

AN INTERNAL MARKET WITHOUT TAX OBSTACLES - SNAPSHOT OR BLUEPRINT?

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On 23rd October 2001 the EU Commission issued a Communication² identifying corporate tax issues facing businesses operating within the European Community and proposing possible ways to alleviate the burdens, although the subtitle³ perhaps indicates the Commission's preferred outcome. Partly because some readers are probably still trying to digest it (it is over 400 pages) and partly because of more newsworthy non-tax matters there has been relatively little comment on the Communication. However, that may also be because many of the issues identified were highlighted in the Ruding report⁴ and at the time there was not the political will to make progress on them. That suggests that the initiatives proposed in the Communication will peter out unless businesses are prepared, across Europe, to lobby finance ministries to be more receptive to ideas which, by reducing administrative and fiscal costs, may render individual Member States more attractive locations and so generate additional taxable income.

This article initially describes the issues identified in the Communication and the various solutions proposed by the Commission, and then considers the wider impact on cross-border tax issues. Finally, it comments on possible outcomes and speculates on the likely attitude of governments towards the Communication. A

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² "A Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee - towards an Internal Market without tax obstacles: Com(2001)582."

³ "A strategy for providing companies with a consolidated corporate tax base for their EU - wide activities."

⁴ Report of the Committee of Independent experts on company taxation (1992).

word of warning: in the time available it has not been possible to cover some of the issues raised in the Communication - e.g. imputation v classical systems of dividend taxation - and thus this summary focuses on the more practical issues raised.

Economic Analysis

The Executive Summary correctly identifies that many of the issues identified in the Communication are similar to those identified in the Ruding report⁵ e.g. tax costs/barriers to cross-border mergers; withholding taxes on cross-border income flows; failure to obtain tax relief for losses accruing in one jurisdiction against profits arising in another Member State; and divergent tax bases in different Member States. The principal change of emphasis is on the increased compliance costs of having to adhere to different tax rules in up to 15 Member States. In particular as more businesses operate cross-border, the real costs of satisfying Member States that no questionable transfer pricing has occurred, and/or Member States applying incompatible measures of profit so giving rise to double taxation, has increased.⁶ The Executive Summary also raises the issue that tax rules of Member States may distort investment decisions, either by favouring domestic investment over investment in other jurisdictions or by encouraging inward investment from other countries as compared with domestic investors.⁷

The problem for the Commission is that there is little hard evidence that tax differences have distorted investment decisions. The studies referred to in the Communication clearly identify that on a post tax basis, the rate of return could radically differ from the statutory tax rate and so affect the real return. What is not clear is whether tax obstacles would in isolation cause sub-optimal economic decisions to be made⁸, or whether other factors such as availability of a well-educated workforce with appropriate language skills, proximity to market etc would

⁵ See Annex 1 (all references to Annex, Part and Section numbers are to Annexes, etc in the Communication).

⁶ Note the length of Part III, Section 5.

⁷ The Communication focuses on distortion of investment patterns arising among Member States when in fact businesses operating within the European Community are increasingly operating outside the EU - and so tax rules which favour (on a post tax basis) investment in the EU may cause companies to forego more profitable (on a pre-tax basis) investment opportunities outside the EU.

⁸ See Part I, B4.2 (p 87).

be more influential.⁹ So despite the fact that the tax base can be a significant factor in overall tax costs,¹⁰ the Communication highlights headline tax rates. There is, of course, a certain irony in this as the Commission has to acknowledge that unless Member States are minded to give up sovereignty over tax, this is a factor over which it is least likely to have influence.¹¹

The Commission is on stronger ground when it focuses on specific tax differences, discussed below, and focuses more on the tax base when it addresses transfer pricing and compliance costs.

Specific Issues

The Parent: Subsidiary Directive

Key deficiencies with this Directive includes the fact that the Directive only applies (subject to any lower threshold that a Member State **chooses** to operate) to 25% + (direct) interests in companies resident in other Member States; that Member States can require up to a 2 year holding period to elapse before dividends can benefit; third country tax may not be taken into account; and not all bodies liable to corporate taxes on income are listed in the Directive.¹²

Mergers Directive

One significant difficulty with the Mergers Directive has always been that some of the operations contemplated by it are not possible under the corporate law of

⁹ To the extent that physical proximity was important to intra-Member State trade - and of course the growth of digitised products and the supply of services electronically is relevant here - it would be logical for countries on the periphery of the Community (such as Ireland) to have a lower tax rate to compensate businesses which located in such countries for increased transport costs to customers in more central Member States.

¹⁰ Consider the extent to which by removing 100% 1st year allowances on plant and machinery, and so broadening the tax basis, the then Chancellor of the Exchequer was able to reduce the corporate tax rate from 52% to 35% in the UK in the mid 1980s.

¹¹ Witness the reaction in 1992 to the suggestion of a minimum EU corporate tax rate.

¹² See Box 14 on page 226, Part III; and pp 230-232.

Member States namely absorption¹³ or division of companies.¹⁴ Again, as with the Parent : Subsidiary Directive, not all bodies subject to corporate tax on income are listed, and so can benefit from, the Directive.¹⁵ More importantly, because of the wording of Article 4 of the Directive, in particular that the assets of a permanent establishment of the transferring company remain effectively connected with a permanent establishment, the transferor company may find that the authorities of the Member State in which the permanent establishment is located can levy tax on chargeable gains in respect of assets if they are to become vested in a fully taxable subsidiary in that Member State.¹⁶

The Communication then identifies types of transactions which are not covered by the Directive or where questionable interpretations by Member States Directive enable tax to be imposed which negates some or all of the benefit of the Directive.¹⁷ The difficulty with some of the examples is that from the view point of the Member State from which taxable activities are being transferred, there is no easy way to retain a tax charge and undoubtedly the Directive was "sold to" Member States on the basis that whilst an immediate charge would be foregone, residual taxing rights would remain. Some of the reforms proposed by the Commission in the Communication would mean that in aggregate less tax would be collected by tax authorities in the Member States and they might not benefit from a subsequent tax charge, either over assets or over shares in companies involved in the transaction

¹³ I.e. the concept of legal merger operated in, *inter alia*, the USA.

¹⁴ In the UK generally this would have to involve asset transfers (whether directly or enveloped in companies, the shares of which were transferred) to other companies, whether or not accompanied by liquidation of the transferor company, or dividends in specie.

¹⁵ Paragraph 3.2.2 (on page 235) gives examples of certain partnerships and Irish banking companies.

¹⁶ Even prior to the Directive, in the UK deferral relief would have been available under what is now section 140 TCGA 1992 i.e. the UK, as the country which had (under domestic UK law) taxing rights over assets of the permanent establishment in another country was prepared to forego an exit charge and instead defer the charge, the trigger for its crystallisation being a dealing with the shares in the non-resident subsidiary to which the assets of the permanent establishment were transferred: see section 140(4). Arguably a dealing with the assets is more likely and so after a six year period had elapsed (see section 140(5)) the view could be taken that the UK had effectively waived its taxing rights. If the UK could concede this, there seems to be no reason why any tax law rights vested in the country in which the permanent establishment was located (and in which the subsidiary would be resident) should not be waived, at least provided the transferee subsidiary's tax basis in the transferred assets remained a historic basis, and not uplifted to market value.

¹⁷ See the discussion on pages 236-239.

held by nationals of the Member States concerned.

Resolution of these issues would either pose a wider debate on whether corporate tax (as opposed, for instance, to an extension of VAT) can be maintained by individual Member States or, possibly, generate different fiscal barriers. The latter would arise were it to be suggested that Member States content themselves with transfer taxes (as compensation for the tax on capital gains etc foregone in the merger): note the Commission's concern that the Directive does not cover other taxes (like transfer taxes) that impede mergers.¹⁸

Cross-Border Loss Relief

The Communication indicates that the ability to use losses to minimise taxation in all relevant jurisdictions is a significant obstacle to cross-border economic activity. Generally in cross border situations relief is available for losses in a permanent establishment in one territory when computing the taxable profits in the "home jurisdiction".¹⁹ The Communication does not address directly the issue of where there is an overall loss by reference to the home country operations but the activities of the branch, on a stand-alone basis, are profitable viewed from the perspective of the territory with taxing rights over the branch activities.²⁰ An issue which does arise in these circumstances, addressed at page 250 of the report, is that not only would tax be paid in the jurisdiction in which the permanent establishment is located but losses of the head office would be reduced by the taxable profits of the permanent establishment. The Communication also identifies that restrictions on the offset of losses in future accounting periods can render the losses less valuable if not nugatory.²¹

¹⁸ See page 240 and Box 24.

¹⁹ There are exceptions such as the retrograde changes made in the UK legislation whereby if there is any possibility of loss relief in the jurisdiction in which the permanent establishment is located, group relief is not available to an affiliate of the company with the overseas loss making permanent establishment: see section 403E Income & Corporation Taxes Act 1988.

²⁰ This of course is only an issue if, as would be normal, the relevant provision in the double tax treaty between the two countries concerned enables the jurisdiction of the permanent establishment to tax the branch on the stand-alone basis rather than by reference to the enterprise's overall performance in both jurisdictions.

²¹ See paragraph 4.1.5 and see, for instance, the UK limitation that trading losses in a company to the extent not used against other current year profits, surrendered or carried back, can only be carried forward whilst the company is carrying on its trade and the restrictions in the group relief legislation whereby the amount of losses capable of being surrendered are only such amount as can reduce to zero the profits of the claimant company (i.e. the claimant company cannot receive an "over surrender" of losses and then carry them forward to shelter against future profits). See section 393(1) and section 403A(1).

In one of the rare references to companies operating outside the Community, the Commission draws a comparison with companies operating in the USA, i.e. the fact that losses in a particular state can be used to shelter profits made in other states as regards federal tax. The Communication makes several other points: firstly, that even at a domestic level restrictions on losses may particularly prejudice smaller business (e.g. the restriction in many countries of not being able to carry back losses, or only for a limited period)²²; and secondly, the ability to use losses in only a single Member State may mean that companies will be prepared to make larger investments in those jurisdictions as there is more of a taxable base against which losses from the new investments can be offset.

The Commission puts forward strong grounds for legislatures making changes in loss relief rules. What does need to be recognised by the Commission is the fact that this would immediately mean that tax receipts in the Community would fall as losses became available more readily. This would suggest that Finance Ministers would need to be convinced that the economic performance of existing businesses, and businesses to be created, would over time generate sufficient taxable income to make up for the tax that would now be saved as a result of more widespread cross-border loss utilisation or impose other taxes to make up for the shortfall.²³

Transfer Pricing

This section of the Communication emphasises the change since the Ruding report i.e. the increase in the number of companies operating in several Member States and the consequential need to deal with more tax administrations, coupled with more stringent rules or guidance on how to approach transfer pricing.²⁴ The Communication identifies the problem that since determining what is at arm's length pricing inevitably involves judgment, different tax authorities come to different conclusions as to the extent to which profit should be allocated to their jurisdictions and therefore economic double taxation can be the result. The important point revealed in the Communication is the fact that significant resources are diverted to

²² See for example the restriction in the UK legislation on carry back losses for only one year, reduced from three years except in the case of terminal losses - see section 393A(2) and (2A).

²³ If the survey featured in Box 36 on cross-border losses was borne out by companies operating in other jurisdictions quite significant amounts of tax would be saved by a widespread relaxation of loss reliefs, both internally and cross-border - see pages 253 and 254.

²⁴ A particular issue highlighted by this section of the Communication is the extent of the documentation that different tax authorities require companies to maintain to demonstrate that it has applied the arm's length principle applied by other jurisdictions in accordance with the OECD Guidelines.

creating and managing the material (which support the particular pricing policies adopted) to meet the requirements of the various Member States' tax authorities. Another factor driving up the cost for businesses is that in view of the increase in interest shown by tax authorities in the Community,²⁵ individual tax administrations are having to enhance their transfer pricing procedures to ensure that other jurisdictions that have strengthened their laws do not thereby increase their tax receipts from a particular corporate group.

Another key point is that under the Mutual Agreement procedures in double tax conventions and under the EU Arbitration Convention there is no obligation on the tax authorities to suspend collection of tax while any disputes over allocation of profits to business entities in different jurisdictions are resolved. Given the significant amounts at stake and therefore the interest running, and the fact that significant time can elapse before any decision under the EU Arbitration Convention is handed down there are significant incentives for companies to agree to economic double taxation rather than dispute the point, particularly as in some jurisdictions access to the EU Arbitration Convention depends on the enterprise giving up its possibility of a court appeal.²⁶

Employee Related Issues

The Communication identifies two principal issues, firstly the fact that there may be multiple taxation of employee incentives, e.g. option schemes, where employees in receipt of options become resident in different Member States at different times. For instance, there may be a liability in one Member State on the grant of an option, another liability in another Member State to which the employee has moved at the time the option was exercised, and potentially a further charge on growth in value of the shares at the time when they are sold. If the employee has moved to another Member State then credit may not be given for the tax borne in the other Member States. The second issue, to some extent being dealt with outside the tax arena, are the limitations on the tax deductibility of contributions to pension schemes established in a jurisdiction different to that in which either the employee or employer are based.²⁷

²⁵ See Box 39 on page 263.

²⁶ See page 279 and page 283 and the reference in particular to the UK and France in respect of Article 7(3) of the Convention.

²⁷ It is noteworthy that in the context of the recent US/UK Double Tax Treaty (currently subject to ratification) there is a section in the Exchange of Notes attempting to allocate taxing rights in relation to options and limited reliefs in relation to pension schemes. More precisely within the limits employees will not find themselves taxed on contributions made into pension schemes based in the other jurisdiction and they will be able to take account of contributions made in one country to some extent in computing the income taxable in the other jurisdiction.

Solutions Proposed by the Commission

The Communication admits that some of the issues are already being dealt with, on a piecemeal basis, by taxpayers seeking to rely on the "four freedoms" and arguing discriminatory behaviour as regards the tax regimes of different Member States. That has over time caused significant changes to individual Member States' tax regimes.²⁸ The Commission rightly identifies that this will depend on the enthusiasm of taxpayers to litigate matters. In contrast if a tax difficulty is identified, for instance under the Mergers Directive, it would be unusual for a taxpayer to set up a structure and then rely on litigation before the European Court of Justice to deal with the issue, partly because of the time that would elapse (and perhaps the need to pay the tax that it was argued was not due under local law because of its contravention of the Treaty) and the inherent uncertainty of litigation given the state of EU tax case law. The Communication therefore accepts that more pressing issues could, for instance, be dealt with, provided there was a political will, by changes to the Parent Subsidiary or Merger Directives, domestic law changes to loss relief etc.²⁹

The Commission identifies that several of the issues raised are an inherent function of the tax base for computing tax being different in different Member States. That is not to say that transfer pricing issues, for instance, would disappear were there to be identical tax basis in all Member States. For instance the Communication does not address the disputes that arise with jurisdictions outside the EU and the fact that if there is any significant differential in tax rates business would still have an incentive for profits to arise in the Member States which had lower tax rates. Compliance costs could be expected to go down if essentially the same figures were to be made available to all relevant jurisdictions or at least the methodology to be adopted in relation to determination of profits in any particular Member State was the same.

Therefore the Commission in the Communication has focussed on four concepts that might be adopted, namely the Home State Taxation approach; the Common (Consolidated) Base; the adoption of an European Union Company Income Tax; and a Single Compulsory Harmonised Tax Base.

Dealing with each proposal in turn, the Home State Taxation concept would involve Member States in which a business operating, whether through permanent establishments or subsidiaries, agreeing that the way in which the tax base of the

²⁸ See for instance the rather belated changes made to the UK rules on groups of companies and some of the recent changes made in relation to double tax relief in the Finance Act 2000.

²⁹ See the discussion on pages 306 and 307.

enterprise was to be calculated would follow the rules applicable to the parent company (or in the case of permanent establishments, the jurisdiction in which the head office was based). Member States would apply their own rate of tax to the profits earned within their jurisdiction. As the report points out³⁰ this ought to enable cross-border loss relief to be obtained, although if there were different rules in different Home States enterprises competing in the same jurisdictions could find their tax base were different depending on the legislation in the Home State concerned. By definition, only companies that had or were prepared to bring their tax bases in line might readily be able to adopt this as a voluntary measure. The Common (Consolidated) Tax Base involves the idea of an additional Community-wide tax code which enterprises operating in several Member States could opt to adopt and which would then be accepted by all or at least some Member States. This would envisage only one tax administration, that of the country in which the principal company in the group was located, being dealt with and information being provided by that tax administration to the tax administrations in other Member States in which the enterprise had operations. As the paper points out,³¹ this would involve agreement between Member States participating as to the way in which profits would be allocated between those jurisdictions, probably in agreement with some formula perhaps based on sales, payroll and assets.

The paper does not spend much time on the concept of European Union Corporate Income Tax as it would require Member States to relinquish significant amounts of tax sovereignty and establish a federal EU tax.³² The other suggestion based on harmonisation would be for the Community to devise, with input from Member States, a single corporate tax code, which it would be compulsory to apply across the Community.

Likely Outcomes

Certain Member States have already indicated a lack of enthusiasm for a Commission driven approach to developments in the corporate tax base. That is partly because if some of the changes proposed were carried out and the EU

³⁰ See page 374.

³¹ See page 376.

³² It is perhaps revealing that the Communication suggests that the revenues could be used to fund the EU institutions with any amount left over allocated between the Member States, rather than the way in which the Value Added Tax is administered with a small percentage being handed over by Member States to the Community institutions and the institutions having to live within the funding forwarded to them.

contained less tax difficulties for companies operating within the Member States, it might paradoxically make it less attractive for EU companies to seek investment opportunities outside the Community. Therefore it seems likely that some individual measures, perhaps to improve the Mergers Directive and deal with deficiencies in the Parent: Subsidiary Directive could be achieved as a result of a mere publication of the Communication. Conceivably, Member States might be persuaded to alter their legislation where Community case law has identified that discriminatory treatment is inconsistent with freedom of movement of capital or, establishment.

It seems difficult, however, to see that all fifteen Member States tax administrations are going to harmonise the demands they place on businesses as regards transfer pricing. Moreover in the immediate future, given the likelihood of reduced corporate tax receipts tax authorities may not want to commit to greater cross-border loss utilisation, at a time when taxable losses are likely to be increasing due to expenses of lay-offs, restructuring etc in the current economic climate. One other possibility is that some Member States adopt measures which will remove some of the barriers as between the Member States concerned. However their finance ministers may be concerned at the loss of revenue not foregone by Member States who do not participate in such initiatives.

Conceivably, in the medium term, change is more likely, particularly if changes to international accounting standards render it less likely that corporate accounts can be used as a starting point for tax computations. Therefore there will be a need for some other measure of profit to be adopted and maybe there will be the possibility of a clean sheet approach to determination of the profits of companies for tax purposes.