerns only those corporate tax harmonisation measures which result from tax competition between Member States. If a measure of this kind has already been adopted by some Member States its political acceptability toward a Member State that has not adopted it is dependent on two estimates. The first is how the Member State at issue can afford to be a less attractive location for investments and so to undermine its tax competitiveness. The second is to which extent Member State is willing to sustain a loss of revenue that is likely to happen as a result of the adoption of the measure in question.

---

87 See Chapter 3.

88 See Chapter 3.

89 If the measure in question is a market-led one such prevention will take place at the expense of tax competitiveness.
CHAPTER 4

The last factor is related to measures belonging to the process of imposed corporate tax harmonisation. According to this factor the political acceptability of a measure proposed at Community level depends upon the loss of revenue it implies for Member States and upon the shrinkage of fiscal and, therefore, of national sovereignty. Indeed, Community's legislative interventions in the field of corporate taxation and more generally in the field of direct taxation cannot happen without consequences for the national sovereignty of Member States. Therefore, the government of each Member State, when it considers a proposal on a corporate tax harmonisation measure, examines that proposal taking into account the aforementioned issues. Nevertheless, it has to be mentioned at this point that a proposed measure is facilitated in achieving political acceptability by a campaign which aims at preparing the ground for its adoption.

In conclusion, the process of corporate tax harmonisation has to avoid causing great controversy and, above all, it has to take into account each national government's approach in order to produce something which will lie in the middle and thus will receive a warm welcome. This applies to imposed as well as to market-led approach of harmonisation since in the former the lack of political acceptability cancels the adoption of a proposed measure, whereas in the latter the dislike of a measure by a Member State might lead to unilateral reactions not in line with the principles of Economic and

---

90 See Chapter 3.
91 See Chapter 3.
Monetary Union.

4.11. Combination of Principles

It is beyond doubt that the number of principles with which the process of corporate tax harmonisation should comply is quite large. In addition, each principle sets its own requirements and has its own objectives which must be met by corporate tax harmonisation measures. As a result, it is very difficult, if not impossible, for a harmonisation measure to fulfill all the conditions so as to achieve a state of perfection.

In this Chapter nine principles were discussed and many of them were further subdivided. Four of these principles (subsidiarity, administrative feasibility, certainty, political acceptability) are mainly of procedural character in the sense that they deal rather with the form than the substance of corporate tax harmonisation measures. Conversely, the remaining five principles (tax neutrality, economic efficiency, equity, flexibility, prevention of tax avoidance-evasion) provide the guidelines on what should be the content or the subject-matter of those measures. Hence, those principles are regarded as more relevant to the substance of the process of corporate tax harmonisation.

None the less, the gravity of the four principles mentioned above cannot be called into question. Indeed, each of the principles mentioned in this Chapter plays its own distinctive part in the process of the harmonisation of corporate tax law. Thus, harmonisation measures should satisfy as many principles as possible.
if they cannot comply with all of them. What remains to be seen is to which principles the already adopted or proposed harmonisation measures conform and to what extent.
CHAPTER 5

LEGISLATIVE MEASURES INITIATED BY THE COMMUNITY
AND AIMED AT SOLVING THE PROBLEM

5.1. Introduction

The purpose of this Chapter is to produce a legal analysis of the legislative measures which have been introduced by the Community in the process of corporate tax harmonisation so far. Those measures must be examined in the context of the principles and conclusions put forward in the previous Chapters, if an integrated analysis is to be achieved.

5.1.1. Classification of the Measures

Corporate tax harmonisation measures can be classified in groups and such classification can employ several criteria. Among the most significant criteria is that one which determines the exact relation between a legislative measure and the process of corporate tax harmonisation. Indeed, if a legislative measure, introduced at Community level, is dealing with one of the four elements of European corporate taxation (base-rates-system-cross border operations), it can be regarded as a direct measure. Conversely, if it is destined to tackle problems arising in another field of law (usually in company law) and inevitably has tax implications or includes some tax provisions which result in a "de facto" tax harmonisation, its relation with corporate tax harmonisation is indirect, because the prime objective of the legislative measure is not the establishment
of corporate tax rules but of company law rules.

An example of indirect measures is provided by the Regulation on European Economic Interest Groupings\(^1\) and the Proposed Regulation on the Statute on the European Company.\(^2\) Both measures contain provisions which define how these two types of companies should be taxed. In view of this, it can be said that European company law overlaps with European corporate tax law at this point, and moreover, that company law harmonisation has taken over the role of corporate tax law harmonisation, at least in this field.\(^3\)

An additional criterion applying only to the classification of direct measures is provided by the EC Treaty and relates to the legal form. Under the Treaty of Rome, a legislative measure adopted during the process of corporate tax harmonisation can take the form either of a Directive or a Convention. This is dictated by Article 100 of the EC Treaty which constitutes the legal basis of corporate tax harmonisation and by Article 220 which refers to the use of Convention as a means of abolishing double taxation in the Community.

Finally, another general but very practical criterion is based on the status of a measure. More specifically, corporate tax harmonisation measures, as all the legislative measures in the Community legal order, can be divided into categories according to the stage of the decision-making process in which they are at a specific moment. In other words, legislative measures may have the

---

1 Council Regulation 2137/85 of 25/7/1985 (OJ 1985, L199/1)
3 Further analysis will follow in 5.5.
status of a Proposal (e.g. Proposed Directive) or may have been adopted (e.g. Directive) or even may have been withdrawn if they are outdated or rejected.

5.1.2. Which Legislative Measures?

Until 1990 the process of corporate tax harmonisation included only proposed measures and there was no progress in terms of adopted legislation. But 1990 was a turning point for the entire process of corporate tax harmonisation, because adopted as well as formally abandoned measures were added to the already proposed. For a better understanding of the point where the process is standing now, it is worth mentioning all the measures in brief and in chronological order.

In 1969 the Commission of the EC proposed two Directives, the first on the "Common System of Taxation Applicable to Mergers, Divisions, Transfer of Assets and Exchange of Shares concerning Companies of Different Member States" (hereafter called the Mergers Directive) and the second on the "Common System of Taxation in the case of Parent Companies and Subsidiaries of Different Member States" (hereafter called the Parent-Subsidiary Directive). These Proposed Directives were subsequently amended and finally adopted in 1990. Together with the Convention on the "Elimination of Double Taxation

---

in Connection with the Adjustment of Profits of Associated Enterprises" (hereafter called the Arbitration Convention).  


In the 80's the Commission focused on the corporate tax base and in 1984 proposed the Directive on the "Harmonization of Laws of the Member States Relating to Tax Arrangements for the Carry-Over of Losses of Undertakings" which was put forward again in 1990. In the following year (1985) an Indirect measure was adopted, namely the Regulation on the European Economic Interest Groupings containing certain tax implications. Three years later, in 1988 a Preliminary Draft Proposal for Directive on the "Harmonization of Rules for

---

8 OJ 1975, C253/2.
Determining the Taxable Profits of Undertakings" (XV/27/88-EN) was published but it was withdrawn in 1990.

Finally, in 1990, apart from the adoption of the two Directives and the Convention, two more Directives were proposed. The first concerned the "Common System of Taxation Applicable to Interest and Royalty Payments made Between Parent Companies and Subsidiaries in Different Member States"\(^{12}\) and the second "The Arrangements for the Taking Into Account by Enterprises of the Losses of their Permanent Establishments and Subsidiaries in other Member States".\(^{13}\) Furthermore, in the summer of 1991 an amended proposal for the Regulation on the Statute on the European Company was presented by the Commission\(^{14}\) including important points in relation to corporate taxation.

5.2. Adopted Measures

5.2.1. The Mergers Directive

The Mergers Directive is classified as a legislative measure dealing with one of the four elements of corporate tax harmonisation, that is cross-border operations. The adoption of the Directive in question removed, at least theoretically until its implementation, a tax barrier which was undermining the proper functioning of the Internal Market.

\(^{13}\) COM(90) 595 (OJ 1991, C53/30).
\(^{14}\) (91) 174 fin. (OJ 1991, C176/1).
Until the adoption of the Directive mergers between companies of different Member States were penalised and subjected to extra tax compared with mergers between companies of the same Member State. Usually, national tax laws exclude from taxation any gains resulting from mergers between domestic companies, the so-called roll-over relief. Conversely, national tax laws rarely, if not at all, offer the same treatment to domestic companies when the latter merge with foreign companies. This constitutes a tax barrier that prevents companies of one Member State from cooperating with companies of another Member State in a specific way (Merger), hampers the free flow of capital in the EC, because cross-border operations through Mergers involves a certain degree of capital mobility, and causes tax induced distortions to the Internal Market.

The Mergers Directive was put before the Council in 1969 but it was not welcomed by two Member States, namely the Netherlands and Germany. Both Member States feared that a possible adoption of the Directive would enable Dutch and German companies to cease residing in the two countries and to merge with companies of other Member States. This would happen because the classical system employed by the Dutch corporate tax law and the "Employees' Participation Scheme" provided by the German company law did not appeal to Dutch and German companies respectively. In the end, the inclusion of a safeguard provision, Article 11 of the Directive, combined with pressure

---

15 e.g the U.K., TA 1970 s278A(5).
16 See Note 4.
17 See Chapter 2 (2.2.4.).
exerted on Germany and the Netherlands made the adoption of the Directive possible in 1990. 18

Before making any comment on the Mergers Directive it is worth looking in detail its provisions. First, the Directive applies to Mergers, Divisions, Transfer of Assets and Exchange of Shares concerning Companies of different Member States (Article 1) which means that the provisions of the Directive cannot be applied to solely domestic situations (e.g. mergers between companies of the same Member State). Secondly, the definitions of the transactions falling within the scope of the Directive are given in Article 2 and derived, to a great extent, from the Third Company law Directive adopted in 1978. 19

Thirdly, there are certain conditions upon which the application of the Directive depends. Specifically, in the case of Mergers, Divisions etc. regulated by the Mergers Directive the following requirements must have been fulfilled:

a) The companies involved must have one of the legal forms described in the Annex of the Directive (Article 3). 20

b) The companies involved must be considered as residents of a Member State (not of the same Member State) according to the tax law of that State (Article 3).

c) The companies involved must not be considered to be residents

18 See Note 6.


20 The Directive applies only to public companies. Other forms, such as limited partnerships, do not benefit.
outside the Community under a double tax agreement (Article 3).\textsuperscript{21}

d) The companies involved must be subject to corporate tax in the country of residence "without the possibility of an option or of being exempt" (Article 3).\textsuperscript{22}

e) The company that receives the assets must not make cash payments to the shareholders of the transferring company exceeding 10% of the nominal value of the securities issued in exchange for the transfer (Article 2a).

f) The transferred assets must remain "connected with a permanent establishment of the receiving company in the Member State of the transferring company" (Article 4.1).

Fourthly, the most important rules laid down by the provisions of the Mergers Directive are the following:

a) Mergers and Divisions fulfilling the requirements previously mentioned do not give rise to "any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their

\textsuperscript{21} Double tax agreement between a Member State and a third country.

\textsuperscript{22} The wording implies that: 1) Holding or Investment companies are not covered, but the final judgment on this rests with the European Court Justice 2) Companies claiming exemption for certain items of income like Dutch companies in the case of participation exemption are covered and 3) Companies which are subject to corporate tax but at the end do not pay such tax due to the existence of tax provisions that allow total exemption of income for a specific reason are not covered.
values for tax purposes" (Article 4.1.).

b) If the receiving company holds shares in the transferring company "any gains accruing to the receiving company on the cancellation of the holding" will not be taxable (Member States can derogate from the rule if the holding is below 25% - Article 7).

c) The permanent establishment in the Member State of the transferring company takes over the rights and obligations of the transferring company with regard to pre-existing tax-exempt provisions reserves and offset of losses (Article 5).

d) The receiving company assumes the right of the transferring company with regard to losses non-exhausted for tax purposes provided there was respective domestic tax provision prior to the adoption of the Directive (Article 6).

e) No tax implications arise for the shareholders unless the latter attribute "to the securities received a value for tax purposes higher than the securities had immediately before the Merger, Division or exchange" (Article 8).

f) Special rules apply to the transfer of a permanent establishment of the transferring company situated in a third Member State (neither in the State of the receiving company nor in the State of the transferring company - Article 10).

g) A safeguard provision is included (Article 11) which enables Member States to derogate from the rules of the Directive "when the Merger, Division, Transfer of Assets or Exchange of Shares has as its principal objective the avoidance or evasion of tax" or "results in a company no longer fulfilling the necessary
conditions for the representation of employees .... according to the arrangements which were in force prior to that operation".

h) Member States must comply with the Directive by 1-1-1992.23

It is beyond doubt that the Mergers Directive is a breakthrough in the field of cross-border operations in the European Internal Market. It is also a unique measure in Community law and perhaps in legal tradition, because in the case of the Mergers Directive the enactment of corporate tax legislation precedes the adoption of the corresponding company law legislation. However, this causes the problem that even if the Mergers Directive is implemented by Member States within the time-limit provided in Article 12 the benefits of the Directive will not be enjoyed by the European companies for two reasons.

First, most Member States either do not include in their company laws provisions for cross-border mergers (Denmark, Germany) or they do not cover all the transactions mentioned in the Directive (U.K., Ireland, Belgium, Italy, France, Portugal). As a result, the transactions contemplated in the Mergers Directive are exempted from tax but are void according to the domestic laws of most of the Member States. This means that the tax laws of the twelve Member States will offer exemptions to transactions which the respective company laws consider as non-existing! Consequently, the exemptions will be legally ineffective since the transactions for which they are provided are void.

Secondly, even if the twelve company laws contained provisions

23 1-1-1993 for Portugal.
permitting the transactions which would then be tax exempt problems would arise from any likely lack of similarity. For example, the company law of one Member State might permit a merger under different conditions from those set out by the company law of another Member State. As has rightly been suggested, in British law the liquidation of a company precedes its dissolution, whereas under French law the dissolution of a company comes before its liquidation (except in the case of merger where there is no liquidation). Such grave differences could cause confusion and would render the provisions of the Mergers Directive inapplicable. Thus, the Commission of the EC, knowing that cross-border mergers need a company law framework which will be the same in all Member States, has proposed the tenth Company Law Directive on Cross-Border Mergers.

The links between the Mergers Directive and the Proposed Tenth Company law Directive confirm that the former serves the principle of flexibility (flexibility towards developments in other fields of law). This view is further strengthened by the fact that the Mergers Directive constitutes the "sine qua non" requirement for the enactment of another Company law measure, that is the adoption of the Regulation on the Statute for the European Company (SE). In fact,

---


26 See Chapter 4 (4.6).
according to the Proposed Regulation\textsuperscript{27} one of the basic ways of formation of a European Company is by the merger of two or more public companies from different Member States. But without the Mergers Directive such formation would be either impossible or very expensive.

Moreover, the Mergers Directive satisfies the principle of subsidiarity\textsuperscript{28} in the sense that it regulates issues which could not be left to domestic laws. As has previously been mentioned, it is exactly the nature of cross-border transactions that requires legislative measures taken at Community level. Otherwise, the tax law of a Member State would include provisions for the regulation of cross-border mergers which might be different from the respective provisions of the tax laws of the other Member States.

This could result in ludicrous situations, since the tax authorities of the Member State of one of the merging companies would exempt the gains accruing from the merger in question, whereas the tax authorities of the Member State of the second merging company would not. Thus, it can be said that the Mergers Directive has been drafted in absolute accordance with the principle of subsidiarity, because it regulates an issue that could not be effectively regulated by the Member States acting on their own.

As far as issues of tax avoidance-evasion are concerned, the Mergers Directive includes a safeguard provision that conforms to the relevant principle mentioned in Chapter 4. In other words, the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{27} COM(91) 174 final-SYN 218 (OJ 1991, C176/1).
\item \textsuperscript{28} See Chapter 4 (4.2.).
\end{itemize}
\end{footnotesize}
transactions covered by the Directive do not enjoy the benefit of tax exemption, if they are parts of a scheme aimed at reducing tax by the use of lawful or unlawful means. Whether this provision (Article 11) will be enough to deal with the problem of tax avoidance and evasion with regard to cross-border mergers in the EC is a question that will be fully answered when the Mergers Directive is put into effect.

Another principle to which the Mergers Directive conforms is that of economic efficiency. Indeed, without the Mergers Directive cross-border operations within the European Community would be faced with serious difficulties due to the existence of tax barriers. These barriers distort free competition, because they benefit inefficient companies in the sense that they prevent foreign companies from entering the domestic market leaving the latter to the domestic companies which may not be the most efficient. The opening of the twelve domestic markets and the creation of a Single Market is aided by the Mergers Directive and this, in turn, will enable the efficient companies to expand without bearing extra tax burden and without being put in a disadvantageous position because of the lack of roll-over relief.

From the administration point of view the Mergers Directive satisfies the principle of administrative feasibility.\(^{29}\) because it does not provide for complex administrative procedures involving the tax authorities of the Member States. This does not mean that administrative problems are not likely to arise when the Directive is

\(^{29}\) See Chapter 4 (4.8.).
put into practice, but, at least in principle, the rules of the Directive seem to be administratively feasible. It is exactly the enforcement of the Directive that will definitely determine another issue as well, that is, whether the adopted provisions are politically acceptable. The fact that the Mergers Directive was finally adopted implies that it satisfies the principle of political acceptability\(^{30}\) but the final judge on this issue will be the process of implementation.

Turning to the principle of equity\(^{31}\) it has to be said that the Directive in question complies with interindividual equity. Specifically, before the adoption of the Mergers Directive if a company from Member State A (ComA\(_1\)) merged with another company from the same Member State there was no tax due, whereas if another company from A (ComA\(_2\)) merged with a company from Member State B the merger was subject to tax. Consequently, the tax law of Member State A treated ComA\(_2\) differently from ComA\(_1\) simply because the former merged with a company from another Member State while the latter did so with a domestic company. Such discrimination, which violated the fundamental principles of Community law constituting an obstacle to the proper functioning of the Internal Market, was abolished by the Mergers Directive.

As regards the principle of neutrality,\(^{32}\) the Mergers Directive achieves International Neutrality by abolishing the discrimination

\(^{30}\) See Chapter 4 (4.10.).
\(^{31}\) See Chapter 4 (4.5.).
\(^{32}\) See Chapter 4 (4.3.).
between domestic and cross-border mergers. Neutrality towards the legal form of the enterprise\textsuperscript{33} is not achieved, because certain categories of enterprises (e.g. limited partnerships, private companies) do not benefit from the Directive. This means that a limited partnership from one Member State cannot merge with a similar company or a public company from another Member State without paying capital gains tax for this cross-border transaction. Consequently, from the taxation point of view it is better establishing public companies than other forms of enterprise, or in other words the taxation of intra-Community mergers favours a specific legal form of enterprises (public companies).

Locational neutrality is partly attained, because the Directive enforces Capital Export (CEN) and Capital Import Neutrality (CIN) to a certain extent, but not completely\textsuperscript{34}. For example, the U.K. treats more favourably cross-border mergers than the remaining Member States and is a better place for investment from the mergers point of view. This advantage is abolished and a company from a Member State will no longer take into consideration which of the twelve tax laws offers the best environment for cross-border mergers in order to locate an investment (= Capital Export Neutrality).

In addition, if two companies (ComA–ComB) from different Member States (A–B) involved in the same type of business wanted to enter into the market of a third Member State (C) and the tax law of

\textsuperscript{33} See Chapter 4 (4.3.2.).

\textsuperscript{34} Separate reference to the provisions that prevent the Directive from achieving complete CEN or CIN will follow in this Subsection.
A did not subject cross-border mergers to taxation, whereas the tax law of B did. ComA would be in a more advantageous position than ComB with regard to the entry to the market of Member State C through a merger with a company residing in C. In this case, it is obvious that CIN does not exist, but after the implementation of the Mergers Directive will exist, at least in principle.

The Mergers Directive would have accomplished complete locational neutrality if it had not retained some tax induced distortions resulting from Article 6. The latter provides that losses suffered by the transferring company and not exhausted for tax purposes can be transferred to the permanent establishment of the receiving company in the Member State in which the transferring company existed, provided that such transfer was permissible for domestic situations under the tax law of that Member State prior to the adoption of the Directive. Unfortunately, such rule deprives the Directive from achieving complete Capital Export Neutrality, since some Member States may continue to offer more advantages, though slight, from the taxation of mergers point of view.

Finally, the absence of a common company law framework in respect of mergers in combination with the slow progress of transposition of the Directive\(^{35}\) raise serious doubts on whether the Directive is enforceable. Unfortunately, this undermines the principle of certainty that should characterise any corporate tax harmonisation measure.\(^{36}\)

\(^{35}\) To be discussed later.

\(^{36}\) See Chapter 4 (4.9.).
At this point reference must be made to some problems arising from the text of the Mergers Directive. First, Article 2(d) which refers to the exchange of shares raises some questions with regard to whether it can be interpreted so widely that it can include the case where the acquisition of shares follows the acquisition of a majority. Such interpretation is in accordance with the general objectives of the Mergers Directive but the final solution may rest with a future judgment of the European Court of Justice.

Secondly, Article 3(b) provides that one of the criteria for determining whether a company is a company from a Member State will be the residence of the company and such decision is based on the tax law of that Member State causes serious problems. Given that Member States use different criteria a judgment of the European Court of Justice that will establish some of them as widely accepted for the benefit of legal certainty may not be excluded.

Thirdly, the 1969 proposed version of the Directive defined the concept of permanent establishment whereas the adopted version does not. Is a permanent establishment defined according to the law of the Member State in which it is situated or according to the tax treaty that may exist between the two involved Member States?

Fourthly, the adopted Directive in Article 7 provides that tax exemption of gains applies only when the receiving company has a holding in the capital of the transferring company. The converse case is not covered although the original version of the Directive extended the exemption to this case as well (Article 8).

³⁷ See Chapter 2 (2.2.2. a).
original version also provided that any capital losses resulting from a merger could be offset against any taxable profits of the new company, but this rule is not included in the text of the adopted Directive.

Fifthly, the safeguard provision (Article 11) does not depend on the suspension of the rules provided by the Directive on any procedure that could guarantee the avoidance of arbitrary decisions. Consequently, a Member State may cease enforcing the Directive in a certain case invoking the reason that the use of the Directive is a vehicle for tax evasion or avoidance. Such a decision may be dictated not by actual facts, but by other interests of the Member State which may be at risk because of the rules of the Directive. In other words, there is nothing in the Directive that could prevent a Member State from abusing Article 11 and attempting to block the enforcement of the Directive. Perhaps, this issue might be further clarified by judicial decisions and especially by a judgment of the European Court of Justice.

In addition, Member States do not share the same views with regard to the interpretation of the term "tax avoidance". In some Member States (e.g. U.K, Greece) the concept of tax avoidance is not clearly defined and thus cannot have a general meaning. Conversely, the tax laws of other Member States (Netherlands = Fraus Legis, France = Abus de Droit) accommodate a general definition for the term in question. Consequently, what falls within the concept of tax avoidance in a Member State may constitute a legal activity according to the law of another Member State and this of course will cause a great deal of confusion.
Sixthly, if a merger finally falls apart and the permanent establishment (the ex-transferring company) is sold, who is going to collect the capital gains tax? Is it the Member State of residence or the Member State of ownership? And what is going to happen if double taxation occurs?

Furthermore, assuming that a company from Member State A (ComA) has established a branch (ComB) in Member State B and that this branch is transformed into a subsidiary will this transformation be covered by the Mergers Directive and, thus, be exempted from capital gains tax? With regard to this question there are two conflicting views.

The first starts from the presupposition that ComB fulfills the requirements described in Article 2(i) and combines Articles 9\(^38\) and 4\(^39\) together with a broad interpretation of Article 10.\(^40\) The result is a positive answer to the question. The second view rejects the pattern followed by the first and underlines that the latter employs a distorted conception of the cross-border element which must

---

\(^{38}\) The provisions applying to mergers apply to transfer of assets as well.

\(^{39}\) The tax exemption provision.

\(^{40}\) If the transferring company has a permanent establishment in a Member State other than that of the transferring company, the latter State will renounce any right to tax the permanent establishment.

Broad Interpretation = if the rule applies to this three countries case (State of receiving, transferring, permanent establishment), why should not apply to a two countries case (State of Parent company, permanent establishment)?
exist for the application of the provisions of the Directive.

More specifically, Article 4 applies to cases in which there is a transferring company and a receiving company from different Member States plus a permanent establishment of the receiving company in the Member State of the transferring company. This permanent establishment takes over the rights and obligations of the transferring company. In the branch incorporation case there is a parent company, its permanent establishment in another Member State and the subsidiary in the same State which becomes the receiving company. The final solution is likely to be given by a future judgment of the European Court of Justice.

Although Article 12 of the Mergers Directive dictates the implementation of the Directive by 1 January 1992, except for Portugal for which the deadline is 1 January 1993, the implementation process is so slow that it has been impossible for Member States to meet the deadline. Some Member States have not taken any measures at all to implement the Directive (Belgium, Greece, Italy, Luxembourg, Ireland, Portugal), whereas others have started the process of implementation or are close to the final stage (France, Denmark, Germany, The Netherlands, Spain, U.K.). However, in the latter category there are some Member States (Germany, U.K.) which cannot fully implement the Mergers Directive, unless they amend certain provisions of their company laws.

The last problem to be discussed is whether the Mergers Directive, especially its fundamental rule in Article 4, is directly effective. The case law of the European Court of Justice has set out certain requirements which must be met if a Directive is to be
regarded as directly effective. First, the time limit provided in the Directive for its transposition into national law must have elapsed. 41 Secondly, the provision(s) at issue must be clear and unambiguous. Thirdly, the same provision(s) must be unconditional in the sense that the right these provisions award "must not be dependent on something within the control of some independent authority such as a Community institution or the Member State itself. In particular, it must not be dependent on the judgment or discretion of any such body". 42 Assuming that Member States will meet the first requirement it remains to be seen whether the other two are fulfilled.

The clarity of the provisions of the Directive is not called in question, but what causes problems is that most of the provisions are not unconditional. 43 This is likely to render some of the provisions, which happen to be the most important, not directly effective, but this will be definitely determined by the European Court of Justice if a case based on the Mergers Directive is brought before it. However the fundamental provision of 4(1) seems to be directly effective which may prove to be very important since Member States have not managed to implement the Mergers Directive in time and given that the European Court of Justice has opened a new era in Community law by ruling that Member States may be hold liable for any

43 e.g.Articles 4(2), 8(2), 11.
damage\textsuperscript{44} a person sustains because of a delayed implementation of EC Directives.\textsuperscript{45}

5.2.2. The Parent-Subsidiary Directive

The Parent-Subsidiary Directive is a legislative measure taken at Community level and aimed at counteracting a tax barrier that hampers the cooperation between companies from different Member States. The tax barrier appears, at least until the implementation of the Directive, when a parent company from a Member State receives income from its subsidiary in another Member State. In such a case the Member State in which the subsidiary resides levies a tax on the income distributed to the parent company, which is called withholding tax and whose rate depends upon the corresponding provision of the bilateral tax treaty (if any)\textsuperscript{46} that has been concluded between the Member State of the parent company and that of the subsidiary.

The fact that withholding tax is a tax imposed simply because income crosses the borders of one Member State on its way to another Member State together with the existence of discriminatory treatment which results from the different tax treaties each Member State has with the other Member States, does not comply with the concept of the

\textsuperscript{44} In this case the damage will be the imposition of taxes that should not have imposed.

\textsuperscript{45} Francovich and Boniface, Cases 6/90 and 9/90, Judgment of the European Court of Justice of 19/11/1991.

\textsuperscript{46} e.g. no tax treaty between Denmark and Greece, Luxembourg and Portugal, etc.
CHAPTER 5

Internal Market. This was the reason that led to the adoption of the Parent-Subsidiary Directive which was originally put before the Council in 1969.47

In fact, there was a 21 years gap between the proposal of the Directive at issue and its adoption.48 All those years the Proposal was shelved due to objections from Germany and the Netherlands and, after its accession in 1981, from Greece. Mutual concessions and hard bargaining in the Council of Ministers (ECOFIN) combined with the urgent need for measures which will secure the establishment of the Internal Market resulted in the adoption of the Directive in July 1990.

The Parent-Subsidiary Directive applies to those cases in which a subsidiary resident in one Member State distributes profits to its parent company in another Member State (Article 1). The application of the Directive depends upon the fulfillment of the following conditions:

a) Both parent and subsidiary must take one of the legal forms described in the Annex of the Directive (Article 2a).49

b) Both companies must be considered as residents of a Member State (not of the same) according to the tax law of that State (Article 2b).50

47 COM (69) 6 final (JO 1969, C39/7).
49 Both companies must be public companies.
50 For the problems caused by the employment of different criteria see similar comments made in the case of the Mergers Directive.
c) None of the companies must be considered as resident outside the Community according to a Double tax agreement (Article 2a).

d) Both companies must be subject to corporate tax in the country of residence "without the possibility of an option or of being exempt" (Article 2c).

e) The parent company must have either a minimum holding of 25% in the capital of the subsidiary (Article 3.1a) or a holding in voting rights, the latter established by a bilateral agreement between the Member State of the parent company and that of the subsidiary (Article 3.2).

f) The aforementioned holding (in capital or in voting rights) must exist for an uninterrupted period of at least two years (Article 3.2).

The basic rule laid down by the Directive is divided into two parts, one concerning the Member State of the parent company and the other concerning the Member State of the subsidiary. The first provides that the Member State of the parent company will either exempt the profits the parent company received from its subsidiary in another Member State from taxation (Article 4.1), or allow the

---

51 See note 21.

52 See note 22; the first four conditions are identical with the respective conditions of the Mergers Directive.

53 This does not prevent Member States from adopting a lower qualifying percentage.

54 Exemption method.
parent company to credit the tax paid by the subsidiary for the dividends distributed against its own tax liability. "...up to the limit of the amount of the corresponding domestic tax." (Article 4.1). It also places an obligation upon the Member State of the parent company to refrain from levying withholding tax on the profits a parent company receives from a subsidiary in another Member State.  

The second is addressed to the Member State of the subsidiary and obliges it not to levy withholding tax on the dividends the subsidiary distributes to its foreign parent company (Article 5.1). Permission to deviate from this rule and impose withholding tax has been granted to Greece (because Greece does not levy corporate tax on distributed profits), Germany (because Germany subjects distributed profits to a lower rate of corporate tax) and Portugal (the scope was the avoidance of a shock in Portugal's revenues).  

The significance of the rule laid down by the Directive is great, because it deals with a problem whose existence contributed to the fragmentation of the Single Market. It is also worth mentioning that the Parent-Subsidiary Directive is the first legislative measure

---

55 Partial credit method.

56 The only Member State that does so is Belgium.

57 The rate must not exceed that provided in Double tax agreements for as long as it applies the dividend exemption method (See Chapter 2) and provided this method is applied there is no time limit.

58 5% Rate for as long the corporate tax rate on distributed profits is 11 points lower than that applying to retained and in any case until mid-1996.

59 For 8 years, 15% for the first 5 years, 10% for the last 3.
that reduces, in some cases slightly, the revenue of Member States and regulates foreign corporate income. In other words it is the first serious challenge to Member States' tax sovereignty in the field of direct taxation. Nevertheless, it must be born in mind that the Parent-Subsidiary Directive achieves equal treatment of all subsidiaries regardless of the Member States in which their parent companies reside and is extremely useful in those cases in which there is no tax treaty between the Member State of the parent and that of the subsidiary.

The consideration of the Directive is facilitated if the latter is examined in the light of the principles set out in Chapter 4. The first conclusion that can be drawn is that the Directive conforms to the principle of subsidiarity, because it regulates a situation which could not be regulated by Member States acting on their own. The need for a centrally imposed legislative solution was obvious, since the existing bilateral treaties between the Member States lacked uniformity and, therefore, caused a fragmentation of the European market. Consequently, it was beyond any doubt that the taxation of profits distributed from a subsidiary in a Member State to its parent in another Member State was an issue that demanded Community, not national, legislation.

With regard to tax neutrality the Parent-Subsidiary Directive falls short of achieving it completely. First, international neutrality is fully established by the abolition of withholding tax in the Member State of the subsidiary in combination with the introduction of the exemption or credit method in the Member State of the parent. As a result, foreign source corporate income enjoys the
same tax treatment as domestic corporate income and this removes a serious obstacle to the free flow of capital within the Single Market.

Secondly, the Directive fails to achieve Neutrality towards the legal form of the enterprise, since it covers only public companies and only associated companies (Parent-Subsidiary).

Thirdly, locational neutrality is achieved to a great extent, but not fully. More specifically, the abolition of withholding tax together with the first method provided in Article 4(1) of the Directive, that is the exemption method, accomplish Capital Import Neutrality, because the profits of the subsidiary are subject to corporate tax only in the Member State in which the subsidiary resides. However, this does not secure Capital Export Neutrality since the corporate tax imposed on the profits of subsidiaries varies among Member States.

Conversely, Capital Export Neutrality is attained by the abolition of withholding taxes together with the application of the

---

60 There is a slight problem in the way the credit method is applied, which will be examined later in this subsection.

61 See similar analysis in the Mergers Directive. The Ruding Committee has recommended the extension of the Directive to cover other types of companies (Ruding Committee's Recommendations, pp.28-29).

62 What about the withholding tax on dividend distributions to other recipients? See Ruding Committee's Recommendations, p.29, and Chapter 6 of the thesis.
full credit method\textsuperscript{63} by the Member State of the parent. The problem arises from the fact that Article 2(1) of the Directive provides for the partial or limited credit method (limited to the amount of the tax which would have been due if the foreign income had been domestic income). This means that Capital Export Neutrality is achieved only in those cases in which foreign tax does not exceed the tax that would have been paid domestically for the same profits if the latter had been domestic profits. Moreover, the abolition of withholding tax combined with the second method, namely the limited credit method, does not achieve Capital Import Neutrality, because the limited credit method is based on calculations that produce an amount over which the foreign tax cannot go and such amount is different for each Member State.

As far as equity is concerned, the Parent-Subsidiary Directive seems to comply with interindividual equity. The discrimination between domestic and transnational groupings is dropped and the foreign income does not bear extra tax burden. The only problem can be identified in the case where a Member State adopts both methods provided in Article 4 of the Directive and uses them in a discretionary way. For instance, Member State A can apply the exemption method when the foreign income is derived from SubB in Member State B and the limited credit method when the foreign income comes from SubC in Member State C. Such a situation that reintroduces discrimination and undermines free competition should have been contemplated by the Directive.

\textsuperscript{63} See Chapters 2 (2.2.1. b) and 4 (4.3.1).
Although the Directive will cause revenue losses to those Member States in which subsidiaries are established, the principle of interjurisdictional equity is not affected.\textsuperscript{64} Indeed, the application of withholding tax on intra-Community distribution of profits was against the aforementioned principle and therefore the Directive is a step towards the full application of the principle.\textsuperscript{65}

The abolition of withholding tax on intra-Community profit distributions improves economic efficiency in two ways. First, it reduces the tax burden of subsidiaries and saves certain amounts of money which can be used in more productive uses (e.g. reinvestment). Secondly, it results in a reduction of tax planning, rerouting of profits and treaty shopping which all require the use of sophisticated and expensive consultation.

Moreover, the Parent-Subsidiary Directive is in accordance with another principle mentioned in Chapter 4, that is flexibility towards the developments in other fields of law. In fact, the Directive constitutes an essential supplement to the company law harmonisation process and more specifically to the Proposed Regulation on the Statute for a European Company (SE).\textsuperscript{66} The latter in Article 3(2) reads: "A SE together with one or more other SEs, or together with one or more companies or legal bodies ....may set up an SE by forming a joint subsidiary". Such means of forming a SE should

\textsuperscript{64} See Chapter 4 (4.5.2.).

\textsuperscript{65} Full application is achieved by the adoption of the full credit method. See analysis in Chapters 2 (2.2.1. b) and 4 (4.3.1.).

\textsuperscript{66} COM(91) 174 final-SYN 218 (OJ 1991, C176/1).
not suffer an extra tax burden and this is accomplished by the Parent-Subsidiary Directive. Nevertheless it should be mentioned that SEs can benefit from the Parent-Subsidiary Directive only if a broad interpretation is adopted as regards Article 2 of the Directive. This Article defines that the Directive applies to companies of the Member States and from the Annex to which the Article refers derives that in most Member States the companies in question are public companies. In view of these, how can a SE which is not a company of a Member State but it is a "European public limited company"\textsuperscript{67} can be included in the concept of company defined in Article 2? Only a broad interpretation of that Article dictated by the logic that the draftsmen of a Directive aimed at facilitating cross-border cooperation would not wish to exclude from the benefits of the Directive SEs which are a vehicle for cross-border cooperation within the Internal Market.

As regards political acceptability the comments are identical with those applying to the Mergers Directive. Conversely, the comments are not the same in relation to administrative feasibility. This does not imply that the Parent-Subsidiary Directive fails to conform to the corresponding principle, but it means that the Directive may face some difficulties in conforming to the principle. Such difficulties are likely to appear for those Member States which will employ the credit method, a method characterised by technical complexity and by the need for extra paper work from tax authorities. This however should not be regarded as something that will cancel the

\textsuperscript{67} Article 1 of the Regulation on the Statute for a European Company.
enforcement of the Directive which in no way contravenes the principle of certainty.

The last principle the Parent-Subsidiary Directive has to meet is that demanding the prevention of tax avoidance and evasion. Article 1(2) deals with the problem of tax avoidance and evasion providing that "the Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud and abuse". However, the wording of this provision does not refer to tax avoidance and evasion clearly. The concept of "the abuse of law" derives from the respective doctrine of Roman law and exists in the laws of continental States but not in the U.K.. Furthermore, the word fraud cannot cover every single case of tax evasion since it is quite possible to have a case where tax evasion took place by other means and not by fraud. The only way to adapt tax evasion and avoidance to the wording of Article 2(1) is by employing a broad interpretation and by seeking recourse to the mischief rule.\(^6^8\)

At this point, it is worth discussing a few problems arising from the Parent-Subsidiary Directive. First, the Directive may tempt a hypothetical non-EC company ComX, resident in State X, to establish a holding company in that Member State with which X has concluded the most beneficial tax treaty (compared with the similar ones concluded between X and the rest of the Member States) and transform the subsidiaries ComX previously had in other Member States into

\(^6^8\) Which means to find the legislator's intentions with regard to the specific provision.
subsidiaries of the holding company. A broad interpretation of Article 1(2) of the Directive and especially the maintaining of treaty based anti-abuse provisions may deprive EC-based companies owned by non EC physical or legal persons of the benefits provided in the Directive. But this may prove not to be enough and may force Member States to renegotiate their tax treaties with non-EC countries on a common basis.

Secondly, the 25% capital holding requirement provided in Article 3(1) combined with the option offered in 3(2) causes confusion, because the possibility of a company that has different categories of shares, each of them with its own voting rights, cannot be disregarded. For example, there can be a case according to which a company may own 25% of the non-voting shares of another company and this can establish a parent-subsidiary relation. Moreover, the criteria included in Article 3 do not correspond to those provided in the Seventh Company law Directive on Consolidation of Accounts.

Thirdly, the application of the credit method is based on the assumption that the Member State of the parent company determines the domestic tax liability of the company taking into account the tax paid by the subsidiary. This means that the Member State of the parent does not call into question the way by which the tax paid to

---

69 "Directive Shopping" instead of "Treaty Shopping".

70 The Ruding Committee has recommended that this threshold should be substantially reduced; Ruding Committee's Recommendations, p.29.

71 Application of the voting criterion.

the Member State of the subsidiary was calculated. But to what extent will this happen given the serious differences between the Member States in respect of the base of corporate taxation?73

Fourthly, another problem arises from Article 4(2) which offers Member States the option of not deducting at parent level any charges relating to the holding.74 This might also result in double taxation and, above all, does not help the free flow of capital. Fifthly, the Directive regulates the relation between parent and directly owned subsidiaries,75 but what about indirect ownership? The latter takes place when parent ComA of Member State A owns subsidiary ComB in Member State B which in its turn owns subsidiary ComC in Member State C.76 If all the Member States in this hypothetical situation apply the same method (Credit or Exemption) the Directive applies to the relation first between ComB and ComC and then to the relation between ComA and ComB and no problem appears. But what is the situation where the Member States in question do not apply the same method?

In such a case, assuming that B exempts foreign source income from taxation and A applies the credit method the result will be unrelieved double taxation, since ComA will not be entitled to a tax credit for the dividends received from ComB as those dividends were

73 See Chapter 2.

74 The so-called "stewardship expenses" which include the expenses incurred by the parent company in managing the subsidiary.

75 The so-called "tooth-comb structure".

76 The so called "Christmas tree structure".
not subject to tax in B. The case is further complicated if ComB is a branch of ComA and not a subsidiary. Can the Parent-Subsidiary Directive be interpreted so broadly in order to include the relations between parent companies and their branches (which would mean that the case would be assimilated to that one including the two subsidiaries) or such an interpretation would distort the content and the purpose of the Directive?

Sixthly, there is no provision in the Directive providing for the consolidation of profits between the parent and its subsidiary as it was envisaged in the 1969 draft (Article 7). Finally, the Directive does not introduce any changes in the operation of Advance Corporation Tax which as a part of the imputation system\textsuperscript{77} (Article 7.1) operates as a de facto withholding tax with regard to non-national investors as it is shown the following example:\textsuperscript{78}

\begin{tabular}{|l|}
\hline
\textbf{U.K. PARENT} & \textbf{E.C. SUBSIDIARY} \\
\hline
Net Dividend = 65 & Profits = 100 \\
Grossed up for Domestic tax liability =100 & Tax at 35\% = 35 \\
Tax at 33\% = 33 & Distributed Profit = 65 \\
Foreign Tax (35) credited against Domestic tax liability (33) = 0 & \\
tax to be paid in the U.K. and 2 & \\
\hline
\end{tabular}

\textsuperscript{77} See analysis in Chapter 2.

\textsuperscript{78} This example is based on the alteration of an analogous example given by M.Gammie, 'Imputation Systems and Foreign Income', (1991/12) Intertax 545 at 547-548.
unrelieved double taxation (35-33).

Distribution Follows and thus ACT is due:

If Dividend = 65 → ACT = 16.25 →

→ Distributed Dividend = 48.75.

The conclusion that can be drawn from this example is that the amount of ACT due (16.25) is a quasi-withholding tax, since there will be no future domestic tax liability against which this amount can be credited.

The last problem is the process of implementation which in the case of the Parent-Subsidiary Directive is slow, but not so slow as in the case of the Mergers Directive. Seven Member States have implemented the Directive (Belgium, France, Germany, Ireland, Luxembourg, Spain, U.K.), whereas in three Member States implementation is in progress (Denmark, Italy, the Netherlands). Two Member States have not done anything to implement the Directive (Greece, Portugal).

Finally, a point must be made on the direct effect of the Directive at issue having in mind the general comments concerning the direct effect of Directives. There are certain uncertainties in most of the provisions of the Directive which call the direct effect of these provisions into question. Nevertheless, the basic rule the Directive lays down (Article 5) is so clear and unconditional that

79 UK’s legislation is in line with the Directive.

80 It must be taken into account that Greek corporate tax law already complies with the Directive to a great extent.

81 See the same comments made in the case of the Mergers Directive.
there is no doubt that the provision containing this rule will have
direct effect from 1 January 1992, but the last word on such issues
lies in the European Court of Justice.82

5.2.3. The Arbitration Convention

The Arbitration Convention whose adoption by the ECOFIN was
based on Article 220 of the EC Treaty, has its origins in Article 25
of the OECD Model Double Tax Convention. It is a measure that
differs from the other two adopted measures in two points.

First, it is not a Directive, though in its original version
was proposed as a Directive,83 but a Convention. The question which
may arise at this point concerns the reason for this change of form,
from a Proposed Directive to a Convention. The most convincing
explanation is that the Council, when it dealt with the issue for the
first time, decided that the measure under discussion should be based
on Article 220 of the EC Treaty, because the latter offered a better
legal basis. What this argument conceals is that Conventions can
more easily accommodate reservations and different approaches
compared with Directives and consequently Member States by adding
their reservations at the end of a Convention may achieve to
circumvent it more easily than a Directive.84 Although Conventions

82 See comments on direct effect and damage caused by the non
implementation of Directives made in the case of the Mergers
Directive.


84 See the reservations at the end of the text of the Arbitration
adopted pursuant to that Article are part of the Community legal system, their ratification by National Parliaments is the "sine qua non" requirement for becoming effective. Conversely, Directives have to be implemented by national measures but, after a certain time limit has been expired, they become directly effective, which does not happen in the case of Conventions.

Secondly, the Arbitration Convention is a measure of adjective law, whereas the two adopted Directives are measures of substantive law. In other words, the Convention regulates certain administrative procedures and actions of the tax authorities, but not actions of enterprises as the two aforementioned Directives did. In spite of its administrative purpose the Convention will have an indirect, though significant, impact on companies involved in intra-Community businesses.

The scope of the Convention is the establishment of a procedure that will take effect in cases of transfer pricing and more specifically, whenever, for the purposes of taxation, there is readjustment of profits of associated companies which are residents in different Member States. The application of the Convention depends upon the following conditions:

a) There must be two enterprises of different Member States

---

86 See analysis in Chapter 2 (2.2.2. b).
87 The Convention refers to Contracting States which has the meaning of Member States.
b) One of the companies must participate directly or indirectly in the management, control or capital of the other company (Article 4.1a) or the same persons must participate directly or indirectly in the management, control or capital of both companies (Article 4.1b).

c) Violation of the arm's length principle.\textsuperscript{88}

d) The violation of the aforementioned principle must give the right to the tax authorities of the Member State in which one of the two companies reside to readjust the profits of that company (Articles 4, 5).

e) The readjustment of profits must result in double taxation in the sense that there are profits which are included in the profits of both companies (Article 1).

f) The taxes to which the Convention will apply must be among those described in Article 2.

If all the above requirements are met the tax authorities of a Member State may inform the company situated in that State that they are going to readjust its profits. The company whose profits are going to be readjusted may inform its affiliated company in another Member State\textsuperscript{89} which in turn will inform the tax authorities of that State within a time limit of three years.\textsuperscript{90} The next stage involves negotiations between the tax authorities of the Member States in

\textsuperscript{88} For the concept of arm's length principle see Chapter 2 (2.2.2. b).

\textsuperscript{89} Article 5.

\textsuperscript{90} Article 6.
which the associated companies are situated.

If there is no agreement within two years of the date on which the case was first submitted to one of the competent authorities an advisory commission is set up (Article 7) and this committee, whose composition is provided by Article 9, must deliver its opinion within six months from the date the case was referred to it (Article 11). The authorities of the Member States involved must eliminate the double taxation within six months of the date on which the commission delivered its opinion by adopting the opinion or by agreeing on a completely different basis; but they must adopt the opinion if they cannot reach an agreement (Article 12). The relation between domestic legal proceedings concerning the readjustment and tax penalties arising from it on one hand and the arbitration procedure on the other is regulated by Articles 7 and 8.

The scope and the content of the Convention make its consideration in the light of the principles mentioned in Chapter 4 impossible. Thus, it is worth criticising the Arbitration Convention by referring to its advantages and disadvantages.

Starting from the former, it has to be stated that the Convention will have a great contribution to the elimination of double taxation and will protect European groups of companies against any arbitrary decisions of the tax authorities. It will also be extremely beneficial to small companies which do not have specialised staff dealing with double taxation problems. In addition, the procedure provided in the Convention takes place with certain deadlines and, above all, must produce a result. Finally, the interested companies are given the right to participate in the
procedure before the advisory commission and to explain their views.

In contrast to the original version of the Convention (the 1976 Proposed Directive) the dispute between the tax authorities is referred to the commission ad hoc but the negotiations between the tax authorities need not stop and the decision of the commission is binding only if the two sides cannot reach an agreement. Furthermore, the concept of "serious penalty" provided by Article 8 is construed differently by Member States, as the unilateral declarations show, and this may cause confusion and may threaten the effectiveness of the Convention. Differences also exist in the way Member States approach the potential coexistence of the arbitration procedure with domestic remedies.

For example, as has rightly been suggested\(^9^1\) in the UK the provisions of the Convention can be applied only if the taxpayer holds negotiations with the Inland Revenue. Conversely, if the taxpayer has filed an appeal against the assessment made by the Inland Revenue the case is decided by independent appeal authorities whose decisions are binding. This means, that the tax authorities cease to be involved in the case and, therefore, there is no ground for the application of the Convention which presupposes such involvement.

Another problem arises from the fact that no definition of the term "enterprise of a Contracting State"\(^9^2\) is given. Recourse may be

\(^9^1\) D. Williams, 'The British Reaction to the French Package', (1991/12) Intertax 560 at 564.

\(^9^2\) Article 1(1).
sought to Article 3(2) which says that "any term not defined in this Convention shall, ..., have the meaning which it has under the double taxation convention between the States concerned", but this does not solve the problem, since there are certain contracting States which have not signed such conventions.\textsuperscript{93}

A problem is also caused by the wording of Article 4(1) because the latter refers to associated companies of two Member States and such reference does not cover the case of a company of one contracting State and the permanent establishment of a company of another contracting State, if that permanent establishment is situated in a third non-contracting (non-EC) State.\textsuperscript{94} However, this problem was circumvented at the last moment by the joint declaration on Article 4(1) which covered the aforementioned case.

There is also another problem concerning the scope of the Convention namely that the Convention deals with the disputes which may arise between tax administrations over transfer pricing and not with the problem of transfer pricing "per se".\textsuperscript{95} It is quite possible

\textsuperscript{93} See Chapter 2.
\textsuperscript{94} e.g. a U.K. company and the permanent establishment of a French company situated in Switzerland. Conversely, the Convention does not apply to a case in which a company of a contracting State and the permanent establishment of a company of a non-Contracting State are involved, even if that permanent establishment is situated in a contracting State (e.g. a U.K. company and the permanent establishment of a U.S. company in France).
\textsuperscript{95} The Ruding Committee has also reached this conclusion and has therefore recommended the adoption of common rules concerning transfer pricing adjustments by Member States (Ruding Committee's
that the introduction of common rules on transfer pricing may result in a reduction of the cases where there is a dispute between tax authorities.

The last and, perhaps, the gravest problem refers to the legal form of the adopted text. Although, it was proposed as a Directive, it was finally adopted as a Convention, which means that the Commission cannot monitor the process of implementation and the European Court of Justice does not have the competence to interpret the Convention, since the latter does not include a relevant provision.

As regards the process of ratification of the Convention by the Contracting States (Member States of EC) this is slow. Not even one Member State has ratified it, and only three Member States have started the necessary proceedings for ratification (France, the Netherlands, U.K.). The rest of the nine Member States have not done anything towards the ratification so far.

5.3. Proposed Measures

5.3.1. The Proposed Directive Concerning Arrangements for the Taking into Account by Enterprises of the Losses of their Permanent Establishments and Subsidiaries Situated in Other Member States

Adherence to the rule of non-discrimination between domestic and intra-Community activities, a rule that constitutes one of the

Recommendations, p.31).

277
cornerstones of the Internal Market, was the reason that led the Commission to propose the Directive "Concerning Arrangements for the Taking into Account by Enterprises of the Losses of their Permanent Establishments and Subsidiaries Situated in other Member States".\textsuperscript{96} This Proposed Directive is essential for the proper functioning of groupings of companies located in the Community, and, especially for the achievement of a more effective and efficient management within those groupings together with a better coordination of their activities.

The application of the proposed Directive depends upon the fulfillment of the following conditions:

a) There must be a "parent" company which must be resident for tax purposes in a Member State according to the tax law of that State (Article 2).

b) The parent company must have permanent establishments (=fixed place of business through which the parent company carries on its business) or subsidiaries (=any company in the capital of which the parent company has a minimum holding of 75% giving it a majority of voting rights)\textsuperscript{97} in other Member States.

c) The parent company and its permanent establishments or subsidiaries must be subject to, "without being exempt from",\textsuperscript{98} one of the taxes mentioned in Article 3.

\textsuperscript{96} COM(90)595 final (OJ 1991, C53/30).

\textsuperscript{97} Member States may provide for a smaller qualifying percentage, but they must always adhere to the majority voting rights criterion.

\textsuperscript{98} Same as in the Mergers and Parent-Subsidiary Directives.
Assuming that the aforementioned requirements are met the basic rule of the Proposed Directive can be applied to the relation between parent companies and their permanent establishments or subsidiaries in other Member States. This rule concerns the treatment of losses incurred by the permanent establishments or subsidiaries situated in Member States different from that in which their parent company resides. Such treatment must take place through the use of one of the three methods provided by the proposed Directive.

The first method concerns permanent establishments and is the credit method which was first provided in the Parent-Subsidiary Directive.\textsuperscript{99} According to this method parent companies must include in their results for a given tax period the positive or negative results of all their permanent establishments situated in another Member State and "where appropriate" credit the tax paid by the latter against any tax which may be payable by the parent companies on the profits of such establishments. The following example\textsuperscript{100} will help in the interpretation of the method:

\textsuperscript{99} In fact the credit method in the proposed Directive forms a package with the credit method provided in the Parent-Subsidiary Directive. Thus, the application of the credit method is obligatory for the parent company if the Member State in which it is situated has opted for this method.

\textsuperscript{100} The examples that follow are based on the similar ones given by O. Thommes, 'The New Commission's Proposals for Directives on Cross-border Investments', (1991/3) Intertax 158 at 164-165.
CHAPTER 5

MEMBER STATE OF PARENT COMPANY

Tax Rate = 40%

1st Year

Domestic Profit = 100

Total Profit = 100 + 100 = 200

Tax on Dom. Prof. = 40

Tax on For. Prof. = 40

Credit for Paid Tax = 30

Final Tax on For. Prof. =

= 40 - 30 = 10

Tax Due = 40 + 10 = 50 (A)

Total Tax on Grouping = (A) + (B) = 50 + 30 = 80

2nd Year

Domestic Profit = 100

Loss = 100

Total Profit = 100 - 100 = 0

Tax Due = 0 (A)

Tax = 0 (B)

Total Tax of Grouping = (A) + (B) = 0 + 0 = 0

3rd Year

Domestic Profit = 100

Profit = 100

Total Income = 100 + 100 = 200 Carry-Forward of 2nd Year

Domestic Tax = 40 Losses = 100 - 100 = 0

Tax on For. Prof. = 40 Tax = 0 (B)

Credit for Paid Tax = 0
Final tax on For.Prof. = 40
Tax Due = 40 + 40 = 80 (A)
Total Tax on Grouping = (A) + (B) = 40 + 40 = 80
TOTAL TAX IN 3 YEARS = 80 + 0 + 80 = 160.

The second method can be applied to the relations between parent companies and their permanent establishments in other Member States\(^{102}\) as well as between parent companies and their subsidiaries in other Member States. It is attached to the exemption method provided for by the Parent-Subsidiary Directive and consists of deducting from the parent's profits for given tax period the loss incurred in the same period by its permanent establishments or subsidiaries and of incorporating the subsequent profits of such permanent establishments or subsidiaries into the profits of the parent, to the extent of the loss that already has been deducted (Articles 7, 9). The following example will facilitate the understanding of the method:

<table>
<thead>
<tr>
<th>MEMBER STATE OF PARENT COMPANY</th>
<th>MEMBER STATE OF PERMANENT ESTABLISHMENT OR SUBSIDIARY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Rate = 40%</td>
<td>Tax Rate = 30%</td>
</tr>
</tbody>
</table>

1st Year

<table>
<thead>
<tr>
<th>Domestic Profit = 100</th>
<th>Profits = 100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic Tax = 40 thus</td>
<td>Tax = 30 (B)</td>
</tr>
</tbody>
</table>

Tax Due = 40 (A)

Total Tax on Grouping = A + B = 40 + 30 = 70

\(^{102}\) If the Member State of the parent company has opted for this method it is in the discretion of the parent company to apply it or not.
CHAPTER 5

2nd Year

Domestic Profit = 100
Loss = 100

Deduction Met. = 100-100 = 0
Tax = 0 (B)

Taxable Income = 0

Domestic Tax = 0 thus

Tax Due = 0 (A)

Total Tax on Grouping = A+B = 0+0 = 0

3rd Year

Domestic Profit = 100
Profit = 100-100 (Carry-
Reincorporation = 100
Forward of 2nd year loss)

Total Profit = 200
= 0

Domestic Tax = 80 thus
Tax = 0 (B)

Tax Due = 80 (A)

Total Tax on Grouping = A+B = 80+0 = 80

TOTAL TAX IN 3 YEARS = 70+0+80 = 150.

The deduction method is the only acceptable method for subsidiaries (Article 9) and bases the calculation of profits or losses of the permanent establishments or subsidiaries on the tax law of the Member State in which those permanent establishments or subsidiaries are situated (Articles 7.2 and 9.2).\(^\text{103}\) In addition, the deductible losses are automatically subject to reincorporation into the parent taxable results "where reincorporation has not occurred by the end of the fifth year following that during which the loss

\(^\text{103}\) In the case of subsidiaries there is an additional element, that is the proportion to the holding which the parent company has in capital.
became deductible" (Article 8a for permanent establishments and 10a for subsidiaries), or "where the permanent establishment is sold, wound up or transformed into a subsidiary" (Article 8b), or where the subsidiary is sold, wound up or transformed into a permanent establishment or the parent's holding in the capital has fallen below the permissible level (Article 10b).

The third method concerns only subsidiaries and can comprise any method a Member States wish to introduce, including the consolidated method (Article 12). According to the latter the profits or losses of subsidiaries are included in the taxable income of the parent company and the tax, to which the parent company is subject, is levied on this consolidated tax base.

The Proposed Directive is a supplement to the Parent-Subsidiary Directive and, since the latter is consistent, to a great extent, with the principles mentioned in Chapter 4, it is expected that the Proposed Directive will comply with those principles. First, it conforms to the principle of subsidiarity and the reasoning is the same with that mentioned for the Parent-Subsidiary Directive. Secondly, since the credit method provided for by the Proposed Directive forms a package together with the credit method of the Parent-Subsidiary Directive and, by virtue of the connection of the deduction method with the exemption method laid down by the Parent-Subsidiary Directive, the comments about locational neutrality made in the case of the Parent-Subsidiary Directive can apply, more or less, to the Proposed Directive as well. Thirdly, international neutrality and interindividual equity are achieved in the same way as in the case of the Parent-Subsidiary

In contrast to the two adopted Directives, the Proposed Directive accomplishes neutrality towards the legal form of enterprise, because its provisions apply to any company irrespective of its legal form. In other words, the benefits of the Proposed Directive are not confined to public companies, but are extended to any other form of enterprise (e.g. one man company, limited partnerships, etc.).

As regards economic efficiency, the Proposed Directive plays a part in achieving it by facilitating the establishment of a more effective way of organising cross-border groupings. Parent companies will be in a position to offset losses of their permanent establishments and subsidiaries against their own profits and, consequently, balance will be attained within the grouping. Furthermore, better coordination of activities is achieved and the position of permanent establishments and subsidiaries is strengthened, because their possible initial loss, which is common when an investment is made abroad, will not undermine their future.

Another principle, that of flexibility, is satisfied by the Proposed Directive in two ways. First, the Proposed Directive is flexible with regard to the process of harmonisation taking place in other fields of law and especially in company law. Without its adoption Article 133 of the proposed Regulation on the European Company will not have legal effect, since the latter provides for the reincorporation which is going to apply to the permanent
establishments of European Companies.

Moreover, the provisions of the Proposed Directive affect the tax status of the European Economic Interest Groupings (EEIG), because the latter are often treated by tax authorities as permanent establishments of their members (=the companies which form the EEIG). Consequently, likely losses of EEIGs should be deductible from the profits of the members, otherwise the legal form of EEIG will become a legal invention without practical effect.

Secondly, conformity to the principle of flexibility is confirmed by the wide discretion the Proposed Directive offers to Member States. More specifically, Article 4 gives Member States the right to extend the beneficial provisions of the Proposed Directive in order to cover non-EC permanent establishments and subsidiaries. Article 12 is also a provision that underlines the flexible character of the Proposed Directive.

From the administrative point of view the Proposed Directive does not seem to cause problems to national tax authorities, especially since it declares that the income of permanent establishments and subsidiaries will be decided in accordance with the rules of the State in which they are located. In addition, the attempts of national tax authorities to combat tax evasion and avoidance are not hampered by the Proposed Directive. The latter includes Article 13 which states that "the Directive shall not preclude the application of provisions laid down by national law or under agreements to prevent tax evasion or abuse". What is significant in relation to the wording of Article 13 is that the word abuse implies the concept of tax avoidance with all the respective
problems discussed in the cases of the Mergers and the Parent-Subsidiary Directives. Furthermore, it is worth noting that the words "tax evasion" and "fraud" on the one hand and "tax avoidance" and "abuse" on the other are interchanged in the text of the corporate tax Directives.

Nevertheless, the Proposed Directive is not perfect and this means that some of its provisions may give rise to certain problems. First, it is not clear whether the credit method described in Article 6 is the full or the limited version of the method. By virtue of the supplementary role of the Proposed Directive to the Parent-Subsidiary it could be assumed that the limited version should apply. Moreover, the phrase "where appropriate" in the same Article needs to be construed as implying that the activities of a permanent establishment were profitable for a given tax period and therefore subjected to taxation.

Secondly, the deduction-reincorporation operates ideally when permanent establishments or subsidiaries are profitable in some years and suffer losses in other years, but does it work when there are only losses? In such case, where offset cannot take place due to the lack of profits, the Member State of the parent company may not be satisfied by the way the Member State in which the permanent establishment or subsidiary is situated calculates the income of that permanent establishment or subsidiary. This could easily lead to a conflict between the two Member States and the eventual result might be double taxation.

Thirdly, why is the credit method confined to permanent establishments and not extended to subsidiaries as well? The
explanation for such discrimination is that the application of the
credit method to subsidiaries is obstructed by several technical
problems arising from the national differences in tax base and rates.
As a result, the Commission fearing that a possible extension of the
method to subsidiaries would be not politically acceptable and would
delay the adoption of the Directive restricted the use of the method
to permanent establishments only.

In addition, the Proposed Directive allows the offsetting of
losses of subsidiaries or permanent establishments against the
profits of the parent company (vertical offsetting) but it does not
permit the offsetting of losses of subsidiaries or permanent
establishments against the profits of other subsidiaries or permanent
establishments of the same parent company (horizontal offsetting).
This irregularity must be eliminated and horizontal offsetting must
be accepted for the benefit of a more efficient performance of
groupings.

Finally, provided that the Proposed Directive will be adopted,
its application depends on the adoption of the 1984 Proposed
Directive on the Carry-Over of Losses. Without the latter in force
the former cannot have a legal effect and will remain inapplicable.
As a result, if the Directive is adopted its enforceability will rely
on the simultaneous adoption of the Directive on the Carry-Over of
Losses, which means that the Proposed Directive does not fully comply
with the principle of certainty. The most significant, though, is
that the Proposed Directive deals with an issue of cross-border
operations, whereas the proposed Directive on Carry-over of Losses
deals with an issue of the tax base. This tends to prove the
existence of a spill-over element\textsuperscript{104} in measures of corporate tax harmonisation and implies that the process of corporate tax harmonisation may not reach its completion solely by the adoption of measures dealing with cross-border operations problems.

The final comment refers to the direct effect of the Proposed Directive, when the latter is finally adopted. Notwithstanding the problems mentioned above, the most significant provisions of the Proposed Directive are clear, unambiguous and unconditional (Articles 1, 5, 6, 7, 9) and, thus, will be directly effective. Of course, the final confirmation will be given by the European Court of Justice if a case based on the Directive in question is brought before it.

5.3.2. The Proposed Directive on Carry-Over Losses

The importance of carry-over of losses to the investment capacity and competitiveness of companies together with the role carry-over of losses plays in the functioning of the aforementioned Proposed Directive have revived the proposed Directive "on the Harmonization of the Laws of the Member States Relating to Tax Arrangements for the Carry-over of Losses of Undertakings".\textsuperscript{105} The latter was put before the Council in 1984 and in the following year its amended version was presented before the Council. It has remained on the shelf for almost six years until recently when it was

\textsuperscript{104} See Chapter 3.

\textsuperscript{105} COM(84)404 (OJ 1984, C253/5) and COM(85)319 final (OJ 1985, C170/3).
relaunched by the Commission.\textsuperscript{106}

The application of the Directive depends on the fulfillment of the following conditions:

a) The Directive applies to undertakings of Member States (Article 1.1).

b) The undertakings concerned must be subject to one of the taxes listed in Article 1(2).

c) These undertakings must "draw up for tax purposes in accordance with conditions laid down by national law annual accounts consisting of a balance sheet and a profit and loss account" (Article 1.1).

The rule the Proposed Directive lays down concerns the carry-back and carry-forward of losses of enterprises and applies only if any possible setting-off against other income or results recorded abroad by permanent establishments or subsidiaries has happened (Article 2). In other words, carry-over of losses is the ultimate means for offsetting losses and according to Article 3(1) it spreads either over "...the three preceding financial years in chronological order..." or over the future indefinitely.\textsuperscript{107} There is also the provision that, if the tax law of a Member State requires that losses must be set off category by category and the setting off cannot take place within 5 years because of the requirement in

\textsuperscript{106} See point 11 in the Explanatory Memorandum of the Proposed Directive on the "...Taking into Account of Losses..." COM(90)595.

\textsuperscript{107} The only limit is the amount of losses. When the latter has been fully set-off against profits carry-forward stops.
question, such requirement will not have any effect (Article 3.3).

The Proposed Directive on Carry-Over of losses is of vital importance for the effectiveness of the Proposed Directive on "...taking into account of losses...". The latter cannot be put into practice without the adoption of the former, as it was clearly shown above. In addition, the correlation between the two Proposed Directives in conjunction with the fact that the Proposed Directive on "...taking into account of losses..." plays a significant part in the proper functioning of European Economic Interest Groupings (EEIGs) and European Companies (SEs) indicates that the Proposed Directive on Carry-Over of Losses will have a positive impact on EEIGs and SEs (principle of flexibility).

As regards the other principles mentioned in Chapter 4, the Proposed Directive on Carry-Over of Losses complies with most of them. First, it satisfies the principle of subsidiarity because it introduces a rule relating to an issue that needs similar treatment by Member States, otherwise problems will arise and this will result in the fragmentation of the Internal Market. Secondly, the principle of economic efficiency is served by the Proposed Directive, since the carry-over of losses is very important for the survival and the investment making of companies.

Thirdly, it does not seem that the Proposed Directive at issue will cause problems to the tax authorities of Member States (administrative feasibility), since many of them already enforce national legislation on carry-over, as it is shown in Chapter 2, and

---

108 Profits and losses do not belong to the same category.
Article 4 of the Proposed Directive provides that "the provisions of this Directive shall not preclude the application of national laws for the prevention of fraud or abuse" (prevention of tax avoidance and evasion).\textsuperscript{109} Thus, there are no doubts that the Proposed Directive, if adopted, will be enforceable given that its provisions do not lack clarity.

Fourthly, the Proposed Directive contributes to the achievement of Capital Export Neutrality, since it harmonises one of the components of the tax base.\textsuperscript{110} As a result, carry-over of losses will no longer be a factor that will affect investment decisions within the European Community. It is also worth noting that the Proposed Directive attains neutrality with regard to the legal form of enterprises, since it does not apply only to public companies, but covers all forms of undertakings.

Nevertheless, the Proposed Directive is not without problems. The first concerns interindividual equity and originates from the wording of Article 3(2) which states that "where a loss has been set off against profits which have been distributed and which at the time of their distribution carried entitlement to tax credit, the

\textsuperscript{109} This provision may need elaboration in the light of the similar provisions included in the company tax Directives the Council adopted recently. This means that the provision in question may need to change to: "The Directive shall not preclude the application of provisions laid down by national law or under agreements to....".

\textsuperscript{110} It must be born in mind that the harmonisation of the tax base and tax rates is one of the methods of achieving Capital Export Neutrality (See Chapter 4).
resulting repayment of tax shall be reduced by the amount of that tax credit, to the extent it has not been covered by a compensatory tax. But such tax credit is in most cases restricted to residents (nationals to a large extent) and not offered to other EC nationals. Such discrimination will continue since the reduction in the repayment of the tax will benefit those who enjoyed the original tax credit, namely the residents (nationals) of a Member State.

The second problem arises from Article 1(1) which provides that the enterprises to which the Directive applies are subject to the taxes listed in paragraph 2 but it does not include the phrase "without being exempt". The same Article does not include any reference to the residence of the concerned companies and it does not deal with the case of companies which are considered as non-EEC residents according to the provisions of bilateral tax agreements.

Finally, whether the Proposed Directive is politically acceptable will be found soon since it has been brought before the Council again for adoption together with the Proposed Directive on "...taking into account of losses..." with which it forms a package. In contrast to this question which is likely to be answered in the near future another question concerning the direct effect of the Directive may have to wait. Although the provisions of the proposed Directive on Carry-Over of Losses seem to conform to the criteria which determine the existence or not of direct effect, the final word

111 See Chapter 2.
112 For the meaning and the essence of this phrase See Note 22.
113 See Note 21.
rests with the European Court of Justice if the latter is given the chance to rule on the Directive after it has become a part of Community law.

5.3.3. The Proposed Directive on "A Common System of Taxation Applicable to Interest and Royalty Payments Made Between Parent Companies and Subsidiaries in Different Member States"

The Proposed Directive on "A Common System...Applicable to Interest and Royalty Payments...." (hereafter called the Proposed Interest-Royalty Directive)\(^{114}\) will introduce, if it is adopted, the abolition of withholding tax which applies to payments of interest and royalty made between parent and subsidiaries in different Member States. It has to be said, though, that the majority of bilateral tax treaties concluded between Member States has already provided for the abolition of withholding tax on interest and royalty payments.

On the other hand, the bilateral tax relations between certain Member States\(^{115}\) are not regulated by tax treaties and, even in cases where a specific Member State has concluded tax treaties with the other Member States, there is not equal treatment in the sense that some tax treaties include provisions for zero or very low rates of withholding tax, whereas others concluded by the same Member State provide for higher rates.\(^{116}\) Moreover, where withholding tax is

\(^{114}\) COM(90) 571 final (OJ 1991, C53/26).

\(^{115}\) e.g. Denmark-Greece, Ireland-Spain, Luxembourg-Portugal.

\(^{116}\) e.g. withholding tax on interest: Belgium-Netherlands=0, Belgium-UK=10%; Italy-Belgium=15%, Italy-Spain=12%, Italy-Greece=10%.
levied, it has the functioning of a prepayment of the corporate tax in purely domestic situations, whereas in cross-border situations is a final levy on the income of non-resident companies which may, or may not, be able to credit it against their tax liability in the country of residence.

The conditions upon which the application of the Directive depends are set out in Articles 3 and 4 and are identical with the respective conditions of the Parent-Subsidiary Directive. As regards the rules the Proposed Interest-Royalty Directive lays down, these can be summarized into the following:

a) No withholding tax will be levied on interest and royalty payments between parent companies and subsidiaries in different Member States (Article 1).\(^\text{117}\)

b) Special 7-year status for Greece and Portugal (10% withholding tax for the first 5 years, 5% for the last 2, then the Council may extend it - Article 5).

c) If the payments are made to a permanent establishment of the recipient company located in the Member State of the debtor company, the Directive will apply provided that the Member State in which the debtor company and the permanent establishment are situated does not apply withholding tax to payments of the kind made between domestic parent companies and subsidiaries (Article 6).

In order to prevent any misinterpretation the Proposed Directive has defined the meaning of "interest" and of "royalty".

\(^{117}\) From subsidiary to parent and vice versa.
The former must be construed as "income from debt-claims of every kind, whether or not carrying a right to participate in the debtor's profits, including premiums and prizes attaching to bonds or debentures". This definition has been derived from Article 11 of the 1977 OECD Model Convention.

The latter, that is royalty, is defined as "payment of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematography films, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience". This definition originates from Article 12 of the OECD Model Convention and is subject to two explanatory remarks.

First, a line must be drawn between royalties paid for the use of equipment and payments for the purchase of equipment. This case, though simple at first glance, becomes complicated when there is a leasing. By virtue of the fact that in a leasing the primary scope is that of hire, it must be accepted that the concept of royalty covers payments made under a leasing contract. Secondly, payments made for after sales service (e.g. assistance and repairs during the guarantee period) do not fall within the concept of Know-How and, thus, should not be regarded as royalties.

The Proposed Interest-Royalty Directive has been proposed in

---

118 Industrial, commercial, scientific experience = Know-How.
accordance with the principle of subsidiarity, because unilateral or bilateral measures taken by the Member States could not deal with the problem effectively. As has already been mentioned, the network of tax treaties between Member States does not secure an equal treatment for companies located within the EC, since companies from certain Member States are in a better position than companies from other Member States with regard to withholding tax on royalty and interest payments.

Furthermore, where withholding tax is levied, the country of the recipient company usually offers limited tax credit for the withholding tax that was paid and this means that a certain amount of the tax remains unrelieved, resulting in double taxation. Even in cases where the tax treaty provides for a zero or very low rate of withholding tax such benefit is conditional upon the completion of administrative formalities whose cost may not be insignificant. In view of all these, the adoption of a measure at Community level is absolutely justified and urgent.

The abolition of withholding tax will increase the efficiency of European companies and the capital mobility within the Internal Market. It will also remove the discrimination between domestic and cross-border groupings (interindividual equity) in relation to withholding tax, which was very common in national tax laws. The loss of revenue for some Member States will not affect the principle

---

120 See Chapter 2 (2.2.1. e).

121 See similar comments made for the Parent-Subsidiary Directive.
of interjurisdictional equity and the reasoning is the same as in the case of the Parent-Subsidiary Directive.\(^{122}\)

With regard to neutrality three comments must be made. First, the Proposed Interest-Royalty Directive achieves international neutrality since a foreign investment will no longer be penalised by the imposition of withholding tax which might not be fully relieved. Consequently, there will be no preferential treatment of domestic investments which induces serious distortions to the Single European Market. In addition the abolition of withholding tax conforms to the principle of locational neutrality, since it attains both Capital Export and Capital Import Neutrality.

Given that withholding tax on royalty and interest will go, none of the Member States will be in a position to attract investments simply because it does not levy withholding tax or because it levies the lowest withholding tax (Capital Export Neutrality). Furthermore, after the abolition of withholding tax Company A from Member State A will cease to be in a better position than Company B from Member State B with regard to a future project in Member State C. Such privileged position was attributed to the fact that the withholding tax provided in the tax treaty between A and C was lower than the respective in the tax treaty between B and C (Capital Import Neutrality).

What the Proposed Interest-Royalty Directive does not attain is neutrality towards the legal form of the enterprises.\(^{123}\)

\(^{122}\) See also Chapter 4.

\(^{123}\) See Chapter 4 (4.3.2.).
specifically, the benefits of the Directive are restricted only to public companies. In addition, the Proposed Directive applies to associated companies (the existence of the parent-subsidiary relationship is a sine qua non condition) and does not cover interest and royalty payments made between non affiliated (associated) companies. Nevertheless, the Proposed Directive satisfies to a certain extent another principle, that of flexibility towards the developments in other fields of law. Indeed, the abolition of withholding tax will facilitate the operations of a specific type of the European Company (SE).125

Conversely, the Proposed Directive fully conforms to the principle of administrative feasibility, since the abolition of withholding tax removes a tax whose imposition, even where the rate is 0, is responsible for a certain amount of administrative work done by the tax authorities. However, the reduction of the administrative burden does not take place at the expense of the principle of certainty or of the prevention of tax avoidance and evasion, because there are not any points in the Directive that are likely to put its enforceability into doubt and Article 7 of the Proposed Interest-Royalty Directive provides that "This Directive shall not preclude the application of domestic or agreement-based provisions

124 The same conclusion has been reached by the Ruding Committee which recommends the extension of the scope of the Directive in order to cover non associated companies (Ruding Committee's Recommendations, p.30).

125 The same comments apply as in the Parent-Subsidiary Directive.
required for the prevention of fraud or abuse".

As regards political acceptability, the Proposed Directive does not lack it for two reasons. First, because most of the bilateral tax treaties between Member States have already introduced the abolition of withholding tax there will be no serious opposition to the adoption of the Directive. Secondly, the Proposed Directive is secured against any possible objection from Greece or Portugal by the provision for a special status for these two countries.

This special status is also the first, though short term, problem arising from the Proposed Directive. Portugal and Greece import capital and technology essential for their attempt to reach the economic level of the other Member States. Such imports will become more expensive in comparison with similar imports in other Member States. As a result the two protected Member States will have to pay more for something they need so much and the Internal Market will remain fragmented in relation to the imposition of withholding tax.

The second problem concerns the confinement of the favourable tax treatment, that is the abolition of withholding tax, to associated companies. Such treatment changes the discrimination between domestic and foreign (EC) companies to a discrimination between associated and non-associated companies. The latter will find themselves in a disadvantageous position from the competition point of view and the whole situation will undermine the principle of free competition which is one of the cornerstones of the Internal Market.

Finally, the adoption of the Proposed Interest-Royalty
Directive is likely to encourage non-EC investors to reorganise their European investments in order to benefit from the provisions of the Directive. The problem is analogous with that of the Parent-Subsidiary Directive and should be dealt in a similar way. As regards the direct effect of the Proposed Directive, after it has been adopted, the clarity of its provisions do not call it into question.

5.4. Withdrawn Measures

The measures included in this category were aimed at dealing with some of the most important aspects of corporate taxation in the European Community. Among the reasons which led to the rejection of those measures the most important are: a) That the tactics the Commission followed in order to secure the adoption of these measures were not successful,\(^{126}\) b) That the measures in question were not in accordance with the stage of economic and political integration in which the Community was when these measures were proposed,\(^{127}\) and c) That the measures were aimed at dealing with tax problems which seemed to be very remote at the time when the respective measures were proposed.

The fact that these measures were never adopted renders any detailed reference to them useless. Nevertheless, a few words must be said because the needs of the Internal Market may call for the

\(^{126}\) See Chapter 3 (3.2.4.).

\(^{127}\) See Chapter 3 (3.3.).
redrafting of these measures. In fact, it is very difficult to exclude any future reintroduction of the withdrawn measures, since the developments relating to one field of corporate tax harmonisation inevitably influence what is going on in another field, as has already been mentioned.\footnote{Cross-border operations measures cannot operate without the prior adoption of measures relating to corporate tax base. For example the Proposed Directive on "...taking into account of losses..." cannot have any effect without the adoption of the Proposed Directive on the Carry-Over of Losses.}

5.4.1. The 1975 Proposed Directive on the Harmonisation of Systems of Company Taxation

The 1975 Proposed Directive\footnote{OJ 11975, C253/2 together with the 1978 Proposed Directive which applied the provisions of the 1975 Directive to Collective Investment Institutions, OJ 1978, C184/8.} provided that each Member State should impose a single rate of corporate tax which could range from 45% to 55%. It also imposed the partial imputation system accompanied by a tax credit which was not restricted to the residents of a Member State but it was extended to all EC residents. In addition, the Proposal included provisions concerning the withholding tax on dividends.

The significance of the Proposal did not lie in the imposition of a band of corporate tax rate or in the rules concerning withholding tax on dividends, but in the abolition of the discrimination between the residents of a Member State entitled to...
set off part of the tax paid at corporate level against their own income tax liability and the non-residents who reside in another State but are not allowed to such tax credit. Such step towards the implementation of equal treatment is absolutely essential if a truly Internal Market is to be established after the 1/1/1993.

Unfortunately, the 1975 proposed Directive was never adopted by the Council of Finance Ministers (ECOFIN). The failure can be attributed to the general reasons already mentioned and to a number of specific reasons the most important of which are the following:

a) The imputation system is not a system whose benefits cannot be called into question.

b) The imputation system is not applied by all Member States.\textsuperscript{130}

c) The imposition of tax rates is a very sensitive issue directly connected with the concept of sovereignty and of the handling of the economy.

d) The second part of the 70's, when the Proposal was presented and was scheduled to be discussed, was a difficult time for measures promoting economic integration.

e) The measure was characterised by administrative complexity.

f) The Commission failed to demonstrate the significance of the measure in question.

\textsuperscript{130} See Chapter 2 (2.2.4.).
5.4.2. The 1988 Preliminary Draft Proposal for a Directive on the Harmonisation of Rules for Determining the Taxable Profits of Undertakings

This measure did not manage to reach the penultimate stage a measure can reach, that is the stage of formal proposal. It contained rules concerning depreciation, capital gains, liabilities and charges, stocks, deductible charges and expenditure and certain items that form part of fixed or current assets. In other words, it covered most of the elements composing what is called the tax base.131

The Draft Proposal was very important because it defined the concept of taxable profit and introduced a common method of calculating it. If it had been adopted the same rules relating to the corporate tax base would have applied throughout the Community. This would have contributed to the creation of a more favourable tax environment which would not only have been less complicated but in which tax legislation would have been placed on more stable foundations.132

Finally, the Draft Proposal was withdrawn, because:

a) The Commission changed its tactics and priorities in the field of corporate tax harmonisation and concentrated on cross-border operation problems.

b) Such a measure required significant concessions by Member States and the latter were not prepared to make them.

c) The need for such a measure was not urgent in 1988, although it

131 See Chapter 2.
132 Explanatory Memorandum, page 2, point 2.
may be proved so after the establishment of the Internal Market in 1993.

5.5. Indirect Measures

This category includes all measures, adopted or proposed at Community level, which are aimed at dealing with problems arising in other fields of law, mainly in company law, and inevitably have tax aspects relevant to the process of corporate tax harmonisation. So far there have been two company law measures falling into this category, that is the Regulation on European Economic Interest Groupings (hereafter called EEIG)\(^{133}\) and the proposed Regulation on the Statute on the European Company (hereafter called SE).\(^{134}\)

5.5.1. The Council Regulation on the European Economic Interest Groupings

In order to understand the connection between the EEIGs and corporate tax harmonisation it is worth outlining the most important, from the taxation point of view, rules concerning EEIGs and deriving from the Council Regulation:

a) An EEIG must comprise at least (Article 4.2):

i) Two companies, firms or other legal bodies from different Member States, or

ii) Two natural persons who carry on their principal

\(^{133}\) Council Regulation 2137/85, OJ 1985 L199/1.

\(^{134}\) COM(91) 174 final-SYN 218, OJ 1991, C176/1.
activities in different Member States, or

iii) A company, firm or other legal body and a natural person from different Member States.

b) A Grouping may not employ more than 500 persons (Article 3.2c).

c) A Grouping shall be registered in the State in which it has its official address (Article 6).

d) The profits resulting from a grouping's activities shall be deemed to be the profits of the members and shall be apportioned among them in the proportions laid down in the contract for the formation of the grouping or, in the absence of any such provision, in equal shares (Article 21).

e) The profits or losses resulting from the activities of a grouping shall be taxable only in the hands of its members (Article 40).

The conclusion that can be drawn from the juxtaposition of the rules relating to EEIGs is that those rules result in the creation of a new type of company which enjoys the same tax treatment, at least theoretically, by all Member States (Article 40). The application of the same tax rule by all Member States results in a "de facto" corporate tax harmonisation that would be almost perfect, if the tax authorities of the 12 were forced to apply Article 21.

Unfortunately, Article 21 is not binding on national tax authorities, because its scope is to set a rule that will regulate the internal relations between the members of a Grouping. In view of this, an EEIG, formed by ComA of Member State A and ComB of Member State B, registered in Member State C and having activities in Member State D, may find itself in a difficult tax position. In such a
case, which is very likely, many tax questions arise: a) How easily will the tax authorities of C and D comply with Article 40, b) How are the profits of the EEIG determined taking into account the fact that the rules governing the determination of corporate taxable profits differ from Member State to Member State, c) Which criteria will the tax authorities of A and B employ for the allocation of profits between the members of the EEIG located in their tax jurisdictions?

Moreover, the structure of EEIG is a vehicle for cross-border ventures suitable to small and medium-sized companies and, thus, the benefits, if any of the "de facto" corporate tax harmonisation are restricted to those companies. Unfortunately, the tax arrangements deriving from the Regulation and concerning EEIGs are rather ambiguous and show the hesitation of the draftsmen of the Regulation. In conclusion, the Regulation is of restricted importance and cannot offer answers to the questions which concern corporate taxation and are raised by the establishment of the Single Market.

5.5.2. The Proposed Regulation on the Statute for a European Company

The proposed Regulation is also an indirect measure whose importance is greater compared with the Regulation on EEIGs. It establishes a new type of company that does not deviate from the already known types of companies, but the European dimension of that company seems to offer some satisfactory solutions to those problems that arise when a company is involved in activities in more than one

---

135 Especially with all those tax problems previously mentioned.
jurisdictions. The following provisions are those which lead to a "de facto" corporate tax harmonisation:

a) The European Company (SE) is a public limited company (Article 1.1).

b) A SE is formed:

i) By public limited companies provided that two of them have their administration in different Member States (Article 2.1), or

ii) By public and private limited companies provided that at least two of them have their administration in different Member States or have a subsidiary company or a branch office in a Member State other than that of their central administration (Article 2.1a), or

iii) By companies or firms within the meaning of EC 58(2) and other legal bodies governed by public or private law provided that at least two of them meet one of the requirements mentioned in ii) (Article 2.2), or

iv) By a public limited company by transforming itself, if it has a subsidiary company or a branch in a Member State other than that of its central administration (Article 2.3).

c) A SE will have a registered office situated at the place specified in the Statutes of that SE and being the same as the place of central administration (Article 5).

d) If a SE has permanent establishments within or outside the EC and the aggregation of the profits of all those establishments results in a net loss that loss may be set off against the
profits of the SE in the Member State where the latter resides but any subsequent profits of the permanent establishments shall constitute taxable income of the SE up to the amount of the imputed losses; the profits and losses of the permanent establishments shall be determined by the laws of the Member State in which they are situated (Article 133).

The conclusion from those provisions is that the European Company is a new type of company whose corporate tax liability is determined by the Member State in which the company has its central administration. In case a SE has permanent establishments any tax differences between the Member State of the SE and that of the permanent establishment are avoided by the rule laid down by Article 133. Moreover, if a SE has subsidiaries any tax problems arising from this fact are overcome, to a great extent, by the Parent-Subsidiary Directive and the other proposed Directives previously mentioned. Therefore, it can be said that the proposed Regulation establishes a new type of company the taxation of which is based on rules accepted by all the Member States.\textsuperscript{136}

Consequently, the European Company may constitute an effective vehicle for ventures in the Internal Market, but the adoption of the Regulation that introduces that type of company has not been achieved

\textsuperscript{136} e.g. the Member State in which a SE is registered is the State that taxes the profits of the SE and applies its tax law, the profits or losses of the permanent establishments are determined by the Member States in which those establishments are located, the Member State in which the SE is located must accept this determination of profits by the Member States of the permanent establishments.
yet. Besides, the proposed Regulation raises some serious tax problems. First, SEs can benefit from the proposed and adopted tax Directives only if these are broadly construed.\textsuperscript{137} Secondly, how easily can the Member State in which the SE is established accept the calculation of the profits of the permanent establishments by the Member States in which these permanent establishments are situated taking into account that Member States employ different rules for such calculation and that the result of the calculation, provided it is negative, will be set off against the profits of the SE?

Despite these setbacks, the enactment of the Regulation will solve some, though not many, problems with regard to corporate taxation and will achieve a kind of corporate tax harmonisation indirectly, but this will concern SEs (if this type of company ever acquires legal recognition) and, thus, will be of minor importance. The vast majority of companies in Europe will continue to have the traditional form of a public limited company or a limited partnership and it is the tax problems of those traditional types of companies that will determine the process of corporate tax harmonisation.

5.6. What Next?

The measures previously mentioned raise many questions in relation to the future of corporate tax harmonisation. First, are such measures, adopted or proposed in the process of adoption,\footnote{137 Which means that the scope of tax Directives will cover SEs. See respective analysis in each Directive.}
sufficient for the proper functioning of the Single European Market or should other measures follow? Perhaps, the final answer to this question will be given during the first years of functioning of the Internal Market whose needs corporate tax harmonisation measures try to meet.

Secondly, is the process of European integration so advanced, especially after the Treaty of Maastricht, that the European Community is being transformed from a confederation into a federation? If so, how can the European corporate tax system benefit from the experience of other federal States?

Thirdly, by adopting or proposing the measures mentioned in this Chapter the Community embarked on an attempt to establish common rules in the field of direct taxation. How far is the Community willing to go and what are the prospects? What will be the shape of corporate taxation by the end of the 90's as the process of European Unification has speeded up after the conclusion of the Treaties on European Economic and Political Union at Maastricht?

All these crucial questions will constitute the subject-matter of the following and final Chapter of this research.
CHAPTER 6
THE SOLUTION AND THE UNCERTAINTY:
The Prospects for Corporate Tax Harmonisation in the EC

6.1. Introduction

The purpose of this final Chapter is to present and evaluate the solution which can be offered to the problem discussed in the previous Chapters and which will conform to the principles set out in Chapter 4. It has been made clear from the title of the thesis and from all the Chapters so far that this solution can only be offered by the process of harmonisation.

What remains to be done in this Chapter is to name and analyse each of the specific measures that compose the proposed solution and whose importance is vital given that the legislative measures adopted or proposed and about to be adopted at Community level are virtually a drop in the ocean. Furthermore, the adoption or non adoption of these measures will determine the taxation of businesses in the European Community and will affect the progress of fiscal integration.

The solution in question will apply to the four aspects of corporate taxation, namely the tax base, the tax rates, the cross-border operations and the tax system (= the integration of corporate income taxation with personal income taxation). Finally,

---

1 See Chapter 5.

2 There will be a fifth category dealing with some individual issues
it will be helpful in the attempt to identify the appropriate solution to start from the experience in federations which have dealt with similar problems in the field of corporate taxation.

6.2. The Federal Experience

Before entering the debate on some of the aspects of federal tax systems the relevance of those systems for the European Community has to be established. It is a recognised rule in any comparative study that the compared objects, in this case the compared systems, must have some similarities if the aim is to identify some elements of the one system that can be applied to the other. The question arising at this point refers to the similarities that exist between the federal states and the European Community and between the problems in the field of corporate taxation the former have encountered and the respective problems the latter has faced.

First, the EC after the conclusion of the Treaty on European Union at Maastricht has departed from the stage of a confederation and is heading towards the stage of a federation, regardless of whether it is ever going to reach this stage. The status of a Union indicates a course towards a federal system and encompasses some characteristics of a federation. For example, in the European Community there are two levels of authority that is the Community

which cannot be allocated to any of the four major fields of corporate taxation (tax incentives, local taxation, administrative issues).
level similar to the federal level in federations and the national which is similar to the state level in federations. Furthermore, in federations the Constitution is of vital importance for the functioning of the system and in the EC the same happens with the Treaty of Rome as it is periodically amended. Of course, there are also other federal characteristics in the EC\(^3\) as well as elements which distance the EC from the federal system,\(^4\) but at least its federal characteristics can establish a degree of similarity to federations.

Secondly, for each federal state there is a single market which is the outcome of the unification of the state markets and functions as a purely domestic market. The establishment of a Single market is a task upon which the EC has embarked and it is expected to take place after 1/1/1993.\(^5\) Consequently, there is a similarity as regards the economic environment within which the EC and the federal states develop.

---

\(^3\) The strengthening of a common foreign policy and the pursuit of a common defence policy, the citizenship of the Union, the cooperation on issues of internal security, etc.

\(^4\) In the EC the national level of authority prevails over the Community, whereas in federations the federal level is stronger. In addition, the federal authorities are more democratically accountable than the respective supranational authorities of the EC.

\(^5\) The problem is that the experience of federal states has shown that a single market without a single currency is not a realistic target and such a single currency may be realized in the end of the decade (1997 or 1999 according to the Treaty on European Union) which is much later than 1993.
Thirdly, the main source of the problems in the field of corporate taxation is the same for the EC and federal states, namely the activity of companies in more than one state. Indeed, the involvement of more than one tax jurisdiction in cases where the same company or associated companies are engaged in economic activities in more than one state (in federations) or Member State (in the EC) causes a great deal of disputes and if it is not dealt with properly may lead to unfair situations (double taxation, tax evasion, etc).

In order to achieve a thorough interpretation of the way corporate tax structures function in federal states it is useful to divide these states into categories according to the degree of fiscal sovereignty the states have retained vis-à-vis the federal government. As a result, three large groups of federal states can be identified: i) Centralized Federal States where the fiscal sovereignty of the individual states in the field of corporate taxation has been eliminated, ii) Decentralized Federal States in which the individual states have retained their fiscal sovereignty imposing corporate tax on businesses having a taxable nexus with their territory and iii) Mixed Federal States in which the individual states may choose between retaining and surrendering their fiscal sovereignty with regard to corporate taxation.

6.2.1. Centralized Federal States

Two federal states can be classified as Centralized federal states, Germany and Australia. In the former the States (Länder) do
not impose corporate taxes in contrast to the Federal Government which does so. Revenues from the imposition of the federal corporate tax are equally shared between the States (Länder) and the Federal Government. In addition, the share that is allocated to the Länder is divided among the individual States according to the location of the head offices of companies in each State, in practice though the criterion has become the location of wage payments. Finally, this criterion may be set aside when there is a need of redistribution aiming at equalizing the living standards among the States.

The second example is that of Australia where although the Constitution allows the coexistence of federal and state taxation the States do not impose corporate tax and this competence has been transferred to the Federal Government. The latter divides the corporate tax revenue among the States according to the population, the density of the population and the number of school age children of each State. In conclusion, in Germany and Australia there is a single corporate tax imposed and administered by the federal authorities and the individual States have abandoned their right to tax corporations. This has led to an advanced stage of corporate tax unification which has made the federal states in question resemble

---

6 At the local level only municipal taxes are levied and the administration of those taxes is left to the "länder".

7 Articles 106(3) and 107(2) of the Federal Constitution.

8 Under s.51(ii).

9 Under the Uniform Tax Scheme of 1942.

10 A less advanced version of corporate tax unification could be that
nation-states, at least from the corporate taxation point of view.

6.2.2. Decentralized Federal States

Two federal states can be allocated to this group namely Switzerland and the United States of America. In the former each individual State (Canton) levies corporate tax the base and the rates of which differ from the corresponding base and rates of the other Cantons and of the Federal Government. However, there is a limited "de facto" harmonisation of the tax base in so far as some Cantons and the Federal Government have laid down similar or identical rules concerning certain elements of the corporate tax base.\(^{11}\) Despite this kind of harmonisation and despite the fact that Cantonal taxes are deductible for Federal corporate tax purposes corporate tax diversity among Cantons is so great that multi-Cantonal companies are faced with a considerable tax burden and with high compliance costs. As a result, there is a process of imposed corporate tax harmonisation under way in Switzerland aiming at reducing the disparities between Cantons' corporate tax laws.

In the other decentralized federation, that is the United States of America,\(^{12}\) the Federal Government and the States have according to which the individual states may impose corporate tax but this tax is identical in all the States or the States may not impose corporate tax but play a role in the administration of the federal corporate tax.

\(^{11}\) e.g. intercompany dividends, depreciation, inventory valuation.

concurrent competence in the area of Corporate taxation. The States' competence is restricted by certain provisions of the Constitution and the Federal Government (Congress) is entitled to impose harmonisation under the Commerce Clause. However, the latter avoids to do so and when it resorts to harmonisation measures these measures deal with minor issues and under no circumstances do they limit the fiscal sovereignty of the States.

State corporate tax is imposed by 45 States which are entitled to define the corporate tax base as they want and to apply the tax rate of their choice. The tax diversity that would arise from the different tax bases and rates is limited to a great extent by the fact that many States use the Federal corporate tax base when calculating businesses' State corporate tax liability. Thus, it can be demonstrated that in the U.S.A. a "de facto" (or voluntary) harmonisation of the corporate tax base exists. In addition, the State corporate tax is treated as a deductible expense for the Federal corporate tax purposes and there is a coexistence of federal and State tax administrations.

What has become perhaps the most impressive element in the U.S. corporate tax structure is that the U.S.A. have dropped the

---

13 a) Due Process Clause (U.S Constitution Amend. 14) = there must be a taxable link between the State and the taxpayer, b) Equal Protection Clause = State taxation must be related to the business activity in the State, c) Commerce Clause (U.S Constitution, art.I, §8, cl.3) = State taxation must not have claims over interstate or foreign commerce.

14 It has done so once in 1959 (Public Law 86-272).
"separate accounting" method for the "formula apportionment". As it has been explained, the former determines the income of a company involved in economic activities in more than one tax jurisdiction by treating each establishment in each state as a separate entity and by attempting to calculate the taxable income for each entity in each state, whereas according to the latter the income of the multi-jurisdictional company is allocated to each of the jurisdictions on the basis of a three factor formula (payroll-property-sales). More specifically, in the U.S. "...a state taxes a fraction of the nationwide income of the firm equal to the average of the fractions of payroll, property and sales occurring or located in the state, compared to the total for the nation".

The "formula apportionment" method can be distorted if the affiliated companies within a group embark upon well planned tax avoidance or tax evasion schemes which are aimed at allocating as much income as possible to the low taxing states. The existence of such abusive situations led to the "unitary approach" according to which "...a corporation engaged in economic activities in a particular state must file a combined report on which it shows the combined profits of all affiliated firms with which it is engaged in

15 Canada followed.

The possibility of applying this method to the EC will be further discussed in another part of this Chapter.

16 See Chapter 2 (2.2.2. b).

a unitary business". What holds a crucial position in the unitary approach is the concept of the "unitary business" the existence of which is dependant upon three conditions namely the unity of ownership, the unity of operation and the unity of use.

However, the application of unitary taxation to the foreign parents of US subsidiaries and to the foreign subsidiaries of US parent companies (the so-called worldwide combination) by the State of California and by other States became the target of heavy criticism. Even the European Parliament adopted a Resolution on 12 December 1984 against unitary taxation. In response to the criticism the Reagan administration condemned the worldwide combination, but the federal government failed to take any measures.

---

18 C. E. McLure, op.cit., at 246.


20 It exists in the case of Christmas tree structure or of tooth-comb structure (See Chapter 5 for these terms).

21 Purchase of auxiliary items, purchase of equipment, advertising, common accounting facilities, common legal representation, intercompany financing and parent guarantees, employee benefit plans, joint efforts in expanding the business.

22 Intercompany transfer of products, shared officers and directors, transfer of executive personnel, submission of monthly financial statements, uniform theory of management, training, interchange of knowledge and expertise, public presentation or image.

23 OJ 1984, C10/1.
In the light of the international reactions the State of California offered the multinational companies to exclude their foreign associated corporations from unitary taxation (the so-called water's edge combination) on condition that these companies pay an annual fee to the State.

6.2.3. Mixed Federal States

This category is the result of the combination of the previous two, because it derives characteristics from both the aforementioned categories. The federation that is allocated to this category is Canada\textsuperscript{24} where there is an agreement between the Federal Government and 7 provinces so far. Under this agreement the Federal corporate tax is reduced by 10\% for companies doing business in one of the seven provinces and these provinces levy their own corporate tax, practically their own tax rate, using the federal tax base. The collection in these provinces is left to the federal tax authorities. As regards the method of determining the income of multi-provincial companies the "apportionment formula" applies based on two factors, sales and wages, and on the water's edge approach.

Those provinces which have not signed the agreement are not entitled to the 10\% reduction of the Federal corporate income tax and have their own tax authorities. Nevertheless, the non-agreeing

provinces adhere to the Federal corporate tax base and this means that the "de jure" harmonisation of the tax base that stems from the tax agreement between the Federal Government and the 7 provinces has been supplemented by the "de facto" harmonisation which has taken place with regard to the non-agreeing provinces. In conclusion, the corporate tax base in Canada has become the object of a harmonisation process, whereas other elements of corporate taxation such as the rates have not.

6.2.4. Some Interesting Conclusions

The first conclusion, and perhaps the most important, that can be drawn from the previous outline of the corporate tax structure in federal countries concerns the tax base. In the examined federations there has been identified either a uniformity of the corporate tax base achieved by the adoption of a single tax base or a similarity of the tax base the States use. On the other hand such uniformity or similarity is not established, with the exception of the centralized federal states, in relation to corporate tax rate. What emerges from this conclusion is that the equalization of the corporate tax base is a key element in a Single market.

Secondly, it has not been mentioned for each federation separately, but it can be mentioned at this point and it applies to all of them and especially to those where the States retain a degree of fiscal sovereignty, that there have not been any "Cross-State"

---

25 This the case in Germany, Australia and partly in Canada.

26 This the case in Switzerland but especially in the U.S.A.
cooperation problems similar to the cross-border problems existing in the EC.\textsuperscript{27} This underlines the need for an effective and speedy process that will deal with such problems in the EC.\textsuperscript{28}

Thirdly, to a great extent the tax disputes between the States in the decentralized federal States\textsuperscript{29} have been avoided due to the application of the "formula apportionment" method. What remains to be seen is whether this method is applicable to the European Community and, above all, whether it is acceptable.\textsuperscript{30}

Finally, the corporate tax structures of the federal states on which this study focused can be characterised as oriented towards either corporate tax unification or corporate tax harmonisation. In particular, unification exists in Germany and Australia where there is a single corporate tax and harmonisation (imposed or competitive) exists in all the other cases where the corporate taxes imposed by the individual States indicate a degree of similarity.

\section*{6.3. Which Could be the Desirable Solution for the EC?}

The discussion on the models of corporate taxation that have been adopted by federal states has brought forward the question which

\begin{flushright}
\textsuperscript{27} See Chapter 2. \\
\textsuperscript{28} Detailed discussion will take place in the last part of this Chapter. \\
\textsuperscript{29} The comment applies to the U.S.A. and Canada, not to Switzerland. \\
\textsuperscript{30} The relevance of this method and its unitary variation for the EC will be discussed in the last part of the Chapter.
\end{flushright}
constitutes the substance of this research and refers to the identification of the corporate tax model that suits to the needs of the EC. In fact, the general idea of that model, that is a model based on corporate tax harmonisation, has been explicitly stated in some parts of the thesis or implied in others, but at this point it must be comprehensively described.

Therefore, the purpose of this subchapter is to review the factors that affect the choice of the EC corporate tax model, to argue on the instrument of fiscal integration\(^{31}\) that will support the proposed model and, finally to state the proposed model (solution) explicitly.

6.3.1. Factors Affecting the Choice

a) The Legal Factor

The first of the factors affecting the choice of the solution to the problem caused by the existence of disparities between the corporate tax laws of the Member States concerns the legal framework to which the proposed solution has to conform. This legal framework is formulated by the EC Treaty\(^{32}\) and especially by Articles 3b\(^{33}\) and 100.\(^{34}\)

\(^{31}\) See Chapter 1 (1.2.6.).

\(^{32}\) For a detailed analysis of the Legal Framework See Chapter 1 (1.3.2.) and Chapter 3 (3.2.3.).

\(^{33}\) The "subsidiarity clause" inserted by Article G(5) of the Treaty on European Union.

\(^{34}\) As amended by Article G(21) of the Treaty on European Union.
On the other hand, if a proposed solution was outside the legal framework defined by the EC Treaty the chances for its adoption and implementation would be practically nil. It would be fundamentally wrong to adhere to a solution which might be perfect from the theoretical point of view but which could not be put into effect due to its incompatibility with the present Community legal regime. This by no means should be interpreted as an argument in favour of the retention of the EC Treaty in its present form.

Conversely, if the present legal framework has setbacks those should be identified and the need for an amendment in the future should not be disregarded. But, it must be taken into account that amendments of the EC Treaty cannot be easily agreed and agreement on them requires lengthy negotiations. Given the fact that the EC Treaty has been amended recently\textsuperscript{35} and that the problem of corporate taxation in the EC needs an immediate solution, this must be worked out in accordance with the existing legal framework.

b) The Economic Factor

The choice of a solution to the problem of corporate taxation in the EC is inevitably dependant on the economic developments and in particular on the progress of economic integration.\textsuperscript{36} The validity of this view has been historically proved since the 1969 proposed Corporate tax Directives were tabled before the Council when the Community had just achieved the stage of Customs Union (1/7/1968).

\textsuperscript{35} Treaty on European Union concluded at Maastricht.

\textsuperscript{36} See the analysis in Chapter 3 (3.3.).
whereas the proposed measures were corresponding to the needs of a Single Market. Thus, when the EC embarked upon the establishment of that Market the need for those measures became obvious and imminent leading to their adoption (July 1990).

Furthermore, the Ruding Committee recognising the close links between its proposed measures in the field of corporate taxation and the process of Economic and Monetary Union, as the latter was decided at Maastricht, allocated those measures to three phases which coincide with the three stages of EMU. However, the possible adoption of a single currency by the end of the decade may not only require some specific measures but a major upheaval.

Indeed, it seems that there is a sequence of economic events with very important political implications. More specifically, the establishment of a Single Market without a single currency is an illusion, but the adoption of a single currency means a centrally planned monetary policy. But monetary policy cannot be separated from fiscal policy and if the former is centrally planned the latter will follow the same pattern. As a result, corporate taxation will have to adapt to such economic developments. The relevance of all these for the proposed solution is that what should be proposed now must fulfill the needs of the pre-Single currency (pseudo)Single Market and should constitute the basis on which further measures will be taken during the single currency era.\(^3\)

---

\(^3\) Provided that this era will become reality, since there are still serious doubts.
c) The Political Factor

As has been mentioned, the links between economic and political developments and especially between economic and political integration are exceptionally strong. The political evolution of the EC is, and will further be, influenced by the way the process of Economic and Monetary Union progresses. If the latter reaches a very advanced stage then the demand for closing the democratic deficit and achieving a greater degree of democratic accountability may lead to a political structure very similar, if not identical, to the federal one or at least may force the Community to face some questions (like that of the political structure) which it has skillfully avoided so far.

Thus, whichever measures are chosen to deal with the problem of corporate taxation in the EC they must be in accordance with the political developments, otherwise they will not have any effect. Furthermore, the solution in question has to be politically acceptable by the Member States in order to be put into effect.

d) The Theoretical Factor

The measures which will be proposed should ideally comply with the theoretical framework set up by the principles discussed in Chapter 4 of this research. In fact, some of these principles can be

---


39 For example a centralized planning of monetary and fiscal policy.

40 See Chapters 3 (3.2.5) and 4 (4.10.).
included in the factors named above but their importance as a whole justifies a separate reference to them.

6.3.2. Why Harmonisation and not Unification or Coordination?

Before commencing the discussion on the proposed solution to the problem of corporate taxation in the EC or, to put it in another way, before entering the debate on the exact type of corporate tax harmonisation and on the specific measures—solutions it encompasses it is worth outlining the reasons for which this research rejects the other two instruments of fiscal integration, namely [corporate] tax unification and [corporate] tax coordination.

Corporate tax unification can certainly provide a solution to the problem of corporate tax problem in the EC through the imposition of uniform rules. Consequently, in a hypothetical case where the disparities between the national corporate tax laws cause a distortion to the Single Market these disparities can be eliminated by the adoption of a single rule by the means of a Regulation. However, this method, if extensively applied, may lead to a situation where every aspect of corporate taxation would be regulated by uniform rules adopted at the Community level and nothing would be left to the competence of the individual Member States. Such a

---

41 e.g. economic efficiency is included in the economic factor, political acceptability in the political factor.

42 It has been obvious from the very beginning of this research that the answer to the problem is given by harmonisation but the real question concerns the exact type of the harmonisation.
centralized corporate tax model is nothing else but a Single European corporate tax law.\textsuperscript{43}

The first reason for rejecting corporate tax unification is that although it satisfies the principles set out in Chapter 4\textsuperscript{44} it is not consistent with the legal framework, that is the EC Treaty. The EC Treaty permits the harmonisation of corporate tax laws through Article 100\textsuperscript{46} and by the means of Directives, whereas the use of Regulations, which are the instruments for unification, is allowed in exceptional cases under Article 235. This means that unification measures in the field of corporate taxation are the exception not the rule under the present form of the EC Treaty.

Secondly, corporate tax unification does not correspond to the present economic situation of the EC (economic factor). Conversely, it presupposes a centralized economic structure according to which the major decisions on economic policy are taken at a central level and there is no room for the existence of diversities and variations. As a result, this need for uniformity dictates the use of unification measures. However, it must be underlined that the EC has not reached such stage and it is not absolutely certain that it will. In case it achieves this advanced stage of economic integration tax unification measures may prove to be necessary, although any comment about

\textsuperscript{43} Like the German or the Australian tax model.

\textsuperscript{44} Except for the principle of subsidiarity.

\textsuperscript{46} The exact wording of the Article refers to the approximation but this word has the same meaning as harmonisation; See the analysis in Chapter 1 (1.2.3. and 1.3.2).
corporate taxation during that stage seems very risky and highly speculative for the time being.

Thirdly, there is not compatibility between corporate tax unification and the current political structure of the EC (political factor). The uniformity and centralization that characterize tax unification cannot be politically acceptable by the Member States and cannot be justified in so far as the democratic deficit in the most powerful institutions as regards decision-making remains so great. In modern democratic states decisions concerning especially direct taxation are taken by the democratically elected national parliaments, whereas during a hypothetical corporate tax unification process decisions on corporate taxation will be taken by the Council of Ministers, an institution not directly accountable to Europeans in contrast to the European Parliament.

Finally, due to the transfer of competence from the national level to the Community (supranational) level tax unification implies, recourse to it should not be sought unless the use of harmonisation measures is thought to be insufficient. So far what has been called into question is not the sufficiency of corporate tax harmonisation measures but the necessity for the adoption of such measures. Taking into account that corporate tax harmonisation induces controversy over its applicability one can easily draw the conclusion that the applicability of corporate tax unification will give rise to greater controversy.

Turning to the second instrument of fiscal integration (tax coordination) and applying it to the field of corporate taxation in the EC the comment that can be made is that corporate tax
coordination falls short of the needs of the European Community. First, it lacks the binding effect \(^{46}\) the other two instruments (unification-harmonisation) of fiscal integration have and corresponds to looser political and economic circumstances than those existing in the Community at the moment.

Secondly, corporate tax coordination cannot meet the needs of the theoretical factor mentioned above, that is the principles set out in Chapter 4 of the thesis. This is attributed to the function of coordination which aims at securing the concerted coexistence of corporate tax laws of different States in cases where there is ground for conflict \(^{47}\) or there is a need for combined legal action. \(^{48}\) What becomes obvious is that corporate tax coordination has little or no contribution to the assimilation of the corporate tax laws of the Member States which is fundamental for the elimination of the disparities existing between these laws and the proper functioning of the Common Market.

Taking into consideration that corporate tax coordination is too little for the problem caused by the different corporate tax laws of the Member States and that corporate tax unification is too much the only solution left is corporate tax harmonisation. The preference for the option of harmonisation has been clearly expressed

\(^{46}\) For example the Arbitration Convention is not so binding compared to the two adopted corporate tax Directives; See Chapter 5 (5.2.3).

\(^{47}\) e.g. between the law of the source State and that of the residence State.

\(^{48}\) Cooperation against tax evasion, etc.
from the beginning of this thesis, because it is consistent with the legal framework under which the EC functions and with the economic and political developments taking place in the European Community. However, it remains to be determined which type of harmonisation from those mentioned in the previous Chapters is the most suitable for the EC.

6.3.3. Which Harmonisation?

As was earlier stated, the concept of harmonisation of laws is quite flexible, adaptable and wide enough to cover many things. In view of this, it is absolutely necessary to define the form and the content (the specific measures) of the corporate tax harmonisation this thesis is favouring. The choice of the former (form) will be based on the general categorization of harmonisation of laws which was discussed in Chapter 1.

First, the proposed harmonisation should be a "horizontal harmonisation" in the sense that it should bring national corporate tax laws into alignment with a view to adapting them to the needs of the Common Market. Furthermore, it is obvious that since there is no special provision in the EC Treaty providing for corporate tax harmonisation there is no case for "vertical corporate tax harmonisation".

Secondly, the lack of a special provision for corporate tax

49 See Chapters 1 (1.2.5.) and 3 (3.2.4.).
50 Chapter 1 (1.2.2.).
51 1.2.5. and also Chapter 3 (3.2.4.).
taxation or for direct taxation in the EC Treaty means that corporate
tax harmonisation can only be positive. Consequently, it includes
all the measures which are taken according to the provisions of the
EC Treaty and which harmonise national corporate tax laws with the
purpose of facilitating the establishment and the proper functioning
of the Common Market.

Thirdly, the proposed harmonisation should not be
"single-phased" but it should be carried out in more than one stage
(gradual harmonisation). This approach is also favoured by the
Ruding Committee which has recommended the adaptation of the
corporate harmonisation process to the three stages of Economic and
Monetary Union. Although the present thesis envisages the same
number of stages there are significant differences in the content of
each stage.

Fourthly, "total harmonisation" in the field of corporate
taxation should be avoided in the light of the principle of
subsidiarity. The consequence of the application of this principle
to corporate taxation is that the Community is entitled to take
harmonisation measures with regard to corporate tax issues when

---

52 "Negative harmonisation" presupposes the existence of
"standstill-clauses" in the Treaty with which national laws comply.
53 Commission of the EC, Conclusions and Recommendations of the
Committee of Independent Experts on Company Taxation, Brussels March
1992, p.28 (the so-called Ruding Committee's Recommendations).
54 These differences will be explained in 6.4.
55 See Chapters 3 (3.4.) and 4 (4.2.).
dealing with these issues at national level is considered as insufficient or ineffective. Thus, the proposed harmonisation has to be "partial harmonisation" and oriented towards those aspects of corporate taxation which pose problems to the establishment or the functioning of the Common Market.\textsuperscript{56}

Finally, the most important choice that has to be made in relation to the form of the proposed corporate tax harmonisation is that concerning whether the harmonisation process should be imposed by the Community or led by the market.\textsuperscript{57} In view of the debate on this dilemma in Chapter 3 and of the principle of subsidiarity, the recommended solution lies in the middle. It has been named as the "hybrid solution"\textsuperscript{58} and opts for the minimum harmonisation, which includes the removal of tax barriers to cross-border company cooperation accompanied by the harmonisation of those elements of national corporate tax laws which undermine the application of the principle of free competition and hamper the proper functioning of the Common Market.

\textsuperscript{56} The Ruding Committee is also against the idea of "total harmonisation", but by proposing harmonisation of corporate tax laws in relation to cross-border operations, tax base, tax rates and to systems (by the end of the decade) the Committee contradicts itself raising serious doubts over its tax philosophy; Ruding Committee's Recommendations p.26.

\textsuperscript{57} "Imposed" or "top-down" approach in contrast to "competitive" or "market-led" or "bottom-up" approach.

\textsuperscript{58} See Chapter 3 (3.2.4.).
6.4. The Hybrid Solution

This part of the concluding Chapter will focus on the specific measures which compose the "Hybrid Solution" or, in other words, the recommended corporate tax structure for the European Community. The specific recommendations will be classified into four groups each of which will correspond to one of the respective aspects of corporate taxation in the EC (cross-border operations, tax base, tax rates, tax system).

6.4.1. Measures Concerning Cross-border Operations

a) Elimination of Withholding Taxes

In purely domestic situations withholding taxes are aimed at securing that a part of the taxpayer's tax liability is met and that tax evasion does not happen. In such cases withholding taxes are not an excessive tax burden, because they are set off against the taxpayer's total tax liability. Conversely, in cross-border payments between two states withholding taxes are imposed by the state from which income originates and when such income is transferred to another state (State of residence). In this case withholding taxes have the functioning of an additional tax burden and constitute a tax obstacle to the cross-border movement of capital.

Therefore, the proper functioning of the Common Market requires that withholding taxes should be abolished in all

---

59 Tax System = The method of integration between corporate and personal taxation.
intra-Community payments. The first step was made by the adoption of the Parent-Subsidiary Directive which abolished the withholding tax levied on the dividends a subsidiary distributes to its parent located in another Member State. However, the problem still exists in relation to dividend payments made between: i) Companies which do not meet the 25% participation requirement and cannot establish the Parent-Subsidiary relation or which are not public companies or which are not subject to corporate tax (partnerships), ii) Non associated companies and iii) A company and an individual shareholder.

The Ruding Committee identified these cases and recommended the extension of the Parent-Subsidiary Directive in order to cover the cases mentioned above. It also suggested that the abolition of withholding tax for cases ii and iii required the adoption of a new Directive which would impose 30% withholding tax on the dividend distributions by EC resident companies, "subject to waiver where appropriate tax identification is provided". These recommendations are regarded as right and important, but are called into question in relation to two points.

First, what should be done to deal with the withholding tax

---

60 See Chapter 5 (5.2.2.).

61 Problem also exists with Advance Corporate tax (See Chapter 5, 5.2.2. and Chapter 2, 2.2.4.) but it will be discussed in 6.3.2. where reference to the corporate tax system will be made.

62 Ruding Committee's Recommendations pp.28-29.

63 Ibid.; It must be clarified at this point that the abolition of withholding tax should also apply to payments by branches to the central company.
provided in the double tax treaties concluded between EC and non-EC states? The only comment the Committee makes is that "...the waiver could be extended to third country investors in appropriate circumstances" without specifying these circumstances. It is beyond doubt that this issue together with the issue of withholding tax on interest and royalty payments made to non-EC companies need a rearrangement of the tax treaties between EC and non-EC states.

Secondly, the timing for the extension of the Parent-Subsidiary Directive to all enterprises which are subject to income tax (e.g. partnerships) and for the adoption of a new Directive to cover cases where there is not a Parent-Subsidiary relation (e.g. individuals) is not in accordance with the needs of the Single Market. Bearing in mind that withholding taxes on cross-border payments constitute a tax obstacle to the free movement of capital and they should have been abolished by 1/1/1993. What the Committee recommends is to deal with the two previously mentioned cases during the second stage of EMU which may end by 1/1/1997 at the earliest or 1/1/1999 the latest. Such approach will retain two serious tax distortions and will impede the proper functioning of the Single Market, at least from the taxation point of view. Thus, these distortions must be abolished as early as possible and in any case not later than 1/1/1994.

---

64 Ibid.
65 The discussion of such rearrangement will follow; See also Chapter 5.
66 Payment of dividends, payment of interest, payment of royalties.
With regard to withholding tax on the cross-border payments of royalties and interest between enterprises the Ruding Committee recommended by the end of 1994 the adoption of the Proposed Directive which provides for the abolition of the tax and the extension of the Directive so as to cover the respective payments between non-associated companies. The Committee's recommendation is quite correct but the adoption of the Directive is not so easy, because, as has been rightly suggested, the payment will leave the source State completely untaxed, whereas in the case of dividends the payment has already been taxed by the source State through the imposition of corporate tax on income.

b) Elimination of Double Taxation on Foreign Source Income

As regards the case where foreign income (dividends) is derived from subsidiaries located in different Member States from that in which the parent resides the problem of double taxation has been dealt in the Parent-Subsidiary Directive. However, the limited credit method which is provided in the Directive still causes a double taxation problem in so far the as amount of the credit is

---


68 This issue is also related to the tax base, but above all, it is primarily a cross-border operation problem.

69 See Chapter 5.

70 The other permissible method provided by the Directive is the exemption method; For more details See Chapters 2 (2.2.1. b) and 5 (5.2.2.).
limited up to the amount of the corresponding domestic tax. This means that the amount of taxes paid by the subsidiary which exceeds that limit cannot be relieved.

The problem could be overcome if the full credit method was provided in the Directive together with a "clearing-house" mechanism. In such case the amount in excess could be taken into account for domestic tax liability purposes but the source State should refund the residence State the amount in excess through a central Community clearance mechanism (clearing-house). The complexity and the administrative burden of this solution have prevented the Ruding Committee from referring to it. Instead, the Committee expressed its preference for the simpler and transparent exemption method\textsuperscript{71} (avoiding though to propose the gradual abolition of the credit method) underlining that this method needs the support of a harmonised base and harmonised rates (spill-over effect).\textsuperscript{72}

When the foreign income is derived from branches (direct income) the methods for double tax relief are in theory the same as in the case of subsidiaries (credit-exemption). In practice though, there is no similar Directive formally recognising and imposing the methods for relieving double taxation and the Member States are

\textsuperscript{71} Exemption method is favoured by businessmen as well, as the findings of the market research that will be incorporated in the Ruding Report indicates.

\textsuperscript{72} The tax authorities of the Member State of the parent want to ensure that the foreign source income was taxed properly which means in accordance with the rules (tax base) and to the extent (rates) they accept.
divided.\textsuperscript{73} Given that the Parent-Subsidiary Directive cannot be applied to branches the best solution would be to extend the scope of the Directive in order to cover the relations between parent companies and their branches in other Member States. Such solution does not require a major amendment of the Directive, because as it was mentioned the methods of double tax relief are identical in both cases.

c) No Discrimination Against Companies of Other Member States

Member States should not apply a discriminatory tax treatment to the permanent establishments and subsidiaries of other Member States. This means that all the aforesaid comments on withholding taxes apply and what has to be added at this point is that the Member State in which subsidiaries or branches of other Member States are situated must not subject them to higher tax rates or stricter rules on the calculation of profits compared to domestic companies and must not deprive them of tax advantages which are offered to domestic companies.\textsuperscript{74} Such discriminations are in direct breach of Article 52 of the EC Treaty.\textsuperscript{75}

\textsuperscript{73} Seven Member States apply the credit method and the others adhere to the exemption.

\textsuperscript{74} e.g. tax credits given when distribution of dividends takes place (this issue will be further examined in 6.4.4.).

\textsuperscript{75} See also Chapter 4 (4.3.2.) and \textit{Commission v. France, Case 270/83, [1986] ECR 285}.
d) Offsetting by Parents of Losses Incurred by Branches or Subsidiaries Located in Different Member States

A serious impediment to cross-border movement of capital is the lack of measures which would permit parent companies situated in a Member State to offset the losses incurred by their branches or subsidiaries in other Member States. The Proposed Directive is a step towards the right direction, but, as the Ruding Committee has also stated, not enough. The Proposed Directive must be adopted soon and must be supplemented by another Directive that will allow "horizontal offsetting" as well by introducing full Community-wide loss offsetting within groups of enterprises. The problem however arises from the fact that the Ruding Committee has recommended the adoption of the latter in Phase III which goes alongside of the third stage of EMU (after 1997 or 1999). Such a delay will result in the

---

76 This issue also concerns the tax base.
77 See Chapter 5 (5.3.1.).
78 Ruding Committee's Recommendations, p. 31.
79 The Ruding Committee set a time limit expiring by the end of 1994, although the need for the adoption of the measure in question is imminent.
80 For the meaning of the term See Chapter 5 (5.3.1.).
81 The so called "consolidation of accounts" or "group taxation" which must be applied to the relation between domestic parent and subsidiaries. The issue is therefore related to the tax base as well, but the problems it causes to cross-border flows are so serious that it was worth being examined at this part; See also Ruding Committee's Recommendations, p. 31.
retention of an indirect tax obstacle to the movement of capital and of a tax distortion to the Single Market. Thus, all the aspects of the issue in question should be dealt with by the end of 1994 or at least within the second Phase (1994-1997) concurrently with the issue of the tax base.

e) Tax Treaties

Bilateral tax treaties serve the purpose of eliminating or reducing double taxation on income and capital\(^2\) which may be caused by the concurrent claim of two tax jurisdictions (the country of source and the country of residence) on the same income or capital. Although such treaties have been classified as an instrument for tax coordination\(^3\), their importance for cross-border operations and in particular for the "hybrid solution" cannot be disregarded. In the context of the EC there are two issues that need consideration in relation to double tax treaties, namely the intra-Community tax treaties (between Member States) and the tax treaties with non-EC states.

First, the network of double tax treaties between EC States is incomplete especially as regards the countries which entered the Community in the 80's (Greece, Portugal and Spain). The filling of the gaps in the intra-Community treaty network is essential\(^4\) because

---

\(^2\) There are also tax treaties concerning taxes on estates gifts and inheritances.

\(^3\) Chapter 1 (1.2.6.).

\(^4\) It is recommended by the Ruding Committee as well; See Ruding
it will reduce the possibilities of tax disputes arising between the Member States and it will satisfy references which have been made to it in measures adopted or proposed at Community level. In view of this, the Member States must agree on some common guidelines which would characterise their tax treaties in order to avoid inequalities in the treatment of their partners.

Secondly, there must be an agreement at Community level on a Model Double tax treaty which will be used by the Member States in their relations with non-EC countries. If the tax treaties the EC states conclude with non-EC states are not similar there will be a flow of capital from the outside world to those EC states which offer the most beneficial Double tax treaties. After agreement has been reached on such a Model the renegotiation of the existing treaties between EC and non-EC states should follow.

Committee's Recommendations, p.32.


86 This task is not difficult since most of the intra-Community tax treaties are based on the 1977 Model OECD Convention.

87 The same is recommended by the Ruding Committee; See Ruding Committee's Recommendations, p.32.

88 The Ruding Committee has recommended the definition of a common attitude with regard to policy on double taxation agreements with respect to third countries but it fails in specifying what that common attitude includes.

89 See also Chapter 5.
6.4.2. Measures Concerning the Tax Base

The harmonisation of the corporate tax base is the most difficult and perhaps the most crucial task the European Community faces in the field of corporate taxation. It is an illusion to believe that the Single Market will function satisfactorily when there are twelve different ways to determine the taxable profits. Moreover, EC businessmen would like to know "ex-ante" the "rules of the game" in order to plan their cross-border operations and in doing so they will be facilitated by the existence of a harmonised tax base which will guarantee that the rules for the determination of the taxable profits do not differ significantly among Member States. However, the technical issues and the complexities arising from the determination of the tax base call for a detailed study of the issue which could be carried out by a Committee of Independent Experts as the Ruding Report rightly suggested. Finally, the corporate tax base, even if it is harmonised, will not cease to cause distortions unless a convergence of the inflation rates of Member States takes place which is one of the targets set up by the Maastricht

---

90 Businessmen have expressed their support for imposed harmonisation of the corporate tax base in the market research that has been incorporated in the Ruding Report; See also Chapter 3 (3.2.4.).

91 Ruding Committee's Recommendations, p.37; The Committee on the tax base must have completed its work by the end of 1994 which is very reasonable and feasible.

92 Depreciation rules for example must take into account inflation if it is high and increase of profits may not represent more sales but it may attributed to the inflationary trends of the economy.
CHAPTER 6

Agreement.93

a) Definition of Taxable Profits

It is very encouraging that at least there is a common starting point in relation to the corporate tax base stemming from the fact that Member States levy corporate tax on profits. It would be a disaster if that harmony was interrupted by a potential attempt of one or more Member States to levy the corporate tax on a different base complying with the recommendations made by economists and accountants who often do not take into account the general impact and the non-economic side effects of their proposals.94

Nevertheless, the existence of two methods for the calculation of profits, one for tax purposes (tax accounting) and one for financial purposes (commercial accounting), and the differences between the two methods95 cause a great deal of confusion and

93 Protocol on the Convergence Criteria referred to in Article 109j of the Treaty establishing the European Community.
94 For example a cash flow base which could be: a) Total receipts from the sale of real goods and services less the total purchase of all real goods and services or b) Inflows less outflows of funds on both real and financial transactions or c) Net amount of money which companies pay out to share capital in the non-corporate sector of the economy.
95 For example in the UK, the Netherlands, Denmark and Ireland the linkage between the accounts for tax purposes and those prepared for reporting purposes is very loose (they have stricter commercial accounting rules than tax accounting rules) whereas in other Member States (Belgium France, Germany, Greece, Italy, Luxembourg, Spain)
contribute to a waste of resources (double accounting work). Thus, the Ruding Committee has rightly recommended that measures should be taken in the third phase (after the imposition of a single currency) aimed at reducing the differences between the two methods. Such measures must be taken in the process of corporate tax harmonisation as well as in the process of company law harmonisation (commercial accounting). What is called into question from the recommendation of the Ruding Committee is the timing for such measures. The appropriate time for the adoption of measures of such kind is when the debate on the harmonisation of the tax base takes place (1994-1997), since such debate should cover all the aspects of the tax base.

b) The Allocation of Tax Base Between the Country of Source and That of Residence and the Problem of Transfer Pricing

This issue is also related to cross-border operations but its importance for the determination of the corporate tax base is so great that it should be considered in this part of the Chapter.

Given that the corporate tax base is the taxable profits of a company the problem of how these profits will be traced, as regards those companies involved in business in more than one Member State, arises. As has been mentioned,96 all Member States use the "separate accounting" method according to which in a given group of associated

such linkage is very close with the tax accounting rules being stricter than commercial accounting rules.

96 See Chapter 2 (2.2.2. b).
companies each of them is taxed separately from its associates. The result of this method is that branches and subsidiaries are taxed first by the Member State in which they are located and then by the Member State in which their parent company is situated.\textsuperscript{97}

However, the Member State of the parent company is faced with great difficulties when attempting to trace the foreign source income of the parent in order to obtain its tax revenue from that income (in some cases it may not be entitled to levy any additional tax due to the double tax relief measures). In addition, the use of transfer pricing methods\textsuperscript{98} by multinational companies in a large scale makes this task even more difficult given that the "arm's length principle" which usually accompanies the separate accounting method and which is destined to counter transfer pricing often proves to be insufficient.\textsuperscript{99}

Another argument against separate accounting is derived from the developments taking place in the EC with regard to acquisitions of companies and the formation of groups. In particular, as the establishment of the Internal Market approaches there is a huge increase in cross-border acquisitions within the EC and this results in the formation of Europe-wide groups.\textsuperscript{100} Under such circumstances

\textsuperscript{97} Double taxation is avoided by the means of the bilateral tax treaties, of the Directives already discussed and by the measures proposed in 6.3.1.

\textsuperscript{98} See Chapter 2 (2.2.2. b).

\textsuperscript{99} Ibid.

\textsuperscript{100} This conclusion is drawn from the 1991 records of the management
the application of the separate accounting method accompanied by the "arm's length principle" requires an extremely close cooperation between national tax authorities which cannot be taken for granted. And even if such cooperation is achieved new problems will arise from the operation of these groups as it seems to be the case in relation to the allocation of headquarters costs and the invoicing for intercompany pricing of centrally provided group services.\textsuperscript{101}

The Ruding Committee missed the great opportunity to induce a debate on the possibility of applying the unitary method\textsuperscript{102} to the EC corporate taxation. Conversely, the Committee expressed its preference to separate accounting and the "arm's length principle" underlining the need for the adoption of common rules or procedures concerning transfer pricing adjustments by Member States.\textsuperscript{103}

In contrast to "separate accounting" unitary taxation can deal with another grave problem that of thin capitalisation,\textsuperscript{104} because under unitary taxation the tax base would be the total group profits, regardless of whether they were made.\textsuperscript{105} It also avoids the already

\begin{flushleft}
consultants KPMG which showed that the EC has become the most popular target region for takeovers.
\end{flushleft}

\textsuperscript{101} The Ruding Committee has recommended the adoption of a Directive dealing with these two issues; Ruding Committee's Recommendations, p.41.

\textsuperscript{102} See 6.2.2.

\textsuperscript{103} Ruding Committee's Recommendations, pp.30-31.

\textsuperscript{104} The concept of thin capitalisation has been discussed in Chapter 2 (2.2.2. i).

\textsuperscript{105} M. Devereux-M. Pearson, Corporate Tax Harmonisation and Economic
mentioned administrative complexities of separate accounting in highly integrated markets such as the Single Market purports to be and reduces the distortions caused by a state's preference to high tax rates (since that State will tax only a fraction of the profits of the group). However, unitary taxation has two disadvantages namely the reallocation of revenues between states during the transitional stage (from the separate accounting) and the potential case according to which a company may have to pay tax even if it has made only losses.\textsuperscript{106}

Nevertheless, the advantages of the "formula apportionment" method and especially of its "unitary" version\textsuperscript{107} in combination with the fact that the "separate accounting" method is not effective in cases where "arm's length prices" cannot be established\textsuperscript{108} or where the economic interdependence between the affiliated is so great that it is impossible to determine the income of each of them call for a comprehensive consideration of the method by the Commission and the Member States.


\textsuperscript{106} Analogous unfair situations may occur under separate accounting if the Losses Directive is adopted. For example parent A made profits 100 and its subsidiaries B and C in other Member States made losses 50 each. The tax liability of A = 100-50-50 = 0 and the Member State of parent will not receive tax revenue from A although A made profits in the jurisdiction of this State.

\textsuperscript{107} See 6.2.2.

\textsuperscript{108} e.g. when a member of the group produces for another member of the group products which have no other market.
Such consideration should take place during the next years alongside the harmonisation of the tax base and should be completed by the time a Single currency is adopted. If the result of the consideration is positive, unitary taxation can be applied in the single currency era provided that a number of conditions have been met.

First, harmonisation of corporate tax base must have been completed otherwise gaps and overlaps in the unitary base will appear due to the different rules Member States will employ for the calculation of profits. Secondly, in order not to violate the principle of interjurisdictional equity there must be a convergence of tax rates, which to a great extent already exists. Thirdly, unitary taxation should apply to Community companies involved in activities in more than one Member States and should stop at Community's edge (not worldwide combination). Finally, there should be agreement on the formula factors (e.g what property should include, etc.) which would be used as well as agreement on the concept of the unitary business and on the procedure that should be followed with regard to the filing of the so-called "Combined

---

109 In order to avoid any increase or decrease in profits which is not real but may result from exchange rate fluctuations.

c) Depreciation

Depreciation rules together with rules on other aspects of the tax base should constitute the content of a Directive on the tax base which will be proposed by the Commission in the light of the proposals of the "ad hoc" Committee of Experts. Conversely, the piecemeal approach adopted by the Ruding Committee which favours the adoption of a Directive for each aspect of corporate tax base separately may lead to inconsistencies and will not satisfy the business community.

Turning to the specific rules of depreciation it must be accepted that the basis for depreciation should be the historic cost (cost of purchase or of production) which was provided (Article 3) in the "Preliminary Draft Proposal for a Directive on the Harmonization of Rules Determining the Taxable Profits of Undertakings" (hereafter called the Draft Proposal). Both methods, namely the straight-line method and the declining balance must be acceptable (Draft Proposal

111 "A corporation engaged in economic activities in a particular state must file a "combined report" on which it shows the combined profits (and apportionment factors) of all affiliated firms with which it is engaged in a unitary business", C. McLure, op.cit., at 246.

112 Stock valuation, reserves, expenses, etc. which will be discussed separately.

113 See Ruding Committee's Recommendations, p.35.

114 XV/27/88-EN; See also Chapter 5 (5.4.2).

115 See Chapter 2 (2.2.2. c).
Article 6) but in relation to buildings only the latter should apply. Furthermore, declining balance depreciation rates may not be more than three times the corresponding rate of straight line (Article 6.1).\(^{116}\)

The rules on depreciation should define the depreciable tangible assets and state their minimum life which has also proposed by the Ruding Committee.\(^{117}\) There is also the need for common depreciation rules on intangible assets such as goodwill, patents etc. and for abolition of accelerated depreciation.\(^{118}\)

d) Deductible Expenses

This is an issue over which the Ruding Committee has contradicted itself by stating that there is no need for harmonisation of the general rules because "...current legislation in Member States has results which in effect are comparable and do not cause sizeable distortions of competition" and admitting in the next paragraph that there are disparities and by recommending the adoption of common rules for the deduction of business expenses!\(^{119}\) Despite the contradiction the recommendation is right and the starting point for the harmonisation of the rules for deductible expenses can be found in the Draft Proposal (Article 27) which connected the deductibility

---

\(^{116}\) These guidelines have been endorsed by the Ruding Committee (p.38).

\(^{117}\) Ibid.

\(^{118}\) For the meaning See Chapter 2; Further reference to this issue will be made in 6.4.5. as a part of the discussion on tax incentives.

\(^{119}\) Ruding Committee's Recommendations, p.41.
of the expenses with their contribution to the formation of taxable income.

e) Reserves - Provisions

The first reference was made in the Draft Proposal (Articles 20-22) and on the basis of the conceptual framework set up by that reference (losses or charges the nature of which is clearly defined and at the date of the balance sheet are either likely to be incurred or certain to be incurred but uncertain as to the amount or as to the date on which they will arise) harmonisation of the rules concerning the reserves and provisions should take place. In particular, it should include deductible taxes, damages, legal costs and fines, consumer rebates and discounts, bad debts, warranty charges, foreign-exchange losses and occupational pensions.120

f) Stock Valuation

Stock Valuation should be based on the acquisition (purchase) cost or the market value, whichever is lower, since there has been a "de facto" harmonisation between the tax laws of the Member States in respect of this issue.121 Three methods of valuation may be permitted (LIFO, FIFO, WEIGHTED AVERAGE)122 and apply to raw materials and consumables, work in progress, finished goods and goods for resale.

120 The last four categories have also been mentioned by the Ruding Committee, Ruding Committee's Recommendations (p.39).
121 See Chapter 2 (2.2.2. f).
122 Ibid.; Also Ruding Committee's Recommendations, p.39.
g) Carry-Over of Losses

The adoption of the respective Proposed Directive on the Carry-Over of Losses\textsuperscript{123} providing for 3 years carry-back and indefinite carry-forward of losses and supplementing the Proposed Directive on the Offsetting of losses incurred by Permanent Establishments or Subsidiaries against the profits of their parent company situated in a different Member State is absolutely essential and should be adopted in the short-term (not later than 1994).

h) Capital Gains

First, the rules outlined at this point will not concern capital gains arising from mergers and all the other cases covered by the Mergers Directive.\textsuperscript{124} Secondly, the assets which should be subject to capital gains taxation should be fixed assets\textsuperscript{125} and controlling shareholding.\textsuperscript{126} Thirdly, if the gains are reinvested there is no point in subjecting them to taxation.\textsuperscript{127} Fourthly, if the gains are not reinvested inflation should be taken into account (indexation) for the determination of the real gains (not the artificially produced by inflation) and these real gains should either form part of the taxable profits or be taxed separately as if they were profits

\textsuperscript{123} See Chapter 5 (5.3.2.).
\textsuperscript{124} See Chapter 5 (5.2.1.).
\textsuperscript{125} Draft Proposal Article 13.
\textsuperscript{126} Ruding Committee's Recommendations, p.43.
\textsuperscript{127} Draft Proposal Article 17; Ruding Committee's Recommendations, p.43.
(subject to the ordinary corporate income tax rate).\textsuperscript{128} Finally, in the case of capital losses such losses should be deducted from the taxable profits of the year in which the losses were realised.

i) Thin Capitalisation

Common rules dealing with the definition and the treatment of thin capitalisation must be adopted by the Member States. As long as "separate accounting" is followed there are only two methods,\textsuperscript{129} either the enactment of a debt/equity ratio\textsuperscript{130} or the application of the "arm's length principle".\textsuperscript{131} If, however, unitary taxation is introduced in the single currency era the problem will be overcome automatically.\textsuperscript{132}

6.4.3. Statutory Corporate Tax Rates

The present thesis rejects any idea of imposed harmonisation with regard to the statutory tax rates.\textsuperscript{133} Without disregarding the

\textsuperscript{128} The former option is preferred by the present thesis, whereas the latter by the Ruding Committee (p.43).

\textsuperscript{129} The former option is preferred by the present thesis, whereas the latter by the Ruding Committee (p.43).

\textsuperscript{130} The Inland Revenue in the UK adheres to such ratio.

\textsuperscript{131} These methods were discussed in OECD, Thin Capitalisation, Paris 1988 and preference was given to the second.


\textsuperscript{133} In contrast to the Ruding Committee which favours an imposed band
fact that tax neutrality requires the harmonisation of rates, however this task can be entrusted to market forces (competitive harmonisation). This view is strengthened by the empirical evidence from the corporate tax rate convergence which has happened in the States consisting the European Community\textsuperscript{134} and from the "decentralised" federal states where there has been a convergence of tax rates induced by market forces.

Furthermore, since market forces achieved such convergence when there was not a Single Market it is much more likely that such convergence will be retained and intensified after the establishment of the Internal Market, when economic interdependence between the Member States will increase. Thus, the determination of corporate tax rates can be left to Member States without endangering the future of the Single Market and without violating the principle of subsidiarity.\textsuperscript{135}

Any attempt to impose corporate tax rates will have serious repercussions on the fiscal sovereignty of the Member States and will result in an overall diminution of their national sovereignty. It will also leave no room for Member States to pursue their own

\textsuperscript{134} Corporate tax rates are around 35\% with some exceptions (e.g. Germany 50\% for retained profits, Ireland 10\% for manufacturing companies).

\textsuperscript{135} If there is no need for a measure that imposes rates at Community level any attempt to adopt such a measure will be in breach of the "subsidiarity clause" (Article 3b of the EC Treaty as inserted by Article G5 of the Treaty on European Union).
policies for which additional revenue through taxation may be required. Finally, the imposition of corporate tax rates is a sign of total harmonisation an approach rejected by this thesis.\textsuperscript{136}

6.4.4. The Corporate Tax System\textsuperscript{137}

a) Abolition of Discriminations\textsuperscript{138}

First, those Member States which apply imputation systems\textsuperscript{139} and attach a tax credit (representing all or part of the corporate tax paid on distributed profits) to each dividend paid to a resident shareholder (individual or company) with the purpose to reduce its income tax liability should be extended to those residing in another Member State (subject to proper tax identification). Otherwise, the discrimination between residents and non-residents which to a very great extent corresponds to the discrimination between nationals and non-nationals (since the vast majority of the residents of a State are nationals of that State) will be retained contrary to the EC Treaty (Article 6).\textsuperscript{140} The Member State of residence which will suffer

\textsuperscript{136} It is has also been denounced by the Ruding Recommendations (p.26) although the Committee contradicts itself by recommending imposed harmonisation of the rates.

\textsuperscript{137} The System for integration of corporate with personal income taxation.

\textsuperscript{138} These discriminations are related to cross-border flows but their relevance to the corporate tax system was the reason to be included in this part of the Chapter.

\textsuperscript{139} See Chapter 2 (2.2.4.).

\textsuperscript{140} The Ruding Committee is in favour of such discrimination and
a revenue loss from the application of the tax credit should be reimbursed the cost of the credit by the Member State of the distributing company through a clearinghouse mechanism.

Secondly, Advanced Corporation Tax as well as other similar taxes (précompte and equalization taxes) where they cannot be offset against domestic corporate tax liability (because there is no such liability) must be reduced by the amount of the foreign corporate tax liability. Finally, both these measures aiming at eliminating the two problems must be adopted by way of Directive not later than 1994.

b) Choice of a Common System?

The choice of a Common system has been on the Community agenda for many years. The first recommendation was made by the Neumark Committee which favoured the split-rate system in contrast to the Van den Tempel Committee which gave its preference to the classical system. Finally, in the 1975 Proposed Directive the Commission included provisions for the adoption of the partial imputation system. whereas the Ruding Committee did not manage to

distortion to the Single Market (p.34)!

\[141\] See Chapters 2 and 5.

\[142\] At least the Ruding Committee did not disregard this distortion and included the respective recommendation, Ruding Committee's Recommendations p.33.


reach a conclusion on this issue.

Excluding any systems that depart from the established and widely accepted principles of taxation\textsuperscript{145} and have theoretical rather than practical importance (since Member States cannot move so easily to them due to the fundamental changes they presuppose) the choice seems to be between the classical and the imputation system. The pros and cons of both systems have been discussed in Chapter 2 and in view of the fact that the imputation system has more advantages than its competitor, although it fails to achieve perfection, it could be the Community's choice. However, the best solution would be the setting up of an "ad hoc" Committee of experts which would have the task to consider the problem of the system and come up with a detailed recommendation (not later than 1994).

6.4.5. Other Issues

a) Local Taxation

Local business taxes should be levied on the tax base which has been determined by the rules of the national corporate income

\textsuperscript{145} For example the ACE (Allowance for Corporate Equity) system proposed by the IFS (See European Taxation , August 1991, p.238). ALLOWANCE = Shareholders' Funds x Appropriate Nominal Rate of Interest; SHAREHOLDERS' FUNDS = Equity Capital (for the first year) then = Shareholders' Fund of the previous period + New Equity + ACE allowance of the previous year + Taxable Profits of the previous year -Tax on those Profits - Dividends and Distributions to Shareholders and Capital repaid.
Nevertheless, this does not alleviate the tax burden faced by companies but there must be a full integration of local with national corporate taxes. Such integration is fully achieved when local taxes are deducted from corporate income tax liability and to a less extent when local taxes are treated as deductible expenses for corporate income tax purposes. The latter is the method followed by those Member States in which local business taxation exists, although the former secures the complete alleviation of an excessive tax burden.

b) Tax Incentives

The use of tax incentives is inconsistent with a market functioning in accordance with the principle of free competition and therefore direct grants should be preferred to tax incentives. In addition, tax incentives offered through the tax base cause an irreparable damage to its simplicity which is a very decisive factor in the enforcement of the tax.

Notwithstanding these general comments tax incentives would be difficult to eliminate, but at least certain restrictions should be placed on them as a start. First, tax incentives may be allowed for reasons of regional development and for productive activities (not financial activities). Secondly, tax incentives should take the

---

146 Ruding Committee's Recommendations, p.44.
147 See Chapter 2 (2.2.5.).
148 This happens to be the opinion of the Ruding Committee as well (Ruding Committee's Recommendations, p.36).
149 The Ruding Committee identified the problem of special tax regimes
form of reduced statutory tax rates or tax holidays and should apply for a prefixed number of years. Thirdly, the adoption of tax incentives by a Member State, due to the distortion such incentives may cause to the unified Market, should be conditional upon the prior consultation with the Commission and the Member States.\textsuperscript{150} Finally, tax incentives must not be restricted only to domestic companies but they ought to be extended to companies of other Member States operating in the territory of the Member State that offers the tax incentives.

c) Extensive Cooperation Between National Tax Authorities

The establishment of the Single Market and the current expansion of companies need the extensive cooperation between the tax authorities of the Member States so as a better tax scrutiny of the multi-jurisdictional activities can be achieved. For this reason the Commission must consult the Inland Revenues of the twelve Member States and then it may propose any specific measures for the achievement of a more efficient cooperation between national tax authorities.\textsuperscript{151}

\begin{quote}
"designed to attract internationally mobile business" (Ruding Committee's Recommendations p.26) but it failed to recommend any detailed measures for the abolition of those regimes.
\end{quote}

\textsuperscript{150} The purpose of this consultation will be to ensure that the adoption of tax incentives is justified.

\textsuperscript{151} Such proposals should be made by the end of 1993.
6.5. The Uncertain Future of Corporate Tax Harmonisation

The foregoing measures meet the needs of the Single Market, restrict the Community's intervention to a minimum offering Member States a great deal of discretion and, above all, do not lead to a complete loss of Member States' fiscal (national) sovereignty.\textsuperscript{152} Moreover, they are intended to deal not only with the short term problems of corporate taxation in the EC but also with the long term implications of the topic. The "hybrid solution" that incorporates all these measures is rational, viable, adaptable to the developments within the EC and also capable of reconciling the two opposite schools (market-led or competitive or bottom-up approach on the one side and the imposed or top-down approach on the other).

In addition, the proposed solution is consistent with the current and future trends in the field of direct taxation which call for low, fair and simple direct taxes. For this reason, it produces a downwards convergence of the statutory corporate tax rates, implements fairness by abolishing discriminations and double taxation and by removing tax obstacles to cross-border operations and leads to the adoption of clear and simple rules with regard to the corporate tax base avoiding complexities and inconsistencies.

Nevertheless, the fact that it took twenty-one years for some

\textsuperscript{152} With regard to certain issues national sovereignty may be reduced but such diminution is dictated by the needs of the Single Market and takes place in accordance with the principle of subsidiarity.
corporate tax measures to be adopted\textsuperscript{153} and that three Proposed Directives which are of vital importance for the proper functioning of the Single Market have been on the ECOFIN's agenda for one and a half years\textsuperscript{154} throws doubts upon the prospects of corporate tax harmonisation. The "principle of an open market economy with free competition" that was inserted in the EC Treaty (Article 3a) by Article G(4) of the Treaty on European Union will suffer serious tax distortions if the recommended measures are not taken in time, not to mention the fact that some of the measures should have been adopted by now.\textsuperscript{155}

Finally, the close interrelation between corporate tax harmonisation and the economic and political developments in the EC means that the pace of the latter will be reflected in the former. The after Maastricht era is an era which poses the crucial dilemma whether there should be a cooling-off period dictated by the internal problems many Member States face and influenced by the reemergence of nationalism or a speeding up in the process of european integration. The outcome will be inevitably reflected in the field of corporate taxation, but whatever it may be, the truth is that if harmonisation

\textsuperscript{153} The Mergers Directive, the Parent-Subsidiary Directive and the Arbitration Convention were adopted in 1990 (See Chapter 5).

\textsuperscript{154} The Proposed Directive on Interest-Royalty Payments, the Proposed Directive on the Offsetting of Losses and that on the Carry of Losses (the latter was proposed in 1984 for the first time and was relaunched as a supplement to the Proposed Directive on the Offsetting of Losses).

\textsuperscript{155} In particular those which affect cross-border operations.
of national corporate tax laws does not take place to the extent that has been discussed in this thesis the result will be a pseudo-Single Market full of tax distortions.
BIBLIOGRAPHY

I. BOOKS


Institute of Economic and Industrial Research, Priorities in Fiscal Policy, (in Greek) Athens, 1989.


International Bureau of Fiscal Documentation, Supplementary Service to European Taxation.

International Bureau of Fiscal Documentation, Tax News Service; Supplementary Service to European Taxation.


P. Kelly et al., *European Economic Interest Groupings*, Bristol, 1990.


P. Te Boekhorst, 'Duty of Member States to Implement Directives (Francovich and Bonifici Cases)', (1992) 32 European Taxation 179.


R. Burke, 'Harmonisation of Taxation in Europe', (1979/2) Intertax 46.

R. Burke, 'Harmonization of Corporation Taxation', (1979/6-7) Intertax 240.


R. Casna, 'Another Step Forward to Tax Harmonisation?', (1978) 18 European Taxation 372.


BIBLIOGRAPHY

British Tax Review 232.


Confederation Fiscale Europeenne, 'Memorandum for the EC Committee of Experts (Ruding Committee)', (1992) 32 European Taxation 51.


Editorial Comment, 'Progress on Tax Harmonisation in the Common Market', (1962) 2 European Taxation 163.

Editorial Comment, 'A Comparative Analysis of the Classical, Dual Rate and Imputation Systems', (1972) 12 European Taxation 112.

Editorial Comment, 'A Common European System of Corporate Taxation?', (1975) 15 European Taxation 41.


Editorial Comment 'The Daily Mail Case (81/87)', (1989/1) Intertax 373.


European Parliament, 'Resolution on Corporate Taxation', *DOC 1-903/83 (PE84 133/fin)*.


A. Giovannini, 'National Tax Systems Versus the European Capital
BIBLIOGRAPHY


M. Keen, 'Aspects of Tax Coordination in the European Community'.

375
BIBLIOGRAPHY


BIBLIOGRAPHY


Segre Report (Translated Fragments), (1967) 27 European Taxation 212.


D. Sheridan, 'Taxation of EEIGs', (1990) 30 European Taxation 146.

H. Simonet, 'Tax Harmonization and the Economic and Monetary Union', (1975/2) Intertax 40.


O. Thommes, 'The New EC Commission's Proposals for Directives on


M. Vasey, 'Decision-Making in the Agriculture Council and the


J. W. B. Westerburgen, 'Tax Harmonisation in the EEC; Where are We and What are the Prospects?', (1990/10) Intertax 483.


