

# **The Ruding Committee Report: An Initial Response**

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## SUMMARY OF MAIN ISSUES

1. A Committee of Experts under the chairmanship of Dr Onno Ruding was appointed by the European Commission to consider three principal questions:
  - (a) Do differences in taxation among Member States cause major distortions in the internal market, particularly as respects investment decisions and competition?
  - (b) If distortions arise, can they be eliminated by market forces and tax competition or is Community action necessary?
  - (c) If Community action is necessary, what specific measures are required?
2. The Committee has concluded that distortions do arise and that their elimination cannot be left to market forces and tax competition. The Committee has put forward detailed proposals, intended to be implemented in three phases. The second and third phases would correspond with the second and third stages of economic and monetary union.
3. This Commentary represents an initial response to the issues raised by the Ruding Committee and the recommendations made.
4. Phase I of the Committee's proposals would be directed principally at eliminating the discriminatory treatment of cross-border investment. This would largely be achieved by eliminating withholding taxes on cross-border flows within the Community and ensuring that dividends received from companies based in other Member States were taxed on a similar basis to dividends from domestic companies.
5. So far as the UK is concerned, implementation of such measures would contribute significantly to solving the surplus ACT (advance corporation tax) problem. On a Community-wide basis, such measures would represent the major step needed to eliminate the distortions identified by the Ruding Committee.

6. Phases I and II would also involve measures designed to harmonise the tax base of corporate income taxes within Europe. If implemented, such measures might further reduce some of the distortions to the location of investments within the Community and eliminate some of the special incentives to investment in particular Member States.
7. However, the proposals would involve a considerable number of changes to the existing tax regimes of Member States. It is also not clear that, overall, the final result would produce a more neutral or satisfactory tax base or that it could be implemented without wider changes in the existing corporate tax systems of Member States.
8. The Ruding Committee also proposes a minimum and maximum corporate tax rate within the Community. However, it is questionable whether this proposal should be adopted, given the increasing globalisation of markets across the world and the potential need to keep European corporate tax rates in line with rates in other countries.
9. With a view to Phase III, the Ruding Committee recommends that further work should be undertaken to identify a longer-term corporate tax regime for the Community. If further proposals for harmonisation are to be made, this calls into question whether the measures proposed at Phase II should be adopted except as part of such further proposals.
10. A more satisfactory route to a harmonised system may be the adoption of the IFS proposals under which an allowance would be given for corporate equity. Once implemented, this would produce a fully neutral corporate tax regime across Europe without the need for immediate and substantial changes in the existing tax bases of Member States.

# **1 BACKGROUND TO THE RUDING COMMITTEE**

## **1.1 The Treaty of Rome and Corporate Tax Harmonisation**

- 1.1.1 The main priority within the Common Market following the signing of the Treaty of Rome in 1957 was the removal of the distortions caused by trade barriers. In the tax field this resulted in a concentration of activity on indirect taxation. This is recognised in Articles 95 to 99 of the Treaty. Article 99, for example, states that provisions should be adopted for the harmonisation of turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and functioning of the single market.
- 1.1.2 The Single European Act of 1987 defines the internal market as ‘an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured ...’. Notwithstanding the obvious impact that direct taxes may have, in particular on the movement of capital, no equivalent provision to Article 99 is made in relation to direct taxes. However, the Treaty of Rome contains a number of Articles that have a bearing upon direct tax issues and may form the basis of Community action.
- 1.1.3 Article 52 confers freedom of establishment throughout the Community and Article 67 requires the removal of barriers to the free movement of capital. In particular, however, the European Commission is given powers under Article 100 to implement Directives designed to harmonise any activities amongst the Member States which can be construed as directly affecting the establishment or functioning of the Common Market. This has formed the basis of Community action in the corporate tax field.
- 1.1.4 Proposals for the harmonisation of corporate income taxes within the Community have a long history. In 1962, the Neumark Report<sup>1</sup> proposed harmonisation on the lines of a split-rate system similar to that which then existed in Germany. By 1971, however, the Van den

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<sup>1</sup>*Tax Harmonisation in the European Economic Community*, 1962.

Tempel Report<sup>1</sup> was proposing the adoption of a classical system. Finally, the adoption of an imputation system of corporation tax received official approval from the Commission in 1975 in its draft Directive for harmonising corporation tax within the Community.<sup>2</sup>

1.1.5 What is clear, however, is that none of the various Community proposals for harmonising the corporate income tax *system* have had an effect on Member States' policies in this field. By 1979, the 1975 draft Directive had effectively been deferred by the European Parliament until the Commission produced proposals for the harmonisation of the tax base.<sup>3</sup> A preliminary draft of such a proposal was produced by the Commission in 1988.<sup>4</sup> Nevertheless, by the end of the 1980s little progress could be seen at a Community level for 30 years discussion on corporate tax harmonisation.

## 1.2 The Commission's New Approach

1.2.1 The arrival of Christiane Scrivener as the first Commissioner whose portfolio is devoted solely to taxation marked a turning-point on direct taxes. In November 1989, she outlined three guidelines for the Commission's proposals in the corporate tax field:<sup>5</sup>

- (a) 'subsidiarity' - that is, intervention only where it is necessary to attain the specific objectives agreed by Member States;
- (b) the completion of the single market - all measures proposed by the Commission must be coherent with that objective; and

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<sup>1</sup> *Company Tax and Income Tax in the European Communities*, 1971.

<sup>2</sup> Draft Directive concerning the harmonisation of systems of company taxation and of withholding tax on dividends, Brussels, 1 August 1975, COM(75) 392 final.

<sup>3</sup> Following the Nyborg Report to the Parliament: European Parliament Working Document 104.79, 2 May 1979.

<sup>4</sup> Preliminary draft proposal for a Directive on the harmonisation of rules for determining the taxable profits of undertakings, XV/27/88-EN.

<sup>5</sup> *Intertax*, 1990/4, p. 207.



- (c) 'concertation' - that is, the proposals and priorities must be defined in close co-operation with all relevant parties.

1.2.2 The new approach adopted by the Commission found expression in its 1990 Communication to the European Parliament and the Council.<sup>1</sup> This noted that any form of company taxation is likely to give rise to economic distortions because of its impact on decisions on the location, nature and financing of investment. In that respect, however, most corporate income taxes are non-neutral in a purely domestic environment, as well as across borders. However, the Commission accepted that Member States should be free to determine their own tax arrangements except where they led to *major* distortions. At the same time the Commission formally withdrew its 1975 draft Directive.

### **1.3 The Formation of European Enterprises**

1.3.1 One of the principal consequences of the move towards a single market will be the concentration of business activities within the Community. Whilst in the past each country within the Community may have had its own 'producer' in a particular business sector, within the single market there should eventually develop larger producer units designed to serve the European, rather than just the national, market. Business units serving the US market, for example, are significantly larger than those in Europe.

1.3.2 Most mergers, but especially those conducted across the borders of two taxing jurisdictions, normally involve two aspects of tax planning:

- (a) the elimination or minimisation of tax liabilities on the merger transaction itself; and
- (b) the establishment, either on the merger or by way of post-merger reorganisation, of a tax-efficient structure.

In relation to the latter aspect, a tax-efficient structure will in particular envisage

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<sup>1</sup> Commission Communication to Parliament and the Council, Guidelines on company taxation, Brussels, 20 April 1990, SEC(90)601 final.

- (i) minimising the costs of financing the merger and the ongoing merged business unit (for example, by ensuring that interest on debt finance is fully deductible against profits otherwise suffering the highest rate of tax);
- (ii) the minimisation of tax on the profits of the merged business unit; and
- (iii) maximising the return to the ultimate shareholders of the merged entity.

1.3.3 Where a cross-border merger results in the profits and the ultimate shareholders of the merged entity being spread across a number of different taxing jurisdictions, it can be difficult to achieve these objectives. In particular, the propensity of tax systems to favour investment by domestic shareholders in domestic enterprises as against foreign investment may result in major tax inefficiencies where profits are earned through a subsidiary in Country A, are transferred to the parent company in Country B, only to be distributed to the ultimate shareholders, some of whom may be resident in Country A.

1.3.4 A great deal of innovative planning has gone into solving these problems. This has included 'stapled stock' or 'dividend access' arrangements, under which the ultimate shareholders are given a share in the subsidiary company as well as the parent company, on condition that the two shares can only be dealt in as a single unit. Thus, in the previous example, the subsidiary in Country A would be able to pay a dividend direct to the ultimate shareholders, bypassing the parent company in Country B. Examples of such structures can be seen between the UK and Ireland in the Wedgwood/Waterford merger, between the UK and the US in the merger of Beecham Group plc and SmithKline Beckman Corporation, and between the UK and France in the merger of Wiggins Teape Appleton and Arjomari.

1.3.5 Such structures are, however, complex and potentially inflexible, in particular in restricting the ways in which the resulting entity can raise capital in the capital markets. Company law, Stock Exchange and business management reasons do not necessarily lend themselves to

the adoption of such structures, as compared with those of a single parent company owning subsidiary undertakings and able to service its shareholders effectively across borders.

- 1.3.6 Nevertheless, if, as the Commission recognises, the economic benefits of the single market are to flow from the expansion of companies' transnational activities between Member States, these structures illustrate perfectly the type of tax issues that must be addressed in the context of the development of the single market. While tax relations between most Member States are addressed through bilateral double tax treaties, such treaties only address these problems imperfectly and on a bilateral basis, rather than the multilateral one that is required in relation to the Community.

## **1.4 The Commission's Package of Measures**

### ***The Mergers Directive***

- 1.4.1 The Commission's 1990 Communication recognised these problems. Accordingly, rather than continuing to pursue the extreme solution of corporate tax harmonisation, it identified a number of measures which would eliminate the principal barriers to the development of Community-wide enterprises. In relation to the transaction tax costs involved in cross-border mergers, the Commission proposed the adoption of a mergers Directive that had first been proposed by the Commission to the Council on 16 January 1969.<sup>1</sup> This was eventually adopted at a meeting of Finance Ministers on 11 June 1990.<sup>2</sup>

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<sup>1</sup> Proposal for a Council Directive (with explanatory memorandum) on the common system of taxation applicable to mergers, divisions and transfers of assets taking place between companies of different Member States, submitted by the Commission to the Council on 16 January 1969, COM(69) 5 final.

<sup>2</sup> The Directive is dated 23 July 1990: Council Directive 90/434/EEC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, *Official Journal of the European Communities*, no. L225 (20 August 1990) at 1.

1.4.2 The Mergers Directive, while an important part of the Community measures aimed at the single market, is not central to the Ruding Committee Report. However, two further measures agreed at the meeting of Finance Ministers on 11 June 1990 are of central importance. The first, again dating back to 1969,<sup>1</sup> is the Directive of 23 July 1990 under which profits may be remitted by a subsidiary company to its parent company without withholding tax.<sup>2</sup>

### *Withholding Taxes and the Parent/Subsidiary Directives*

1.4.3 The role of withholding taxes as the principal cause of economic inefficiencies in cross-border situations was identified by Devereux and Pearson in an IFS Report in 1989.<sup>3</sup> They had concluded that

... proposals for harmonisation are more likely to be acceptable, and more likely to achieve the goal of economic efficiency, if they are directed towards the taxation of transnational flows rather than domestic tax rates and bases. ... withholding taxes on the payment of dividends and interest abroad should be abolished since they are detrimental to the efficiency of the European economy to an extent disproportionate to the revenue they raise.

The Parent/Subsidiary Directive implements this proposal that withholding taxes on dividends be abolished. In addition, on 28 November 1990, the Commission announced a further proposed Directive designed to abolish withholding taxes on interest and royalty payments between parent and subsidiary companies.<sup>4</sup>

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<sup>1</sup> Proposal for a Council Directive (with explanatory memorandum) concerning the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, submitted by the Commission to the Council on 16 January 1969, COM(69) 6 final.

<sup>2</sup> Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, *Official Journal of the European Communities*, no. L225 (20 August 1990) at 6.

<sup>3</sup> M. Devereux and M. Pearson, *Corporate Tax Harmonisation and Economic Efficiency*, IFS Report Series no. 35, October 1989.

<sup>4</sup> Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States, submitted by the Commission to the Council on 6 December 1990, COM(90) 571 final.

### ***Transfer Pricing Procedures and the Arbitration Convention***

- 1.4.4 The two Parent/Subsidiary Directives are principally aimed at resolving which Member State has primary taxing rights in relation to cross-border payments of dividends, interest and royalties. However, the increase in intra-Community trade and financial flows between associated companies is also likely to give rise to the increased use by Member States of transfer pricing techniques designed to protect their tax base.
- 1.4.5 Where one Member State seeks a transfer pricing adjustment which is not mirrored by a corresponding adjustment in another Member State, double taxation of corporate profits may arise. While such adjustments are normally contemplated through the competent authority procedure established under bilateral double tax treaties, such procedures do not guarantee that the competent authorities will actually agree and that the matter will be resolved to the satisfaction of the taxpayer.
- 1.4.6 Accordingly, the third measure agreed at the meeting of Finance Ministers on 11 June 1990 was the adoption of an arbitration convention for transfer pricing disputes.<sup>1</sup> This had its origins in a proposal submitted by the Commission to the Council on 29 November 1976 and is designed to provide a procedure under which enterprises can ensure that transfer pricing disputes involving different national revenue authorities are resolved, if necessary through an independent advisory commission.
- 1.4.7 While the Mergers and Parent/Subsidiary Directives came into effect on 1 January 1992, and may have direct effect in Member States in the absence of implementing domestic legislation, the Convention will only apply once it has been ratified by each of the Member States. Thereafter, the two Directives are intended to continue in force indefinitely, although the Parent/Subsidiary Directive does contemplate that it may

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<sup>1</sup> Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, 90/436/EEC, *Official Journal of the European Communities*, no. L225 (20 August 1990) at 10.

come to an end when a common system of company taxation is introduced. The Convention will, however, only operate for five years from its entry into force.<sup>1</sup>

- 1.4.8 Transfer pricing disputes are notable for the time they can take and the compliance burden that they can impose upon enterprises. Recognising this, the Commission in its April 1990 Communication announced its intention to carry out a systematic examination of Member States' rules and regulations on transfer pricing with a view to making them more uniform. It was also to examine the conditions under which a co-operation procedure could be established between the tax administrations when one of them proposed to adjust the profits of an enterprise.

### *The European Company and Relief for Losses*

- 1.4.9 The final specific proposal in the Commission's Communication concerned the rules for dealing with losses of Community-based enterprises. The proposal for a European Company Statute includes provisions for dealing with the losses of such companies.<sup>2</sup> Under these proposals, the results of any permanent establishments of such a company may be aggregated and relief given for any resulting loss in the Member State in which the company is formed.<sup>3</sup> In 1984, the Commission had also proposed a draft Directive harmonising the basis upon which Member States provided relief for losses under domestic

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<sup>1</sup> While there is some ambiguity as to when the five years begins to run, it is believed that this represents the UK Inland Revenue's view of the matter.

<sup>2</sup> Amended Proposal for a Council Regulation (EEC) on the Statute for a European Company, COM(91) 174 final, submitted by the Commission pursuant to Article 149(3) of the EEC Treaty on 16 May 1991.

<sup>3</sup> A further transparent entity, the European Economic Interest Grouping, also allows losses to be set against the participating companies' profits.

provisions.<sup>1</sup> The Commission now proposed a draft Directive intended to give relief for losses incurred by permanent establishments and subsidiary companies across borders.<sup>2</sup>

## **1.5 The Committee of Independent Experts (The Ruding Committee)**

1.5.1 These four areas of specific action,

- (a) the elimination of tax barriers to cross-border mergers,
- (b) the abolition of withholding taxes on dividends, interest and royalty payments between parent and subsidiary companies,
- (c) the allocation of profits on arm's length principles under agreed transfer pricing procedures, and
- (d) the consolidation of profits and losses on a Community basis,

accordingly represented the focus of the Commission's immediate action on corporate taxation in the light of the move towards the single market.

1.5.2 While the Commission abandoned its 1975 proposal for the harmonisation of corporate tax *systems*, it announced a further study designed to identify the extent to which differences in the corporate tax systems of Member States did distort the development and operation of the single market. The Committee of independent experts, under the

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<sup>1</sup> Proposal for a Council Directive on the harmonisation of the laws of the Member States relating to tax arrangements for the carry-over of losses of undertakings, COM(84) 404 final, OJ C253, 20 September 1984.

<sup>2</sup> Proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States, submitted by the Commission on 6 December 1990, COM(90) 595 final.

Chairmanship of Dr Onno Ruding, was finally appointed in December 1990. The Commission asked the Committee to address the following questions:

- (a) Do disparities which exist between corporation taxes and the tax burdens on companies from one Member State to the next induce distortions in investment decisions affecting the functioning of the internal market?
- (b) If so, can those distortions be eliminated simply through the interplay of market forces and competition between national tax systems or are Community measures required?
- (c) Should any action at Community level concentrate on one or more elements of company taxation, namely the differences in tax treatment associated with the legal status of companies, the tax bases or rates?
- (d) Should any measures envisaged lead to harmonisation, approximation or the straightforward establishment of a framework for national taxation? What would be the effect of such measures or the absence of such measures on Community objectives such as cohesion, environmental protection and fair treatment of small and medium-sized firms?

1.5.3 The Ruding Committee published its conclusions and recommendations on 18 March 1992. Its full Report is not expected to be published until May 1992. Nevertheless, it is on the basis of its recommendations, and reaction to them, that the Commission will decide what proposals it should present to the Council. A preliminary evaluation of those recommendations is made in the following chapters of this Commentary.



## **2 THE RUDING COMMITTEE'S FINDINGS**

### **2.1 Do Differences in Corporate Taxation Cause Distortions?**

2.1.1 Not unexpectedly, the Ruding Committee found that most aspects of the various corporate income tax regimes operated by Member States differed to some extent. The principal differences related to

- (a) the nature of the corporate tax system;
- (b) statutory tax rates;
- (c) the definition of the tax base and the types of tax relief;
- (d) withholding taxes on income flows abroad; and
- (e) the manner of giving relief from double taxation.

Major differences were also identified in relation to the taxation of unincorporated businesses and net wealth. The critical question, however, is whether and, if so, to what extent do these differences *matter*.

### **2.2 Economic Efficiency**

#### *Neutrality in a Domestic and International Context*

2.2.1 With free movement of capital within the Community, and with the elimination of other barriers to business activity in the single market, it would perhaps be surprising if differences in tax regimes did *not* matter. This was recognised by the recent OECD study of corporate taxation,<sup>1</sup> which noted that

Capital Markets in OECD countries are increasingly integrated as Member countries have removed controls on international investment and foreign exchange regulations. At the same time, the proportion of international activities accounted for by large multinational enterprises (MNEs) has increased. One consequence of this gradual liberalisation and globalisation is that international capital flows may have become more sensitive to differences in

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<sup>1</sup>*Taxing Profits in a Global Economy: Domestic and International Issues*, OECD, 1991.

the tax regimes as between countries. Differences in the taxation of corporate profits may now be one of the few remaining potential barriers to a better international allocation of capital. With the commitment of the European Communities (whose Member States now comprise one half of those of the OECD) to establish a single market by 1993, removal of potential obstacles, including tax obstacles, has increased in importance.

- 2.2.2 In considering the neutrality or otherwise of the corporate tax system, account needs to be taken of its impact on
- (a) the level and timing of investment;
  - (b) the type of asset and activity in which the company invests; and
  - (c) the source and type of finance the company raises to enable it to invest.
- 2.2.3 A neutral tax system ensures that a marginal investment - one that is just worth doing in the *absence* of tax - remains worth doing notwithstanding the introduction of a corporate income tax. This requires that all the costs involved in a project are tax deductible. A neutral system also does not discriminate between one asset or activity and another, and does not encourage the use of one form of finance (e.g. debt) over another (e.g. new equity or retentions).
- 2.2.4 To the extent that, *domestically*, a corporate income tax is non-neutral in its effects, there are valid arguments from a domestic point of view for seeking to make it more neutral. This is quite apart from its relationship *internationally* to other, different, corporate tax regimes. Neutrality arguments can be made independently of the globalisation of financial markets and the development of the European single market.
- 2.2.5 Nevertheless, open international capital markets inevitably have an effect on the domestic tax system. Those markets may offer companies and individuals the ability to substitute a more favourable foreign tax regime for a less favourable domestic one. Similarly, the ability to tax inward investment may be dependent upon the way in which other tax regimes seek to tax the return to that investment.

- 2.2.6 The country into which the investment is made and the profit is earned - the source country - will be able to tax the return to that investment so long as other countries also seek to do so and give a foreign tax credit for the source country taxation. In those circumstances the source country might be unwise to give up the tax that other countries effectively allow it to charge. If other countries change their system, however, the source country may be bound to follow suit.
- 2.2.7 That apart, corporate tax systems may be non-neutral in a purely domestic context, even though they are devised by a single tax-policy-making body. The non-neutralities may well be considerably worsened where, internationally, there are other tax-policy-making bodies, each pursuing different policy objectives or, perhaps, the same objectives but through different and incompatible ways. Domestic non-neutralities may, therefore, be magnified many times over in the presence of open international markets.
- 2.2.8 The neutrality of tax systems is normally evaluated in an international context in terms of *capital import neutrality* and *capital export neutrality*. These concepts seek to measure the extent to which tax systems are economically efficient in not distorting the allocation of resources. *Capital export neutrality* is said to exist when investors pay equivalent taxes on the return to their investment regardless of the country in which that return is earned. This is concerned with the efficient location of investment by residents. *Capital import neutrality* exists when all investments within the country face the same tax burden regardless of whether they are owned by a domestic or a foreign investor. This is concerned with the equal treatment of investment by non-residents.
- 2.2.9 Needless to say, neither capital import nor capital export neutrality currently exists between Member States of the European Community. While the solution to domestic non-neutralities may be politically and technically difficult, it is nevertheless within the gift of a single Government. The presence of several competing Governments can make international non-neutralities seemingly insoluble. In particular, the essence of the problem internationally is to ensure a satisfactory and fair basis for dividing tax revenues between different countries in a manner that can be enforced by each of them.

### *The Cost of Capital within the Community*

- 2.2.10 The Ruding Committee noted that the corporate tax component in the cost of capital varied between countries, reflecting the differences in their various tax systems. More significantly, however, this component was generally higher in relation to cross-border investment within the Community than it was for domestic investment. This effect was greater in relation to new enterprises, which rely more heavily on equity funding, than for established enterprises that could rely upon retained profits.
- 2.2.11 Consistent with both the earlier Devereux and Pearson study and the evidence of the OECD Report, the Ruding Committee concluded that dividend withholding taxes were the principal contributor to this bias against intra-Community rather than domestic investment. Other differences, such as the method of double tax relief, withholding taxes on interest and the tax base, rate and system, each contributed to the overall effect but were generally of less significance.<sup>1</sup>

### *The Impact of Taxes on Dividends*

- 2.2.12 In structural terms, this confirms the conclusion that might well have been expected. Corporate income taxes will generally be imposed upon some measure of a company's profits. Under current systems, those profits represent the return to the shareholder on his investment in the company concerned. In this sense, the corporate income tax is taxing the shareholder at source, irrespective of the distribution of those profits to the shareholder. Unless the profits from which the distribution is made have escaped source country tax, therefore, the imposition of a withholding tax represents a *second* layer of taxation on the same profits by the source country.

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<sup>1</sup> While the basic differences in the various corporate tax systems do not appear to be a significant source of discrimination between domestic and foreign investment, the existence of unrelieved imputation taxes, such as advance corporation tax and the *précompte*, do have a greater impact.

- 2.2.13 The distortion caused by a withholding tax is, accordingly, likely to be correspondingly greater than those caused by other differences - for example, in the computation of profit - between two corporate income tax systems. While interest and royalties and similar payments may be subject to a withholding tax at source, that does not reflect a *double charge*<sup>1</sup> by the source country because such payments are likely to be deductible in the source country in computing the paying company's taxable profits.
- 2.2.14 In relation to the country to which the payment flows, the exemption and credit system of double tax relief are both effective to eliminate double taxation to the extent that the source country taxes the flow. While the precise effects of each system may differ, in circumstances in which corporate income tax rates have tended to converge, even those countries, such as the UK, that use the credit rather than the exemption method are in effect close to having an exemption method.

### *Empirical Evidence of Distortion*

- 2.2.15 As part of its work, the Ruding Committee conducted a survey of enterprises in 17 European States to identify to what extent differences in taxation were taken into account. The results of the survey indicate that 48% of the respondents claimed that taxation is always or usually is a *major* factor in the decision as to where to locate a production plant. The corresponding figures for other forms of investment were 38% for a sales outlet, 41% for a research and development centre, 57% for a co-ordination centre and 78% in the case of a financial centre.
- 2.2.16 Again it would be surprising if tax did not enter into location decisions at all. The significance of the responses, however, lies more in the fact that tax was stated by respondents to represent a major factor in these cases. The figures suggest that location decisions in relation to some

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<sup>1</sup> unless they are treated by the source country as a disguised distribution of profit.

activities depend upon a variety of factors of which tax is one, while for other activities tax is predominant. The Ruding Committee concludes that

Such evidence suggests that tax differences among Member States do have a major impact on foreign location decisions of multinational firms and thus cause distortions in competition, especially in the area of financial activities. The outcome is likely to be a misallocation of resources within the Community, resulting in reduced productivity, which in turn reduces the Community's overall competitiveness relative to non-EC countries. However, the Committee has found no satisfactory way of quantifying the size of this misallocation, either in absolute terms or in relation to other market distortions that may exist. Nor is taxation the only important determinant of investment location decisions. Nevertheless, the fact that empirical evidence gathered by the Committee indicates that taxation does have a strong influence on the location of investment and on financing decisions is *prima facie* evidence that the distortions in competition and resulting inefficiency losses caused by taxation could be large.

## **2.3 The Impact of Tax on Location Decisions**

### ***Tax as One of Several Factors***

- 2.3.1 The difficulty in a sense in reaching a conclusion as to the impact of tax on location decisions is that, while experience suggests that taxation *is* a factor that is taken into account and may be perceived as an important element in any location decision, the elimination of tax as a factor may *not* result in the investment being located elsewhere. Other factors may still point to making the investment in the same location. Other potential locations may seek to make themselves more competitive not through their tax systems but through other factors, for example, by making improvements to their infrastructure or through lower wage rates.
- 2.3.2 In other words, tax is a relative factor the degree of importance attaching to which will not depend just on its absolute differential between two systems - one of which may for example offer 100% allowances while the other offers 25% - but on its relative importance in the light of all other factors. These other factors may clearly differ between projects,

so that for one project the 75% differential in tax allowances may be crucial, while for another the distance from the expected markets or the non-availability of labour or suitable housing may, in the event, make the 75% differential of limited significance to the decision.

- 2.3.3 It is for this reason that financial centres are particularly sensitive to tax differentials, perhaps even small ones, because there may be few location factors of significance other than tax that need be taken into account. The tax-driven nature of financing decisions and the location of financial centres is also reflected in the conclusion by the Committee that differences in the tax systems affect enterprises' direct investment decisions and their financial and legal structures.

## **2.4 Location Decisions and Investment in Different Activities and Assets**

- 2.4.1 The tax base and tax rates are likely to be factors not only in relation to decisions as to where to locate a project but also in relation to decisions as to whether to invest in one project rather than another. In relation to *location* decisions, we may not wish to encourage unnecessary distortion through the adoption by different Member States of different tax bases and rates. Nevertheless, the variety of considerations outlined above suggests that harmonisation of corporate income taxes alone may not in practice have a significant effect on location decisions by companies, notwithstanding the response to the questionnaire sent out by the Ruding Committee. Federal countries such as Canada and the US exist with different State or provincial corporate taxes.<sup>1</sup> There might not be a significant gain in terms of *location* decisions from the harmonisation of the tax base.
- 2.4.2 However, that does not mean that harmonisation of the tax base is not important for other reasons. Within a single market, such as the UK, the aim of a non-neutrality of the corporation tax system may be to

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<sup>1</sup> In relation to the US and Canada, see C. McClure, 'European integration and taxation of corporate income at source: lessons from the US', and R. Boadway, 'Corporate tax harmonisation: lessons from Canada', both in *Beyond 1992: A European Tax System*, eds M. Gammie and B. Robinson, IFS Commentary no. 13, July 1989.

encourage investment in some activities while discouraging others. This departure from neutrality may be regarded as a bad thing, but so long as it is only the UK Government that is taking the decisions, it may at least be assumed that the distortion introduced to the system by, for example, providing accelerated depreciation allowances has a rational policy justification. However, where the policy decisions are being taken, not by one Government, but by 12 Governments, the potential for non-neutralities in a single market in which capital can flow freely is considerable.

## **2.5 The Impact of Market Forces and Tax Competition**

- 2.5.1 If distortions do arise from the interaction of the various corporate tax systems, should they be eliminated by market forces or by specific Community action? The absence of agreement between the Member States may mean that market forces are given a free hand. The Ruding Committee noted that there has been a convergence of both corporate and personal tax rates within the Community. On the other hand, the reductions in tax rates have not been accompanied by broadening of the tax base in most countries. In relation to depreciation allowances, for example, there has been little convergence.
- 2.5.2 There has, nevertheless, been a marked convergence in the corporate tax component of the cost of capital across the Community. This is due principally to a convergence in the countries' interest and inflation rates rather than deliberate action on the part of the national tax authorities. This suggests that, as economic and monetary union proceed, the extent to which differences in tax systems really matter may reduce, even though there is no formal harmonisation of the systems, provided the element of double taxation is eliminated from cross-border flows.
- 2.5.3 It is this need to eliminate double taxation in cross-border flows that makes a satisfactory basis for allocating revenues between Member States of such importance.<sup>1</sup> The Ruding Committee found no

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<sup>1</sup> And the allocation in relation to corporate income attributable to equity investment will be reserved to the source country. Under the ACE proposal outlined in Chapter 4, such income can be shared between the source and the residence country.



convincing evidence that unbridled tax competition between Member States would lead to an erosion of the corporate tax base overall. Although it noted, however, that the risk was more serious in respect of the imposition of a withholding tax on interest, which could result in a flight of capital to non-EC countries.

- 2.5.4 Tax competition of itself would not, therefore, justify harmonisation of corporate taxes. On the other hand, the tendency of countries to introduce special tax regimes to attract investment was considered more serious. The Committee concluded that

The case for harmonisation therefore largely rests on the extent to which it removes major distortions in resource allocation and competition and to a lesser extent on whether it enhances the fairness, administrative feasibility, simplicity, certainty, and transparency of taxation in Member States.

## **2.6 The Source Basis**

- 2.6.1 In relation to the overall relationship between different Member States, including the primary right to tax, the Ruding Committee comes down strongly in favour of source-country entitlement, non-discrimination and reciprocity. Thus, it asserts that the source country has the prior right to tax business income from direct investment earned within its jurisdiction. At the same time, a country's tax regime should not discriminate against inward investment by foreign firms and individuals or foreign investment by domestic firms and individuals. Reciprocity usually entails adopting equality of withholding tax rates under bilateral double taxation treaties.
- 2.6.2 On a Community basis the Ruding Committee proposals will result in the allocation of tax in respect of corporate equity income almost entirely to the source State. Is this appropriate? The reason double taxation arises in an international context is that both source and residence countries have generally sought to tax such income. The reason is clear: the source country is able to tax the return to the equity investment because it arises within its jurisdiction. On the other hand, the return to that investment represents the return on capital provided from the residence country. Both countries contribute to the ultimate profit: the residence country by providing the capital and the source

country by providing the infrastructure, labour and other location factors that enable the profit to be earned. To that extent, some sharing of the return on the investment between the two countries would seem more appropriate.

## **2.7 Administrative and Compliance Issues**

- 2.7.1 The Committee noted that the greater the difference in the tax rules of each Member State, the higher the overall costs of compliance. On the other hand, the empirical evidence suggested that compliance costs were not an important determinant of investment location decisions. This is perhaps unsurprising if only because, with the exception of establishment costs (for example, registration with the tax authorities), the main impact of compliance costs is only felt sometime after the location decision has been taken. Those costs are also not very visible in relation to most projects and may well tend to take second place to other regulatory and audit requirements.
- 2.7.2 Compliance costs are relatively more onerous for small and medium-sized businesses and this may discourage them from making cross-border investments. However, it is unclear from the Ruding Committee recommendations to what extent such enterprises are *actually* discouraged, or might indeed represent a significant part of cross-border activity giving rise to *direct* tax issues (rather than VAT ones) if they were not discouraged.
- 2.7.3 One further administrative impediment to investment, however, was the lack of certainty surrounding Member States' tax rules. This may be more apparent prior to making a cross-border investment if there is uncertainty as to the way in which an investment will actually be taxed by the revenue authorities concerned: for example, whether they will regard an investment as a joint venture or a partnership, whether they will allow losses to be deducted from other profits and how profits (including transfer prices) will be calculated. The solutions to such issues, however, involve administrative action rather than measures to harmonise corporate income taxes.

### **3 THE RUDING COMMITTEE RECOMMENDATIONS**

#### **3.1 Implementation**

3.1.1 The recommendations made by the Ruding Committee are summarised in the Appendices. This and the following chapter provide a preliminary evaluation of those recommendations. A number of aspects of the recommendations require elaboration. However, at this stage it is the big picture that is important. The detail can be filled in later if the recommendations are acted upon by the Commission and Member States. The recommendations are intended to be implemented in three phases:

- (a) Phase I, to be implemented by the end of 1994;
- (b) Phase II, on which work is to commence immediately with a view to implementation during the second phase of economic and monetary union; and
- (c) Phase III, which is to be implemented concurrently with full economic and monetary union.

#### **3.2 Taxation of Cross-Border Flows**

3.2.1 In broad terms, the main Phase I recommendations largely endorse the direction that has been pursued by the Commission since 1990. The essential feature of the recommendations is the elimination of the double taxation of flows between entities located in different Member States. Thus the Ruding Committee envisages

- (a) the extension of the Parent/Subsidiary Directive<sup>1</sup> to cases in which a substantially smaller participation is held in the paying company than the current requirement of 25% of capital or voting rights;
- (b) the adoption of the draft interest and royalties Directive and its extension to all such payments between enterprises;

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<sup>1</sup> concerning the distribution of profits between companies of different Member States without withholding.

- (c) the adoption of the Arbitration Convention and the development of common rules and procedures to deal with transfer pricing matters, including the possible adoption of advance rulings on transfer pricing matters; and
- (d) the completion of the bilateral double tax treaty network between Member States.

Finally, as a first stage of a more comprehensive policy for allowing losses to be offset on a Community-wide basis, the Ruding Committee recommends that the draft Directive on losses be adopted.

3.2.2 Looking at the big picture, therefore, its outline appears to be as follows:

1. Cross-border flows *other than distributions of profit* are deductible by the paying enterprise in computing its profits and are brought into account by the recipient as part of its business income.
2. If the cross-border flow is a distribution of an enterprise's profit, that profit is taxed in the source State and either exempted by the receiving State or taxed subject to credit for the source country tax.
3. Double taxation of profits is eliminated by allocating profits between Member States on the basis of transfer prices, if appropriate through the adoption of advance pricing agreements, rather than through formula apportionment.
4. Where an enterprise incurs a loss in one State but makes a profit in another, it should only be taxed on the basis of the overall net profit, even though as a matter of legal form the profit and the loss arise in separate legal entities constituted in different jurisdictions.

### **3.3 The Role of Withholding Taxes within the Community**

#### ***The Dual Function of Withholding Taxes***

- 3.3.1 An essential feature of this structure is that payments are made *without withholding tax*. However, to believe that deduction of tax at source is *of itself* the problem is to confuse the dual role that withholding taxes perform. A withholding tax serves two functions:
- (a) it is a means by which a country *exercises its taxing* jurisdiction over a person in respect of amounts derived in that jurisdiction but which it cannot otherwise tax by direct assessment on that person; and
  - (b) it is a means by which *compliance with tax obligations* is secured even over those whom the paying State has jurisdiction to tax by direct assessment.

A withholding tax on payments between two resident taxpayers serves to illustrate the compliance function. In relation to cross-border payments between two taxing jurisdictions, withholding taxes are normally associated with the first function - i.e. *taxation* by the source country. In that case neither country is concerned with the collection problems of the other. The source country cannot look to the other country to collect its tax. Accordingly, it gets its tax when it can by requiring the payer to withhold.

#### ***The Parent/Subsidiary Directive concerning Profits***

- 3.3.2 In the context of the Parent/Subsidiary Directives concerning dividends, interest and royalties, the abolition of withholding taxes refers to the source Member State *giving up its right to tax* the recipient of the payment. Thus, in the case of a dividend, the source State is entitled to tax that company in respect of the profit earned within its jurisdiction but under the Directives it ceases to be entitled to tax a shareholder in another Member State on the distribution of that profit.

3.3.3 As corporation tax may itself be equivalent to taxation at source, the abolition of withholding taxes in the *taxing* rather than the *compliance* sense eliminates the element of double taxation by the source State. In this respect, an imputation or compensatory tax - such as advance corporation tax or the *précompte* - serves a different function from a withholding tax. It operates to ensure that all profits distributed by the company have borne corporate income tax in the source State. Not surprisingly, therefore, the existing Parent/Subsidiary Directive specifically excludes such taxes from its application.<sup>1</sup>

#### ***The Draft Parent/Subsidiary Directive concerning Interest and Royalties***

3.3.4 This also illustrates the fundamental difference between the Parent/Subsidiary Directive on distributions of profits and the draft parent/subsidiary Directive on the payment of interest and royalties. In the former case, a source State can be more sanguine at giving up its right to tax the shareholder if it has already taxed the corporate income attributable to the equity investment. As interest is deductible in computing business profits, a source State's only opportunity to tax the provider of loan finance is by levying a withholding tax.

3.3.5 The abolition of a withholding tax on interest accordingly represents the source State giving up its *only* tax on that income. While it may frequently agree to do so as part of a bilateral double taxation treaty, this is a result of a process of negotiation under which the source State will have hoped to have obtained corresponding benefits. Within the

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<sup>1</sup>This also accounts for the derogation under the Parent/Subsidiary Directive in favour of Greece which operates a dividend deduction system. As corporate profits paid out by way of dividend bear a zero tax rate in the company because they are deductible, the withholding tax is the only tax on corporate equity income in Greece.

context of the single market, each Member State must believe that the overall benefits that will flow to it from that market make it worthwhile agreeing to implement the draft Directive on interest and royalties.<sup>1</sup>

- 3.3.6 This difference between source country *taxation* of corporate income attributable to equity investment and source country *exemption* of interest and royalties will put pressure on the rules which seek to define the borderline between the two. The principal area in which this will arise is that of thin capitalisation. The Ruding Committee accordingly recommends that the Commission should take action within Phase II to co-ordinate with Member States a common approach to the definition and treatment of thin capitalisation. It may be, however, that the co-ordination of transfer pricing policies and of thin capitalisation rules should also include common rules for identifying disguised distributions of profits.

#### ***The Compliance Function of Withholding Taxes***

- 3.3.7 This, however, leaves open the compliance function of a withholding tax within the single market. One consequence of the single market is that payments between enterprises located in different Member States become akin to *domestic* payments. Thus, although the source State is no longer entitled to tax the recipient of a dividend or of interest when he is located in another Member State, it could still collect tax *on behalf of* the Member State in which the recipient is based by enforcing an obligation to deduct tax at source.
- 3.3.8 This is the stated rationale that lies behind the Ruding Committee's recommendation that a uniform withholding tax of 30% be imposed on dividend distributions by EC-resident companies, subject to waiver if the recipient demonstrates that he is an EC-resident taxpayer. Nevertheless, given the Ruding Committee's further recommendations

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<sup>1</sup> This assumes that a withholding tax is in any event effective. The international capital markets operate on the basis of interest being paid gross because of the reluctance of investors to suffer tax in the source State. It is arguable, therefore, to what extent a source State can effectively collect tax by withholding. If the effect of such source country taxation is merely to put up the cost of capital to its enterprises, those enterprises may just be less competitive internationally.

regarding cross-border portfolio investment,<sup>1</sup> under which the benefit of the corporate income tax paid in the source country may be extended to shareholders resident in another Member State, the imposition of a withholding tax to secure compliance seems less necessary, certainly at a 30% rate.

- 3.3.9 The imposition of a withholding tax in such circumstances must be predicated on the basis that the State in which the shareholder is resident will impose a further substantive liability in respect of the distributed profits. While this may be the case in those countries which adopt a classical system, this will presumably not be the case in those countries which adopt an imputation system - at least if the Ruding Committee's other recommendations are adopted.

#### *Payments to Third Countries*

- 3.3.10 In this respect there is a greater rationale in requiring a common rate of withholding on dividends paid to persons resident in *third* countries rather than persons in other Member States. If Member States remain free to set their own policies for cross-border flows to third countries, withholding tax rates are likely to be eliminated by competition between Member States to attract base or holding companies which can then gather in profits of subsidiary enterprises across Europe without withholding before repatriating those profits to the third country.
- 3.3.11 The Ruding Committee proposes that the Commission and Member States should define a common policy stance to double taxation agreement as between themselves and as regards third countries. However, the imposition of a 30% withholding tax on dividend payments to third countries may be a lost cause, given the existence of favourable holding company regimes in a number of Member States, in particular the Netherlands and Luxemburg. Those regimes give rise to difficulty under the existing Parent/Subsidiary Directive, which allows Member States to continue to impose withholding taxes where necessary to counter fraud or abuse.

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<sup>1</sup> See Section 3.4 below.



- 3.3.12 Were this provision to be used by each Member State to counter any arrangement which reduced, overall, the withholding tax suffered on investment into the Community from third countries, the beneficial effect of the Directive could be very substantially reduced. While the countervailing benefits of a reduction in withholding taxes on dividends under a bilateral double taxation treaty can be assessed, this is more difficult on a Community-wide basis.
- 3.3.13 The imposition of a common withholding tax on dividends paid to third countries may bring some order to the system and enable the Community to negotiate a reduced withholding rate to be applied by all Member States in relation to investment from a particular third country. On the other hand, this would require the modification of the existing bilateral double taxation network as it affects all Member States, a process that should keep treaty negotiators in business for the foreseeable future.

#### *Withholding Taxes on Interest*

- 3.3.14 As previously explained, a dividend under current tax systems represents a *post-tax* payment. Interest paid without withholding is an untaxed payment. As such, the arguments for ensuring that it travels in taxed form are considerably greater. This would involve the imposition of a withholding tax on interest on cross-border payments to act as a compliance tool for the receiving Member State even though it has been agreed as between the source and the receiving State that the latter's taxing rights shall prevail.
- 3.3.15 This has been a further reason for the delay in adopting the draft parent/subsidiary Directive concerning interest and royalties. However, the general difficulty in imposing withholding taxes on interest is reflected in the fact that the international capital markets operate on the basis that interest is paid gross. Previous attempts by the Commission

to propose a common withholding tax on interest have come to nothing and the failure of the German withholding tax in 1989 has been taken as indicative of the difficulty of action in this area.<sup>1</sup>

- 3.3.16 To the extent that a Community-wide withholding tax operated merely to ensure compliance with Member States' own regimes for taxing interest, it might have some prospect of success. It is not clear, however, that it would operate effectively to the extent that the capital concerned was derived from third country sources. In this respect, precisely the same difficulties arise in relation to interest payments as were discussed previously in respect of dividend payments to third countries. If the effect of a withholding tax is merely to raise the cost of capital to enterprises within the Community, its benefit to Member States in revenue-raising terms may be negated.

#### *The Impact on Domestic Withholding Tax Rules*

- 3.3.17 A final point to note is that the more general elimination of withholding taxes on cross-border flows between enterprises would be likely to have an impact on the use of domestic withholding taxes to ensure compliance with domestic tax obligations. Subject to any anti-abuse rules, enterprises may prefer to pay gross across borders and avoid the cash flow effect of deduction at source on domestic payments.

### **3.4 Cross-Border Taxation of Dividend Income**

#### *The Elimination of Double Taxation*

- 3.4.1 Where interest or royalties are paid across borders, the State of the recipient company is free to tax those payments. No question of double taxation arises. Unless it has treated the payment as a disguised distribution of profit, the source State will have taxed neither the payment itself nor the income that supported that payment. The same

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<sup>1</sup> A withholding tax at 10% was imposed by Germany with effect from 1 January 1989. It was withdrawn on 2 July 1989 and the German Government estimated that DM120 billion flowed out of the country in response to the tax. New proposals were made in 1991 for a 25% withholding tax on interest.

position applies in relation to other payments for goods or services supplied across borders unless they are connected with a permanent establishment in the source State.

3.4.2 In the case of dividends, however, tax will have been charged by the Member State of the paying company on the profits distributed, albeit no longer by way of withholding. In this case the Member State in which the shareholder is resident will have a choice as to whether to give relief from double taxation by way of the credit or exemption method. Both methods are contemplated by the Ruding Committee. Its preference, on grounds of administrative simplicity, is for the exemption method subject to the adoption of its proposals regarding the tax base and tax rates.

3.4.3 Although double taxation will be eliminated at the corporate level, double taxation of those profits will arise if they are distributed on by the recipient company and that distribution is taxed in its own right. To the extent that companies need to raise equity capital to finance investment, the present European corporate tax systems discriminate in favour of domestic investment. Capital markets are as a result fragmented within the Community. This is principally because corporate tax systems that give relief in one way or another to the shareholder for the tax suffered at the corporate level on profits that are distributed do not extend that relief in respect of *foreign* rather than *domestic* tax paid by the company.

### ***The Surplus ACT Issue***

3.4.4 It is an issue epitomised by the surplus advance corporation tax (ACT) issue in the UK but which can also arise under the French or German systems, to name but two. The surplus ACT problem may be illustrated if we assume a European subsidiary of a UK parent earning profits of 100 on which it pays tax of 30. Under the Parent/Subsidiary Directive the after-tax profit of 70 can be remitted without withholding tax to the UK. The UK parent will have a residual corporation tax liability of 3. It can distribute 52.5 attracting an ACT liability of 17.5 and surplus

ACT written off of 14.5 after credit against the mainstream tax. On an equivalent 100 of profits earned in the UK, the company could distribute 67.

3.4.5 It is worth emphasising that the current UK imputation system in fact gives rise to two separate but related issues:

- (a) it discourages the use of the UK as a base or holding company location for investment within the Community;
- (b) it discriminates against those UK-based multinational companies that derive a certain proportion of their taxable profits from abroad.

The first of these arises because the ACT system ensures that foreign income passing through the UK bears UK tax even though it has also been taxed in another European jurisdiction. Countries such as the Netherlands, Luxemburg and France which have adopted favourable holding company regimes effectively exempt such profits from tax.

3.4.6 For the great majority of companies, the ACT system does not pose a particular problem. The stacking rules employed in the UK permit ACT to be set first against UK source income. Thus, if we assume that a company pays out 40% of its available profits, its foreign source income taxed at UK-equivalent rates must represent around 50% of its profits on an ongoing basis before it is likely to give rise to a permanent surplus ACT problem.

3.4.7 Surplus ACT is, however, a problem for two reasons:

- (a) It distorts investment decisions by those companies with the problem. Depending upon whether a company has no ACT problem, a temporary problem or a permanent problem, a company faces a very different marginal tax rate on an additional £1 of UK income. The incentive is to acquire UK sources of income and to incur expense outside the UK.
- (b) It prevents the formation of truly European enterprises, thus putting European entities at a disadvantage compared, for example, with non-EC enterprises such as US and Japanese enterprises.

To the extent that it is a problem across imputation systems within Europe, it may also act as an inhibition on the development of European capital markets.

### *The International Tax Policy Issue*

- 3.4.8 The objective of an integrated system of corporate taxation is to ensure that corporate profits are only taxed once rather than twice - once at the corporate level and again at the personal level. The problem on cross-border dividend payments arises because, while international double taxation is generally eliminated at the *corporate* level through the exemption or credit system, few countries are prepared to extend the benefit of the foreign tax credits to the personal level. Thus, domestic profits under an integration system are taxed once, normally at the corporate level with credit for the corporate tax at the personal level. Foreign profits are taxed once - normally in the source country - so long as they are held at the corporate level. As soon as they are distributed, however, they bear further tax.
- 3.4.9 In this respect it can be noted that one of the policy recommendations made by the US Treasury in its report on personal and corporate tax integration in the US<sup>1</sup> was that foreign taxes should not be treated as equivalent to US taxes as integration could then eliminate all US taxes on foreign source profits. This caused the Treasury to propose either a corporate-level compensatory tax or shareholder-level tax on the distribution of foreign source profits and to reject a proposal for taxing corporate profits at shareholder level by way of allocation.
- 3.4.10 While this may be a legitimate international tax policy stance where genuine issues of domestic and foreign investment have to be addressed, the distinction between domestic and foreign does not exist so far as profits arising in different Member States are concerned if the single market is viewed from a wholly European perspective. The Chancellor

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<sup>1</sup> *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once*, US Treasury, January 1992.

put his finger on the issue precisely when he said in his March 1992 Budget Speech that from 1 January 1993, the single market ‘... will give British business access to the largest *home market* in the world’.

### ***Solutions and the Ruding Committee Recommendations***

- 3.4.11 The importance of the issue depends in part upon whether companies finance their investment from retained profits or from new share issues. If the company uses retained profits, the exemption or credit system at the corporate level is effective to eliminate the double taxation and the further charge on the distribution of profits to shareholders is less distortive.<sup>1</sup>
- 3.4.12 If, however, the company raises new equity capital upon which it must pay dividends, the problem is of a different character. In the UK the high dividend payout ratio, coupled with the high degree of overseas investment - a consequence in part of UK history and of its position as an oil-producing country - serves to magnify an issue that exists under other imputation systems. The fact that ACT is creditable against future tax liabilities, rather than being paid and forgotten, as is normally the case in other countries which impose an imputation or compensatory tax, contributes to the difficulty.
- 3.4.13 However, whatever the particular problems for the UK in this regard, the fact remains that the development of a single capital market for equity investment within the Community and of European-wide enterprises corresponding in size to their US and Japanese counterparts may well be inhibited without change in this area. A solution that has often been put forward has been to allow imputation credits to be paid across borders within the Community. This, however, poses particular problems for so long as different forms of shareholder relief systems

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<sup>1</sup> In this scenario, domestic profits retained by the company still bear corporation tax which, because they are not distributed, is not imputed to the shareholders. Shareholders may be taxed on any capital gains that they realise. Capital gains taxes are essentially classical in nature because double taxation is not relieved except to the extent that the price that can be realised reflects the prospect of future imputation. Accordingly, on this view, the discrimination against non-domestic investment is reduced because both domestic and foreign investment suffer a single charge at the corporate level and shareholders are taxed (or not) equally on capital gains.

operate within Member States and some Member States retain a classical system of corporation tax under which no relief is given at the personal level for tax paid on profits at the corporate level.

3.4.14 In relation to the UK, its willingness to allow the imputation credit to be repaid under bilateral double tax treaties to shareholders in non-Community States would have the effect, in the absence of other measures, of extending cross-border imputation within the Community to third countries. To address this problem while allowing different corporate tax systems to co-exist within the Community, each Member State needs to tax domestic and foreign source dividends equally and, to the extent that foreign dividends are routed through domestic companies, they need to retain their character for these purposes as foreign source dividends.<sup>1</sup>

3.4.15 This is essentially the solution proposed by the Ruding Committee. It explicitly rejects conferring the benefit of the imputation credit across borders as contrary to the source basis of taxation for corporate equity income that it espouses. Instead it proposes that

- (a) Member States which apply an imputation system should be obliged, on a reciprocal basis, to allow corporate income taxes paid in other Member States to be offset against their imputation taxes (such as ACT) where income derived from that other State is redistributed; and
- (b) those Member States which extend tax relief for dividends received by domestic shareholders from domestic companies should be obliged, on a reciprocal basis, to provide equivalent relief for dividends derived directly from companies in other Member States.

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<sup>1</sup> For a more detailed description of the issues and this solution, see M. Gammie, 'Imputation systems and foreign income: the UK surplus ACT problem and its relationship to European corporate tax harmonisation', *Intertax*, 1991/12, p. 545.

### *Implications for the UK System*

- 3.4.16 These recommendations, if implemented in the UK, will go some way to remove the surplus ACT issue and to remove the barriers to UK companies expanding within the Community. It is, of course, true that a considerable part of overseas investment by UK companies is outside the Community - in particular into the US. To the extent that the adoption of a Community solution shifts the UK imputation system to favouring European investment (rather than just UK investment) against third country investment, this might be regarded as a satisfactory policy position.
- 3.4.17 However, it raises the question as to whether it would be possible (or sensible) in this respect to adopt a purely Community solution: in other words, once dividends can flow within the Community without withholding, will it be possible to isolate profits ultimately derived from outside the Community as compared with those that are derived within it? To the extent that the Ruding Committee recommendations also appear to suggest that the relief should only be given on a reciprocal basis, this might also require dividends to be identified with profits earned in particular Member States. If the solution to this issue is to be approached only on a bilateral basis, a more fruitful course might be to allow countries to agree bilaterally to repay imputation credits across borders. However, such bilateral solutions could well just prolong the distortions in cross-border investment that arise from this issue.

### *The Exemption of Foreign Source Dividends*

- 3.4.18 A feature of the UK domestic taxation of dividend income is that it is not subject to further taxation in the hands of the majority of shareholders.<sup>1</sup> In addition, the UK repays the domestic tax credit to UK exempt investors - notably pension funds and personal equity plan (PEP) portfolio investors. The Ruding Committee accepts that the cost

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<sup>1</sup>The majority of shareholders will either be exempt or liable to tax at the basic rate, which the tax credit discharges.



of its recommendations must fall on the residence country if the principle of source country taxation of corporate equity income is to be maintained.

- 3.4.19 While the UK can adopt a system under which other Member States' taxes can be set off against the liability to pay ACT, it could not accede to a system under which it repaid the tax credit representing ACT that had never been paid to the UK Treasury. While denying repayment of the tax credit to tax-exempt investors might reduce the size of this problem, it would not prevent repayment of tax to individual portfolio investors or foreign investors under a double tax treaty.
- 3.4.20 The solution for the UK, therefore, would seem to be either to revert to a classical system of corporation tax or to exempt foreign source dividends from tax at the basic rate. Thus in the example in paragraph 3.4.4, the company would be free to distribute 67 of its European subsidiary's remittance - the same as in the case of UK profits.<sup>1</sup> Such an approach would also resolve the unfavourable treatment of holding companies under the existing ACT system.
- 3.4.21 Clearly, however, whatever the solution, there is a cost attached to it so far as the UK is concerned. This is likely to be the most difficult aspect of the recommendations for the UK Government, whatever its complexion.<sup>2</sup>

### **3.5 Transfer Pricing and Relief for Losses**

- 3.5.1 The Ruding Committee envisages that the allocation of profits between Member States will be made on arm's length principles based on co-ordinated transfer pricing policies. In reaching this conclusion, the Ruding Committee implicitly rejects the adoption of a unitary basis

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<sup>1</sup> A tax-exempt investor would still do better out of UK profits as it would be entitled to repayment of a tax credit. No tax credit would attach to the foreign source dividends. However, in this case the UK is effectively exempting domestic profits from tax entirely.

<sup>2</sup> This is an issue that arises from the allocation of the corporate tax revenues between Member States that must arise from any proposed solution. The UK would no doubt wish to review its policy of extending partial repayment of the tax credit to other Member States under its bilateral double tax treaties.

within Europe. Under such an approach the consolidated profits of European-wide enterprises would be allocated between Member States on the basis of specified factors, such as payroll, property and sales.

- 3.5.2 This system is used by a number of States in the US where the attempts by some to use it on a world-wide basis have tended to bring it into disrepute. The objections to such a system are considerably reduced if a 'water's edge' approach is adopted, in this case the water's edge being the borders for the time being of the European Community.
- 3.5.3 A unitary basis can obviously overcome many of the problems associated with taxing permanent establishments which otherwise exist under an arm's length approach. In this respect, one reason for its adoption in the US is the absence of separate accounting by States to determine the geographical source of income earned by a single company operating within several States.<sup>1</sup> A company operating within a number of Member States exhibits the same characteristics and the adoption of an arm's length approach effectively requires separate accounting of some sort for its permanent establishments.
- 3.5.4 A formula apportionment approach needs to operate on a consolidated basis between associated companies if opportunities for abuse are to be avoided. In the absence of a consolidated basis, European-wide enterprises would have the choice of being taxed on a unitary basis where they operated through permanent establishments or on an arm's length basis where they operated through subsidiaries. Apart from the administrative implications of such an approach, the opportunities for tax avoidance could be considerable.
- 3.5.5 On the basis, therefore, that formula apportionment would need to be implemented on a Community-wide consolidated basis, its immediate adoption would not appear to be a practical possibility. Nevertheless

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<sup>1</sup>For a discussion of the issues raised by unitary systems in the context of the single market, see C. McClure, 'European integration and taxation of corporate income at source: lessons from the US', in *Beyond 1992: A European Tax System*, eds M. Gammie and B. Robinson, IFS Commentary no. 13, July 1989.

in the longer term, the development of European-wide enterprises is likely to make the adoption of an arm's length standard more and more difficult to apply.<sup>1</sup>

3.5.6 This difficulty is recognised by the suggestion in the Ruding Committee recommendations that advance pricing agreements might be contemplated, so following the lead of the US in this respect. Such agreements may tend towards a formula apportionment basis when struck between the enterprise and the Member States concerned. Nevertheless, the essential difficulty faced by tax administrators in applying such an arm's length standard to multinational enterprises was succinctly stated by Bird as follows:<sup>2</sup>

Tax administrators face substantial problems in determining precisely what profits are subject to tax. ... These problems largely arise from the widespread acceptance of the 'fiscal myth' that every subsidiary of a multinational enterprise is a completely separate entity operating at arm's length from its parent and other subsidiaries. That this is a myth is obvious from the very existence of such enterprises. The essence of a multinational firm, its competitive edge as it were, is its ability to operate as a single entity in world financial and technological markets, thus achieving higher net revenues from its operations as a whole than could be achieved under separate management<sup>3</sup> on an arm's length basis.

3.5.7 A formula apportionment basis does not necessarily require a common tax base. In the US, States are relatively free to define taxable income as they wish although in practice many follow the federal government's definition of taxable income with minor modifications, and the same is the case in Canada. One effect of a unitary basis is that the benefit of incentives such as accelerated depreciation introduced by one

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<sup>1</sup> Apart from the proposals in relation to transfer pricing, this is also recognised by the recommendation that common rules should be established for the allocation of headquarters' costs and centrally provided services.

<sup>2</sup> R. Bird, 'Shaping a new international tax order', *Bulletin for International Fiscal Documentation*, vol. 42, July 1988.

<sup>3</sup> If local management are remunerated on the basis of results, they will have an incentive to act as an independent enterprise in so far as they are given freedom to do so. To the extent that a unitary basis looks to payroll, the sharing of results in this way would to some extent be reflected in the basis.

Member State would be spread amongst others adopting the unitary basis, unless confined for example to equipment situated in the local State.

- 3.5.8 The adoption of a unitary basis could clearly have a major effect on the allocation of corporate tax revenues around Europe. It would be entirely possible for one State in which an enterprise made losses to collect tax by reference to profits made elsewhere. It may also lessen the impact of high tax rates in a particular jurisdiction. So long as a source basis operates, investment in a high tax jurisdiction is likely to be discouraged. Under formula apportionment it may not, given that the State will tax only a proportion of the profits at the high rate. In that case the discouragement is to the location of the factors that go into the formula in the high tax State rather than profits themselves.
- 3.5.9 The issues raised by the proposals for allowing losses on a Community-wide basis are not dissimilar to those raised by formula apportionment. While specific measures might be proposed to ensure that distortions between permanent establishments and subsidiaries are eliminated, the difficulties of dealing with losses in a domestic group can be considerable, quite apart from those involved in a Community-wide group. Allowing parent companies to claim relief for losses incurred by subsidiaries in other Member States clearly has revenue implications for the parent company State, quite apart from the difficulty in ensuring that relief for the loss is not given more than once and ensuring that profits are taxed on a corresponding basis.
- 3.5.10 It is not surprising, therefore, that the draft losses Directive has made little or no progress. To the extent that there is a concern to eliminate the distinction between permanent establishments and subsidiaries within the Community, an easier direction for immediate action would be to build upon the source country concept adopted in relation to cross-border flows. Under this approach, profits and losses arising

within a permanent establishment would only be taxed (and relieved) in the source country and would be exempt in the enterprise's home country.<sup>1</sup>

- 3.5.11 More fundamental proposals for dealing with losses on a Community-wide basis would seem to go hand in hand with the taxation of profits on the same basis. As such, it would form part of a more comprehensive proposal for a European corporate tax system.<sup>2</sup>

### **3.6 Recommendations for the Tax Base**

- 3.6.1 The recommendations of the Ruding Committee considered above are concerned principally with cross-border flows, whether in the form of dividends, interest or royalties or the supply of goods and services. The remaining recommendations of the Ruding Committee consist of a variety of detailed measures to harmonise the tax base of the different corporate tax systems. This process is intended to start in Phase I with the appointment of an independent committee of technical experts to examine and make recommendations for action on various aspects of the tax base identified by the Ruding Committee.
- 3.6.2 The principal recommendations regarding the tax base are, in summary, as follows:
1. harmonised depreciation based on historic cost, with a choice of declining balance or straight-line methods;
  2. harmonised depreciation of goodwill and intangibles;
  3. harmonised leasing rules;
  4. a choice of LIFO, FIFO, average cost or base stock methods for inventory;

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<sup>1</sup>The Ruding Committee recommendations would allow the company to distribute the profits attributable to the permanent establishment with the benefit of the source State taxation. In the case of the proposals discussed previously in relation to the UK, such profits would be treated as foreign source and dividends out of them would be exempt in the shareholders' hands.

<sup>2</sup>This would not, however, prevent the adoption of common rules across the Community for dealing with domestic loss reliefs, as proposed by the Commission in 1984.

5. harmonised deductions for provisions including bad debts and foreign currency losses; and
  6. harmonised capital gains taxation based on an indexed system with roll-over relief on business assets and controlling shareholdings.
- 3.6.3 Given that the major distortions to cross-border investment arise from the taxation of cross-border flows, the question arises as to whether it is necessary to harmonise the tax base. This was discussed in relation to location decisions in the previous chapter. Assuming, however, that harmonisation of the tax base is considered necessary or desirable, the question is whether a tax base along the above lines is the correct one to adopt.
- 3.6.4 This question is particularly pertinent, given the considerable effort that would undoubtedly be needed not only to formulate the necessary Community measures but also for Member States then to implement such measures, which may have a substantial impact on their current tax systems. It might, for example, be concluded that it would be as easy for the Community actually to adopt a European Corporation Tax system that would be adopted lock, stock and barrel by Member States to replace their existing corporate tax bases.
- 3.6.5 That said, a number of immediate comments can be made on the proposals made by the Ruding Committee:
1. On the basis that cross-border dividend flows are taxed in source States and may well be exempt in receiving States, the exemption of controlling shareholdings in subsidiary companies would seem to be a sensible position. Generally, a reason for maintaining a capital gains tax charge on the disposal of such shareholdings is to prevent the indefinite deferral of capital gains on the underlying assets of the subsidiary. However, if such assets are normally to be entitled to be rolled over on reinvestment, the justification for taxing shareholdings disappears. On the other hand, this allows virtually permanent deferral of tax on business assets.

2. The ability to choose a LIFO basis for stock introduces a measure of CCA adjustment to the system. Ultimately the whole of the nominal profit arising on stock may be taxed, but the effect of the system is to defer realisation and taxation until stock levels are fully wound down.
  3. This measure of indexation for stock is matched by some indexation of capital gains but depreciation allowances are to be calculated on an historic cost basis. At the same time no proposals are made for any monetary working capital adjustment and nominal interest will remain fully deductible in computing profits.
- 3.6.6 The result is a system with some elements of indexation but by no means a coherent overall attempt to adjust the profits tax base for inflation. From the UK's perspective, the profits tax base will be narrower. The overall impact of the recommendations produces a tax base that is neither fish nor fowl. The adoption of such a base across the Community would clearly reduce the various distortions that are currently created for location decisions by enterprises. It would also make it more difficult for individual countries to use their corporate tax systems to provide particular incentives, without that being readily apparent. Both of these were explicit aims of the Ruding Committee recommendations.
- 3.6.7 However, it is by no means clear that the degree of distortion arising from the current differences in the tax base warrants the undoubted effort that will be involved in implementing the proposals. In large part this stems from the fact that the final result may not be overall a more neutral and less distortive corporate tax regime. If greater neutrality is what is really required from changing corporate tax systems within Europe, the measures outlined in the next chapter of this Commentary offer a more satisfactory way forward.

### **3.7 Tax Rates**

- 3.7.1 The Ruding Committee proposes a maximum and a minimum corporate tax rate and the integration of local corporate income taxes into those rates. This latter point primarily affects Germany and Italy. The desire to establish a minimum rate might be seen as a worthy objective in so far as it is designed to protect one Member State against the reduction of corporate tax rates in other Member States. On the other hand, looked

at in other terms - i.e. holding *up* tax rates in one Member State for the benefit of other Member States - it may seem rather less appropriate, especially given the non-neutral effects of current corporate tax systems. Such a proposal must also deal with the issues it raises for Ireland, with its 10% manufacturing tax rate and, indeed, the UK with its small companies rate of 25%.

- 3.7.2 The need for a maximum corporation tax rate and for the incorporation of local taxes into that rate seems even less clear. If particular countries wish to make themselves uncompetitive in terms of tax rates as compared with other countries, that must be a matter for them. In addition, so long as different tax systems exist within Europe, the divergence of tax rates will to some extent reflect the difference in corporate tax systems. Thus the nominal rates of 25 or 33% in the UK may through the imputation system become an actual rate of corporation tax of between zero and 10.67%.
- 3.7.3 The Commission's draft 1975 Directive for a common imputation system proposed tax rates within bands of 45 to 55%. This now looks distinctly out of date. While it may be thought that corporate tax rates have currently reached some sort of equilibrium between 30 and 40%, the increasing globalisation of markets may make the establishment of minimum corporate tax rates within the Community difficult to maintain. A minimum corporate tax rate must clearly not operate as an inhibition to further reduction of corporate tax rates within the Community if that is a necessary response to the reduction of corporate tax rates *outside* the Community.
- 3.7.4 Nevertheless, while headline tax rates may have some impact on investment decisions, it is by no means clear that multinational businesses fail to perceive the real effect of the corporate tax system on their activities in terms of its impact on the post-tax return they earn. If this were not the case, countries would uniformly reduce their corporate tax rates and no longer bother with the 'hidden' incentives in the form of accelerated depreciation that concerned the Ruding Committee.



3.7.5 Thus, while the pre-1984 corporation tax system in the UK distorted investment decisions, it did so because of the way in which investment in particular assets and activities was favoured, so producing for many companies a zero tax rate notwithstanding a headline rate of 52%. This illustrates that the focus on tax rates inevitably tends to detract from the real issue of identifying a satisfactory tax base to which to apply that rate.

## 4 A EUROPEAN CORPORATION TAX SYSTEM

### 4.1 The Rationale for Taxing Companies

#### *Relationship with the Personal and International Tax Systems*

4.1.1 The full Report of the Ruding Committee has yet to be published and an overall assessment of the analysis that has led to its conclusions cannot yet be made. In the course of its deliberations, however, we might expect that the Committee would have asked itself what role it believed corporate income taxes should play within the Community. On the basis that the true burden of any tax that is imposed upon a company will ultimately fall upon one or more of its customers, employees or suppliers of capital, we might ask why we should wish to tax companies at all.<sup>1</sup> Abolition of corporate income taxes would certainly be a final solution to the problem of harmonisation.

4.1.2 Generally speaking a corporate income tax fulfils two principal functions:

- (a) on the basis that the personal tax system is designed to tax income,<sup>2</sup> the corporate tax system acts as a necessary 'anti-avoidance' device to ensure that personal income tax is not indefinitely deferred by retaining and reinvesting the profits attributable to the suppliers of equity capital to the business; and
- (b) to the extent that the supplier of capital is based outside the taxing jurisdiction and is subject to tax on the return to his capital in his country of residence, it enables the source country to 'poach' part of the tax revenues of the residence country by ensuring that that return to capital is taxed first in the company.

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<sup>1</sup> For a more detailed examination of the issues that arise from this question, see M. Gammie, 'Reforming corporate taxation: an evaluation of the US Treasury Integration Proposals and other corporate tax systems in an international context', *British Tax Review*, forthcoming, 1992.

<sup>2</sup> This assumption is one that must clearly be tested in relation to each Member State. In the UK the personal tax system is a long way from being an income tax system given that the majority of equity investment is held by tax-exempt investors. The US Treasury study on integration also highlights the extent to which equity investment in the US is held by tax-exempt investors.

### *Taxing Accruals*

- 4.1.3 Given an income tax in the personal sector, corporate tax systems are an essential element of domestic tax systems for the taxation of personal savings. As such, the corporate tax system must be consistent with the policy objectives of the personal tax system and will generally be designed to correct for one or more deficiencies in the personal tax system. The most apparent deficiency is likely to be that income should ideally be taxed on an accruals basis but, in practice, most income tax systems have to rely heavily on taxing realisations, with the opportunities that offers to taxpayers to defer taxation.
- 4.1.4 In seeking to correct this deficiency, three particular problems have to be resolved in the relationship between the corporate and personal tax systems:
- (a) *what to tax*, ie income received or income accrued: this particular problem affects both the computation of corporate profits and the taxation of the shareholders' capital gains;
  - (b) *when to tax*: in the absence of an accruals basis, profits may arise to the company without being matched by any immediate receipt by the shareholder and the shareholder may realise a gain on his shares in anticipation of the company's future profits, either of which may then lead to the same profit being taxed twice; and
  - (c) *at what rate to tax*, given that companies will normally be taxed at a single rate and shareholders at a variety of rates.
- 4.1.5 These difficulties can be identified both in a domestic context and in an international context and are reflected in the combination of the corporate tax base, tax system and tax rate. In this respect, the integration of domestic personal and corporate tax systems is designed to alleviate these problems. As a result within a single jurisdiction it may be that some overall symmetry can be discerned between the two.

## *The Structure of the Personal and Corporate Tax Systems*

- 4.1.6 In the UK, corporate income used to service loan capital is exempt from tax while nominal interest income is fully taxed in the hands of the lender without adjustment for inflation. On the other hand, corporate equity income is taxed on what is largely a nominal profits base while shareholders are either not taxed or, at least, are taxed on inflation-adjusted gains.<sup>1</sup> The effect might very broadly be said to ensure that, overall, the nominal return to capital invested in the company in whatever form is taxed once, either in the hands of the company or those of its suppliers of capital.
- 4.1.7 Given that the balance between personal and corporate tax systems is likely to differ in different taxing jurisdictions, the difficulties of harmonising one element of those systems - the corporate income tax - are likely to be considerable. The Ruding Committee concluded that

Given that the rationale underlying the corporation tax may differ from one country to another, particularly in an international context, and each type of system has its own merits and shortcomings, it is unlikely that all Member States would be willing to accept the same type of corporation tax system in the near future.

However, the difficulty involves not just the *system* of corporation tax, but also its base. In the light of the stylised description of the UK system given above, it can be seen that proposals to adopt a corporate profits base that is fully indexed could potentially destroy the balance between the corporate and personal tax systems.

## **4.2 Criteria for a Harmonised Corporate Tax System**

- 4.2.1 These issues illustrate the difficulty of harmonising one element of the system without addressing all of them. Nevertheless, this is not to say that the attempt should not be made, nor that with the development of

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<sup>1</sup> Indexing capital gains on corporate equity might be said to reflect the view that dividends represent the real return on equity investment as the company will not distribute the profits it needs to maintain its real value.

the single market and economic and monetary union, it will not be necessary. The question then is to identify the best way of going about it.

4.2.2 The Ruding Committee considered that further efforts should be made during Phase I to identify the basis of a fully harmonised corporation tax system for implementation in the longer term within the Community. For the reasons outlined in the previous chapter, it is by no means clear that the proposals for harmonising the tax base represent the best way forward, or a necessary step other than as part of a more fundamental harmonisation of both the tax base and the tax system. It must be doubtful whether Member States would wish to pursue such proposals for harmonising the tax base if a different course of development were to emerge from further study of a longer-term solution.

4.2.3 The criteria identified by the Ruding Committee against which any proposals for a European corporation tax system might be judged are as follows:

- neutrality between different legal structures;
- neutrality between different methods of financing;
- neutrality between distributed and undistributed profits;
- neutrality between investment in the equity of domestic and other Member State companies;
- the need to create a strong European equity market;
- the fair distribution of tax revenues between source and residence States; and
- practicality, simplicity, transparency, collection and enforcement.

4.2.4 The proposals for harmonising the tax base fall short of such objectives. On the other hand, they would largely be realised through the adoption of the ACE system of corporation tax that has been proposed by the IFS Capital Taxes Group.<sup>1</sup> This is outlined below.

### **4.3 An Allowance for Corporate Equity (The 'ACE' System)**

#### *The ACE Allowance*

4.3.1 Under the ACE system, companies would be entitled to deduct an amount (the 'ACE allowance') in calculating their profits equal to a nominal rate of interest (the 'ACE rate') on their shareholders' funds. The ACE allowance can in effect be regarded as equivalent to the company making provision for future dividends. Thus, the actual payment of dividends would reduce the amount of the ACE allowance. To calculate the allowance the company would maintain in its books a shareholders' funds account (SFA) which would be adjusted as indicated below.

4.3.2 The SFA would be adjusted by reference to actual payments and receipts of money by the company. This makes the operation of the SFA relatively straightforward because

- (a) it ensures that the time at which an adjustment has to be made is readily identifiable by reference to the payment or receipt in question;
- (b) it ensures that the amount of the adjustment can be determined by reference to an ascertainable amount or value; and
- (c) it ensures that the ACE allowance for any period can be determined at the end of the period by reference to the balance of the SFA over the period and will not be subject to any subsequent adjustment.

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<sup>1</sup> IFS Capital Taxes Group, *Equity for Companies: A Corporation Tax for the 1990s*, IFS Commentary no. 26, April 1991. Further examination of this proposal will be contained in the final report of the Capital Taxes Group to be published in May 1992.

An illustration of the amounts that contribute to or reduce the SFA is given in Table 1.

TABLE 1 Shareholders' Funds Account
The closing value of shareholders' funds in the previous period + The ACE allowance for the previous period = The opening balance for the period
Additions during the period include: + Total taxable profits (i.e. net of the ACE allowance) in the previous period* + Proceeds of new equity issues + Dividends received from other companies + Amounts received on the disposal of shares in other companies + Tax repaid on an adjustment of taxable profits
Reductions during the period include: - Tax payable on taxable profits* - Dividends paid - Capital repaid or shares repurchased - Amounts invested in shares of other companies

\* This is calculated solely through the tax paid during the period, by grossing up the tax paid by reference to the relevant corporate tax rate. The fact, therefore, that tax is paid on *estimated* profits is irrelevant. The balance of the SFA will be adjusted as and when final profits are determined and further tax is paid or repaid.

4.3.3 The ACE allowance would be calculated by multiplying shareholders' funds by an appropriate nominal rate of interest and the resulting amount would be deducted in computing profits. As such, the SFA would be similar to a running loan account for funds provided by the shareholders. The ACE rate would be fixed by government for companies in general. It would not, therefore, reflect the cost of funds to the particular company but rather the riskless rate of return that a shareholder could expect to obtain on the funds if invested elsewhere. This might be reflected in the rate obtainable on a medium-term government security.

### *The Effects of the ACE System*

4.3.4 In terms of its overall effect, the ACE system has a number of advantages:<sup>1</sup>

- *it is neutral with respect to marginal investment because the ACE allowance ensures that pre- and post-tax rates of return on projects that are just viable in the absence of tax (i.e. that could just earn a normal market rate of return) are the same;*
- *it is broadly neutral to the choice of finance because it substantially equalises the treatment of debt and equity and retained profits;*
- *it is neutral as regards the choice of assets and activities;*
- *because the ACE allowance is set in nominal terms in the same way as interest rates, it automatically adjusts the tax base for inflation; and*
- *although ACE requires the calculation of shareholders' funds, there are corresponding benefits in the UK in that indexation of capital gains within the corporate sector is no longer required and shareholdings in other companies are exempted from tax. In addition, it becomes possible to tax more closely by reference to the company's reported accounts profits.<sup>2</sup>*

4.3.5 The ACE system achieves neutrality between choice of assets and activities because it effectively achieves the equivalent of an accruals basis of taxation. If A acquires an asset for 100 and at the end of period 1 it has increased in value to 110, an income tax charged on an accruals basis would (in the absence of inflation) immediately bring income of

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<sup>1</sup> See also M. Devereux and H. Freeman, 'A general neutral profits tax', *Fiscal Studies*, vol. 12, no. 3, August 1991, p. 1.

<sup>2</sup> The ability to tax on the basis of reported profits arises because the system is neutral as to the timing of realisation of profit. As such, this should assist in solving many of the problems of the current system that are associated with timing - that is, with realisations versus accruals. It would enable substantial simplification of the capital allowances code and reliance if desired on the company's own depreciation policies.



10 into charge. Under a realisations-based income tax, this result would arise if 10 is paid by way of dividends or interest. In either case, the taxpayer carries forward the post-tax amount for further investment.

- 4.3.6 On the other hand, if a capital gain of 10 accrues but is not realised, no tax is charged at the end of period 1 and the taxpayer can carry forward 110 for investment. He has effectively received an interest-free loan from the Government which will only be called in as and when realisation occurs. There is then an inhibition on realisation (and accordingly the efficient reallocation of his savings) because it will result in the repayment of the interest-free loan. This inefficiency can be removed by ensuring that when realisation does occur, tax is charged together with interest from the time at which the income first accrued.
- 4.3.7 In practical terms increasing the eventual tax paid to reflect the benefit of deferral is generally regarded as very difficult. However, the ACE system achieves this result because shareholders' funds include taxable profits (less tax) for previous periods. Thus, to the extent that the taxpayer defers paying tax, he reduces the ACE allowance that he receives for the future (i.e. he pays less tax now but more in the future). To the extent that he realises the accrued income or gain and pays tax, he receives a greater ACE allowance in the future (i.e. he pays more tax now but less in the future).<sup>1</sup>

### *Investment in Other Companies*

- 4.3.8 Under the ACE system, only one allowance is given for shareholders' funds. Thus, amounts invested by one company in another must be deducted from the shareholders' funds of the first and added to those of the second. At the same time, equity capital owned by one company in another is exempt from tax. These two features ensure that

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<sup>1</sup>To the extent that immediate realisation involves an actual cash outflow of tax, the ACE system is neutral in this respect on the assumption that the company can fund the payment of the tax at the ACE rate. It can do this effectively by raising further equity capital.

inter-corporate dividends and capital gains are both exempt and that flows from one company to another produce corresponding adjustments in each other's shareholders' funds.<sup>1</sup>

4.3.9 Although shares owned by one company in another are exempt, the ACE system does not offer any opportunity to defer tax on the appreciation in value of the company's assets. Assume A Ltd invests 100 in subscribing shares in B Ltd which B Ltd uses to acquire land. A Ltd's shareholders' funds will be nil and B Ltd's 100.<sup>2</sup> The land appreciates in value to 500, at which point A Ltd sells its shares in B Ltd to C Ltd for, say, 500.

4.3.10 While A Ltd appears to have avoided tax on the appreciation in value of the land, this is not the case. The position is neutral as between A Ltd and C Ltd: A Ltd's shareholders' funds are increased by 500 but this is matched by an equivalent reduction in C Ltd's funds. B Ltd's shareholders' funds are unaltered at 100, reflecting the fact illustrated above that it is receiving a lower current ACE allowance so opening itself to a higher tax liability in the future.<sup>3</sup>

4.3.11 The ACE system is capable of operating in relation to foreign investment on both an exemption or credit method. However, in line with the preference of the Ruding Committee, the exemption system in relation to intra-Community investments would appear to be the better approach.

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<sup>1</sup> The SFA ensures that in calculating the ACE allowance for each company, the adjustments to shareholders' funds take effect at the same time and so prevent manipulation of the allowance. This is equivalent to ensuring that in relation to interest paid, the payment and the receipt are respectively treated for tax purposes as deducted and brought into charge at the same time.

<sup>2</sup> If A Ltd funds its investment in B Ltd in whole or part with debt, it will suffer a negative ACE allowance which will restrict the relief it can obtain for interest paid on the debt. This will be achieved through the SFA which will have a negative balance so producing an addition to taxable profits rather than a reduction.

<sup>3</sup> It is to be expected that C Ltd will take this into account in the price it is prepared to pay for B Ltd. A separate issue arises as to whether the accruing ACE allowance in B Ltd can be set against the current profits of other companies in B Ltd's group.

### *Harmonisation through the ACE System*

4.3.12 As a basis for European Community harmonisation of corporate income taxes, the ACE system offers a number of advantages:

- on a Community basis it provides a basis for sharing tax on the return to corporate equity investment;
- it can put debt and equity finance and retained profits on a broadly similar basis;<sup>1</sup> and
- irrespective of the different methods of calculating profit that currently exist, it puts each country's corporate tax on a neutral basis, but without the immediate difficulty of harmonising the tax base.

4.3.13 The relevance of harmonisation through the ACE system can best be demonstrated by comparing the proposals made by the Ruding Committee for harmonising the tax base with what would be required were the ACE system to be adopted by Member States. This is illustrated in the Appendices. The adoption of ACE would not preclude other measures to harmonise the tax base if that was thought desirable, for example in the interests of increased administrative simplicity. However, the very neutrality of the ACE system means not only that those other measures become of less importance but also that they should therefore be more achievable because less will turn on them.

4.3.14 The adoption of the ACE system would necessitate a review by Member States of the relationship between their personal and corporate tax systems.<sup>2</sup> As, however, has been indicated earlier in this Commentary, this may well be necessary under the proposals made by the Ruding Committee both for dealing with the taxation of dividends within the Community and for harmonising the tax base.

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<sup>1</sup>This will, however, also depend upon how the personal tax system deals with the shareholder. For example, there would be an incentive to retain profits if dividends were taxable but capital gains were exempt.

<sup>2</sup>In the UK the ACE system was designed to operate as a fully integrated system with extended personal equity plans, under which the return to shareholders in the form of dividends and capital gains are exempt. However, the ACE allowance effectively reflects the accruing return to the shareholder and the ACE system can also accordingly work satisfactorily with income tax systems which tax dividends and capital gains on a nominal basis or which tax the ACE allowance and impute that tax to shareholders.

## APPENDIX 1: RUDING PHASE I

THE RUDING RECOMMENDATIONS PHASE I (BY THE END OF 1994)	THE ACE PROPOSAL
The scope of the Parent/Subsidiary Directive should be extended to cover all enterprises subject to corporate income tax, irrespective of their legal form.	
The draft interest and royalties Directive should be adopted and the scope of the Directive extended to encompass all such payments between enterprises within the Community and the Directive include accompanying measures to ensure that the corresponding income is effectively taxed within the Community in the hands of the beneficial owner.	
The Commission should take all necessary steps to ensure that all Member States ratify the Arbitration Convention as soon as possible.	
The Commission should take action to establish appropriate rules or procedures concerning transfer pricing adjustments by Member States.	
The participation threshold prescribed by the Parent/Subsidiary Directive should be substantially reduced.	
Existing discrimination in the taxation of dividends distributed from profits earned in another Member State should be removed.	
Bilateral income tax treaties should be concluded between those Member States without such treaties and the coverage of existing treaties should be extended where it is at present limited.	
Bilateral tax treaties on estates, gifts and inheritances should be concluded between Member States.	

THE RUDING RECOMMENDATIONS PHASE I (CONTINUED)	THE ACE PROPOSAL
The Commission should, in concert with Member States, take action aimed at defining a common attitude in tax treaties between Member States and with third countries.	
Member States which apply imputation taxes on the distribution of profits should be obliged, on a reciprocal basis, to allow such taxes to be reduced by corporate income tax paid in the other Member States in respect of dividends remitted by a subsidiary or profits earned by a permanent establishment.	
Member States with various forms of tax relief for dividends received by domestic shareholders from domestic companies should be obliged, on a reciprocal basis, to provide equivalent relief for dividends received by domestic shareholders from companies in other Member States.	
Countries with imputation systems should <i>not</i> extend imputation credits to non-resident shareholders.	
Further efforts should be made to achieve a more fully harmonised corporation tax system within the Community, particularly as regards the treatment of dividend income. The Commission and Member States should examine in the course of Phase I alternative approaches to determine the most appropriate common corporation tax system for the Community for implementation in Phase III.	

THE RUDING RECOMMENDATIONS PHASE I (CONTINUED)	THE ACE PROPOSAL
<p>The draft Directive dealing with losses of permanent establishments and subsidiaries in another Member State should be adopted.</p>	<p>Measures to deal with losses would still need to be considered under ACE. However, on the basis that corporate equity income is divided between the source country and the country from which the equity investment is made and the exemption system operates, there may be no need to deal with losses across borders.</p>
<p>The Commission should prepare a draft Directive prescribing a minimum statutory corporation tax rate of 30% in all Member States for all companies, regardless of whether profits are retained or distributed as dividends. This would not preclude levying a lower rate on small and medium-sized businesses subject to the 30% minimum. The 30% rate could be adjusted in response to future developments in non-EC countries.</p>	<p>It is unlikely that a minimum tax rate would be sought under the ACE system as the source country taxes on the true economic profits or location-specific rent derived within its territory.</p>
<p>The Commission should establish an independent group of technical experts to examine and make firm recommendations for action on various aspects of the tax base, as identified in the Ruding Recommendations.</p>	<p>Harmonisation of the tax base could well be left to the individual action of Member States. Clearly, however, a technical group would be required to examine in more detail the adoption of ACE by each of the Member States.</p>
<p>The Commission should prepare a draft Directive on depreciation practices. This would prescribe historic cost as the basis for depreciation and give free choice for the taxpayer between declining balance depreciation and straight-line depreciation for all depreciable assets other than buildings. Declining balance rates should not exceed three times the rates applicable for straight-line depreciation. All special depreciation rules with an incentive effect should be abolished.</p>	<p>Under ACE, neutrality would not be lost even in the presence of different depreciation policies. Harmonisation of such policies would be easier if desired because of the neutrality of the system. Alternatively, greater reliance on accounting depreciation policies would be possible.</p>

THE RUDING RECOMMENDATIONS PHASE I (CONTINUED)	THE ACE PROPOSAL
The Commission should prepare a draft Directive establishing uniform tax treatment for depreciation of goodwill and other intangible assets and for harmonising the basic income tax aspects of leasing.	See previous comment.
There should be a free but irrevocable choice for business enterprises to use FIFO, LIFO, average cost or base stock methods of stock valuation.	It would be unnecessary to alter the existing policies adopted by Member States. The ACE system ensures that the corporate profits base is fully indexed.
The Commission, with the assistance of the technical group, should as a matter of urgency study the implications of harmonising the deductibility of provisions designed to meet companies' commitments to the retirement of employees.	
The Commission should urgently study solutions to ensure that pension contributions are tax-deductible, regardless of where the pension fund is situated or whether any subsequent benefits paid out would be taxable in the same Member State.	
The Commission should prepare a draft Directive to establish common rules for the deduction of business expenses based on the principle that all expenses related to a trade or business should be deductible.	The principle of full deduction for proper business expenses should apply under ACE. However, to the extent that an item is not deductible and additional tax is paid, the company will be compensated by a higher level of ACE allowance.
The Commission should prepare a draft Directive to establish rules for the allocation of headquarters' costs and the invoicing for inter-company pricing of centrally provided group services, including a common definition of 'shareholder costs' to avoid non-deductibility of such costs in both parent and subsidiary countries.	This could also apply under ACE.

<b>THE RUDING RECOMMENDATIONS PHASE I (CONTINUED)</b>	<b>THE ACE PROPOSAL</b>
<p>The draft Directive dealing with the carry-forward and carry-back of losses of enterprises should be adopted.</p>	<p>This would also apply under ACE. A loss attributable to the ACE allowance would be dealt with in the same way as a loss attributable to the payment of interest.</p>



## APPENDIX 2: RUDING PHASE II

THE RUDING RECOMMENDATIONS PHASE II (IMMEDIATE ACTION FOR IMPLEMENTATION IN 1994)	THE ACE PROPOSAL
The Parent/Subsidiary Directive should be extended to all enterprises subject to income tax.	
A Directive should establish a uniform withholding tax of 30% on the dividend distributions by EC-resident companies, subject to waiver where appropriate tax identification is provided.	A withholding tax may be appropriate under ACE depending upon the personal tax systems adopted by Member States. A withholding tax would operate in relation to third countries.
A maximum statutory corporation tax rate should be established not exceeding the minimum rate by a factor of more than one-third, i.e. 40%.	This would be unnecessary under ACE, given that the source country taxes the location-specific rent.
There should only be one tax on corporate income in Member States. However, where this is not the case, local corporate income taxes should be taken into account in relation to the statutory maximum and minimum rate.	See previous comment.
All hidden subsidies in the form of accelerated depreciation schedules should be abolished.	A subsidy in the form of accelerated depreciation should not affect the neutrality of the ACE system.
After consultation with the technical committee, the Commission should prepare a draft Directive establishing harmonised rules for the depreciation for buildings, minimum lives for different categories of assets, maximum rates of depreciation and the technical aspects of the free choice of depreciation method.	Specific action would not be required for the reasons previously given, but could be left to individual Member States or dealt with through normal accounting policies.
The independent technical group should elaborate the details of stock valuation, for example the technical details of a uniform approach to stock valuation provisions for slowly rotating stocks, to be implemented by Directive.	This would not be required under ACE.

<b>THE RUDING RECOMMENDATIONS PHASE II (CONTINUED)</b>	<b>THE ACE PROPOSAL</b>
All Member States should introduce full vertical and horizontal offsetting of losses within groups of enterprises at the national level.	Consideration would be required as to the use of losses under the ACE system but for the reasons previously given it may not be as necessary to extend losses across borders.
After consultation with the technical group, the Commission should prepare a draft Directive under which provisions, such as those relating to bad debts, warranty charges and foreign exchange, should be deductible for tax without arbitrary limit provided they are based on generally agreed accounting practice.	Specific action would not be required for the reasons previously given, but could be left to individual Member States or dealt with through normal accounting policies.
Quantitative limitations on bad debt provisions should be abolished and provisions for losses based on estimates of statistical averages should be accepted.	Limitations would not be required under ACE. Accounting policies could prevail.
The Commission should take action to co-ordinate with Member States a common approach to the definition and treatment of thin capitalisation.	Some provisions would be required under ACE to identify disguised distributions but as debt and equity would be treated similarly, the significance of the provisions would be reduced.
The Commission should prepare a draft Directive so that, in relation to depreciable and non-depreciable assets, roll-over relief would be permitted for capital gains where reinvestment took place within a specified period.	This would be unnecessary under the ACE system. Roll-over provisions could be adopted or not without affecting the neutrality of the system.
The Commission should prepare a draft Directive so that, in relation to controlling shareholdings, roll-over relief would be permitted for capital gains where reinvestment took place within a specified time. The concept of a controlling shareholding would be harmonised.	This would be unnecessary under the ACE system as it would provide for holdings in other companies to be exempt from tax.

THE RUDING RECOMMENDATIONS PHASE II (CONTINUED)	THE ACE PROPOSAL
The Commission should prepare a draft Directive so that, in the absence of reinvestment, capital gains on fixed assets and controlling shareholdings should be taxed at the ordinary corporate tax rate and on fixed assets and financial holdings other than treasury placements, the cost of acquisition should be indexed. Losses would be deductible.	Indexation of specific assets would not be required as the ACE allowance fully adjusts for inflation.
Existing and future tax incentives should be subject to appropriate 'sunset' provisions.	Such incentives should not affect the neutrality of the system.
There should be a minimum harmonisation of tax collection provisions to accompany the harmonisation of the tax base.	This would be unnecessary as differences in the timing of tax payments is fully dealt with through the adjustments to the shareholders' funds account.
Member States should refrain from levying taxes on the net worth or the total assets of enterprises, but should be permitted to tax specific assets.	
Unincorporated businesses should be allowed the option of being taxed as a company.	Unincorporated businesses would be taxed identically to incorporated businesses under the ACE system and this election would not be required.

### APPENDIX 3: RUDING PHASE III

THE RUDING RECOMMENDATIONS	THE ACE PROPOSAL
<b>PHASE III</b>	
<p>Further efforts should be made to achieve a more fully harmonised corporation tax system within the Community, particularly as regards the treatment of dividend income. The Commission and Member States should examine in the course of Phase I alternative approaches to determine the most appropriate common corporation tax system for the Community for implementation in Phase III.</p>	<p>The ACE system would be one such system.</p>
<p>The draft losses Directive should be extended to allow Community-wide horizontal loss-offsetting within groups of enterprises.</p>	
<p>Appropriate measures should be taken by the Commission to reduce the differences between commercial accounts and accounts used for tax purposes.</p>	<p>The ACE system would permit greater reliance to be attached to the commercial accounts.</p>