Corporate Taxation in the European Union –

Tax competition and tax harmonisation

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1. Introduction

This study is intended to provide an overview of the current state of affairs and developments in the field of business taxation in the European Union. The term “business taxation” is designedly used in a narrow sense in the framework of this study and refers essentially to the taxation profits of capital companies (corporate tax) and company profits distributed to shareholders. Within the last years, the future of company taxation in the European Union has strongly moved to the forefront of discussions. In particular one question, that has caused great controversy at times, is at the centre of debate: In the European Union is there tax competition in the field of company taxation? In which way does this tax competition affect the individual member states and the European Union as a whole? And is this competition to be deemed harmful or beneficial? The rising interest in the issue of tax competition is reflected by a growing amount of literature in this field. However, not only academic literature, but also Commission communications and statements by the different EU Member States or interest groups are abounding today. As a matter of course, there is a great variety of standpoints, and this study is also meant to provide some guidance with regard to a number of questions: Does business taxation have a future in the European Union? Does it make sense to tax company profits? How could the future of business taxation look like? What scenarios are likely to, or, depending on one’s viewpoint, threaten to become reality? This study moreover wants to show that there is in fact need for action in this field. It suggests measures that we could take, or have to take, if we want to make sure that also in the future, the capital companies continue, according to their capacity, to contribute a share of their profits to the financing of the welfare state.

2. Tax policy and tax law in the European Union

2.1. Functions of tax policy

Taxes are compulsory payments to the State or to local or regional authorities for which the taxpayer does not receive a direct compensation in return and which are needed for the execution of particular tasks. Taxes are the most important source of revenue of modern States where they are employed to finance public services. However, beside its financing functions, taxes also play an important role in the economic policy of a State. Tax policy is considered as part of economic policy and should fulfil the following functions:

- Fiscal function
- Allocation function
- Steering function
- Redistribution function
- Stabilisation function

Whereas the fiscal function purely refers to the revenues committed to the State, the allocation function refers the financing of the State's tasks. The allocation function is therefore about distributing the State's revenues, or, in other words, about allocating the gains from the employment of capital and labour in the production process and about assigning gains from these economic resources to the private or to the public side, and, on the public side, to the different areas in which the State has a role (which public services are to be provided, and to what extent?). The European Union and its member states are all economies which are based on the principles of the market economy. This means that a number of decisions are to a large extent left to the market: Which goods and services should be provided? How much should they cost? Who should benefit from these goods and services and to what extent? However, the market economy does not offer satisfactory solutions for all goods and services. In areas where the market fails to satisfy existing needs, the State has to take on allocation functions to provide the goods and services demanded by society. Among the different member states, there is not always agreement on which goods and services are to be provided by the State or by private companies, and in some areas there is even an important divide on these questions. However, it is to a large extent admitted by all States that there are some core areas where the State should and must be responsible for the provision of goods and services.

Moreover, taxes can also be used as an instrument to influence the behaviour of particular persons and companies in order to impede certain activities that have a negative impact or to promote other activities which are considered to have positive effects or effects which are welcomed by society. Energy taxes are a case in point: they increase energy costs and therefore contribute to decreasing energy consumption. Another example is tobacco taxes, which should incite people to give up

smoking. On the other side, tax benefits granted for environmentally-friendly measures or particular investments should offer incentives for providing services or makings investments which are demanded by society.

The redistribution function is a very central instrument of tax policy. In all areas where the market according to the respective society produces an uneven distribution of revenues and resources, taxes are employed to correct or to at least alleviate disparities. Thus, taxes are a very important means to fight poverty and eliminate inequalities.

And, last but not least, taxes can be applied well-targeted to achieve certain objectives in the field of stabilisation policy and growth policy such as combating unemployment, counterbalance inflation or steer economic growth. Tax cuts, and in particular tax cuts in favour of people with low income, can for instance increase the purchasing power of consumers in times of recession, thereby increase demand and exert an overall positive influence on the economy. Not only tax cuts, but also investment incentives such as benefits (for instance in the form of increased depreciation rates or accelerated depreciation) for particular investments can have a positive impact on the economy. Moreover, the State can offer additional incentives in the form of tax benefits for research and development activities to encourage companies to increase their R&D costs. As a result, the companies not only improve their competitiveness, but also promote growth and employment.

2.2. The special position of tax policy in the European Union

For several reasons, tax policy has a special position in the European Union. In the framework of this study, we do not intend to discuss the nature of the Union or related legal questions. We just wish to underline that the European Union is a supranational organisation without fiscal sovereignty and has, unlike the nation state in the classical sense, no right to introduce or fix taxes[1]. It has however to be kept in mind that the European Union budget is, although only indirectly, financed by taxes, too, as the member states' contributions consist to a very large extent of tax payments.

Since 1970, the European Union budget is no longer financed by financial contributions, but by the so-called own resources. There are four categories of own resources: customs duties, agricultural levies, VAT, and GNI-based own resources[2]. According to the Financial Perspective for the period 2007-2013, the annual revenues of the Union are approx. € 125 billion. The customs duties and the agricultural levies make up for around 12% of these revenues; the VAT contributes about 14%. The most important part of the EU revenues are GNI-based own resources, which are calculated on the basis of the member states' economic performance. Due to a great number of special rules and derogations, the system of own resources has become very complex and difficult to understand. For this reason, reforms are being considered. A new national tax is being discussed which could, from

[1] Genschel (2002), 1 et seq.
[2] Gross National Income

2014 on, contribute at least partly to the EU budget. However, also then, no authority in fiscal matters should be conferred upon the European Union. At present, it is still uncertain whether this concept will have any success at the political level or not[3].

As a consequence, the role of tax policy in the European Union or at EU level in general can be compared to the role of tax policy in the individual nation states in the classical sense to a limited extent only. The European Union's role in the field of tax policy is actually reduced to coordinating tax policy and tax-related rules in the member states and to harmonising these rules in some particular areas. In particular direct taxes remain in essence within the member states' responsibility. The member states are of course obliged to observe and transpose in their legal orders European Directives on direct taxation. Moreover, tax rules in the individual member states must be compatible with Community rules; this means in particular that the four basic freedoms enshrined in the EC Treaty are also relevant for national tax legislation.

Moreover, the national tax rules also have to comply with the competition rules in the EC Treaty. The member states have in particular to make sure that their tax rules are consistent with community rules on state aid.

In the main, national tax laws have to comply with the four basic freedoms, which have a very central role in the EC Treaty. At the same time, it has to be noted that ECJ rulings on direct taxes play an ever greater role in the area of direct taxation. This is why the ECJ is already referred to as the real driver of harmonisation as regards direct taxation in the European Union[4]. Despite some high-explosive rulings which had far-reaching effects on the member states' rules on direct taxation, this term is not really justified. It is true; the ECJ has the power to stop tax discrimination. But it cannot enforce tax harmonisation in the positive sense of a harmonisation of national legislations.

2.3. Tax law in the European Union

In the context of European law, the distinction between indirect and direct taxes is particularly important. This distinction comes from academic financial literature. Basically, we speak about direct taxes when these are paid by the ultimate taxpayer, as compared to indirect taxes, where the tax burden is passed on to third persons. In this context, we should not discuss the difficulties resulting from this distinction. In accordance with this definition, it is clear that under European law, income taxes and therefore corporate taxes are to be considered as direct taxes, whereas VAT and other excise duties (tobacco tax, energy taxes, and similar taxes) fall under the scope of the rules on indirect taxation.

[3] COM(2004) 505final
[4] Dürschmitt / Schiller, EuR (2006), p. 275 et seq.

2.3.1. Indirect taxes in the EC Treaty

The rules on taxation in the EC Treaty are in principle limited to provisions on the harmonisation of indirect taxes. The relevant provisions are to be found in Articles 90-93 EC Treaty.

Art 90 EC Treaty:

> *„No Member State should impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products. Furthermore, no Member State shall impose on the products of other Member States any internal taxation of such a nature as to afford indirect protection to other products."*

Art 91 EC Treaty:

> *„Where products are exported to the territory of any Member State, any repayment of internal taxation shall not exceed the internal taxation imposed on them whether directly or indirectly. "*

Art 92 EC Treaty:

> *„In the case of charges other than turnover taxes, excise duties and other forms of indirect taxation, remissions and repayments in respect of exports to other member states may not be granted and countervailing charges in respect of imports from Member States may not be imposed unless the measures contemplated have been previously approved for a limited period by the Council acting by a qualified majority on a proposal from the Commission"*

Art 93 EC Treaty:

> *„The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market within the time limit laid down in Article 14.“*

Article 93 of the EC Treaty is the most important basis for the harmonisation of indirect taxes. Harmonisation concerning VAT and the most important excise duties such as tobacco tax, mineral oil tax and alcohol tax takes place on the grounds of this article. From the beginning of the year 2004, the Energy Tax Directive has been in force. By means of this directive, the scope of the system of minimum taxation, which was until then limited to mineral oil products, was extended to include all other competing energy sources such as coal, gas and electricity. Moreover, the minimum rates for mineral oil tax were adjusted, for the first time since 1982[5]. Given these legal acts, it can be concluded that at EU level, a certain level of harmonisation exists in the field of indirect taxation.

2.3.2. Direct taxes in the EC Treaty

The EC Treaty contains no explicit rules on direct taxes. But it is broadly argued that the EC Treaty provides enough room for manoeuvre for harmonising direct taxes in the European Union, and in particular in Title VI ("common rules on competition, taxation and the approximation of laws). Here, chapter 3, and in particular Article 94 (approximation of laws) in connection with Article 96 (elimination of competition distortion) are relevant, to the same extent as the Treaty's provisions on competition law and Part Six on General and Final Provisions (in particular Articles 293 and 308).

Article 94 EC Treaty:

> *„The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market."*

[5] IP/03/1456

Article 96 EC Treaty:

„Where the Commission finds that a difference between the provision laid down by law, regulation or administrative action in Member States is distorting the conditions of competition in the common market and that the resultant distortions need to be eliminated, it shall consult the Member States concerned. If such consultation does not result in an agreement eliminating the distortion in question, the Council shall, on a proposal from the Commission, acting by qualified majority, issue the necessary directives. The Commission and the Council may take any other appropriate measures provided for in this Treaty. "

Article 308 EC Treaty:

„If action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community, and this Treaty has not provided the necessary powers, the Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament, take the appropriate measures."

Article 293 EC Treaty, which is relevant to taxation, states as follows:

„Member States shall, so far as it is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals::

- *....*
- *The abolition of double taxation within the Community,*
- *....*

Article 94 of the EC Treaty is a general rule which is not limited to purely fiscal application areas. According to this Article, both national laws or regulations and administrative practices that have a direct impact on the establishment or functioning of the internal market are to be harmonised. In this field, as in taxation in general, decisions need to be taken unanimously.

2.4. Competition law – rules on state aid and their impact on direct taxes

Beside the above-mentioned provisions, the rules on competition law in the EC Treaty play a major role as regards fiscal developments. The tax rules in the individual member states need to be

consistent with competition law, this means essentially with the rules on state aid. state aid is governed by Articles 87 to 89.

Article 87 EC Treaty states as follows:

„(1) Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.

(2) The following shall be compatible with the common market:

a) *aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;*
b) *aid to make good the damage caused by natural disasters or exceptional occurrences;*
c) *aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division.*

(3) The following may be considered to be compatible with the common market:

a) *aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment;*
b) *aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;*
c) *aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent this is contrary to the common interest;*
d) *aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest;*
e) *such other categories of aid as may be specified by decision of the Council acting by a qualified majority on a proposal from the Commission.*

Article 88 EC Treaty states as follows:

„(1) The Commission shall, in cooperation with Member States, keep under constant review all systems of aid existing in those States. If shall propose to the latter any appropriate measures required by the progressive development or by the functioning of the common market.

(2) If, after giving notice to the parties concerned to submit their comments, the Commission finds that aid granted by a State or through a State resources is not compatible with the common market having regard to Article 87, or that such aid is being misused, it shall decide that the State concerned shall abolish or alter such aid within a period of time to be determined by the Commission. If the State concerned does not comply with this decision within the prescribed time, the Commission or any other interested State may, in derogation from the provisions of Articles 226 and 227, refer the matter to the Court of Justice direct. On application by a Member State, the Council may, acting unanimously, decide that aid which that State is granting or intends to grant shall be considered to be compatible with the common market, in derogation from the provisions of Article 87 or from the regulations provided for in Article 89, if such a decision is justified by exceptional circumstances. If, as regards the aid in question, the Commission has already initiated the procedure provided for in the first subparagraph of this paragraph, the fact that the State concerned has made its application to the Council shall have effect of suspending that procedure until the Council has made its attitude known.If, however, the Council has not made its attitude known within three months of the said application being made, the Commission shall give its decision on the case.

(3) The Commission shall be informed, in sufficient time to enable it to submit its comments, of any plans to grant or alter aid. If it considers that any such plan is not compatible with the common market having regard to Article 87, it shall without delay initiate the procedure provided for in paragraph 2. The Member State concerned shall not put its proposed measures into effect until this procedure has resulted in a final decision."

According to settled case law of the ECJ, tax concessions also fall under the scope of the definition of state aid in Article 87 paragraph 1 of the EC Treaty.

This is why the European Commission, against the background of the EU Council (Ecofin) of December 1, 1997 which decided on some measures to fight harmful tax competition, has promised to draw up guidelines on the application of Article 87 (before Article 92) and Article 88 (before Article 93) of the EC Treaty in the field of direct company taxation.

The corresponding Commission notice on the application of the state aid rules to measures relating to direct business taxation was presented to the Council on December 10, 1998[6]. In this notice, the Commission pointed out that the EC Treaty authorized the Community to take measures to eliminate different cases of competition distortion. According to the notice, also tax rules could constitute competition distorting measures. The notice aimed at clarifying and improving the application of the rules on tax-related state aid to eliminate distortions of competition related due to state aid. According to the notice, tax measures are to be considered as state aid if the following criteria are met:[7]

1) *The measure must confer on recipients an advantage which relieves them of charges that are normally borne from their budgets. The advantage may be provided through a reduction in the firm's tax burden in various ways, in particular by:*
    - *a reduction in the tax base;*
    - *a total or partial reduction in the amount of tax; or*
    - *deferment, cancellation or even special rescheduling of tax debt.*

2) *Second, the advantage must be granted by the State or through State resources. A loss of tax revenue is equivalent to consumption of State resources in the form of fiscal expenditure. This criterion also applies to aid granted by regional or local bodies in the Member States. Furthermore, State support may be provided just as much through tax provisions of a legislative, regulatory or administrative nature as through the practices of the tax authorities.*

3) *Third, the measure must affect competition and trade between Member States. This criterion presupposes that the beneficiary of the measure exercises an economic activity, regardless of the beneficiary's legal status or means of financing. Under settled case-law, for the purposes of this provision, the criterion of trade being affected is met if the recipient firm carries on an economic activity involving trade between Member States. The mere fact that the aid strengthens the firm's position compared with that of other firms which are competitors in intra-Community trade is enough to allow the conclusion to be drawn that intra-Community trade is affected. Neither the fact that aid is relatively small in amount, nor the fact that the recipient is moderate in size or its share of the Community market very small, nor indeed the fact*

[6] 98/C 384 / 03; OJ C 384/3 of December 10, 1998
[7] 98/C 384 / 03; OJ C 384/3 of December 10, 1998

that the recipient does not carry out exports or exports virtually all its production outside the Community do anything to alter this conclusion.

4) *Lastly, the measure must be specific or selective in that it favours 'certain undertakings or the production of certain goods`. The selective advantage involved here may derive from an exception to the tax provisions of a legislative, regulatory or administrative nature or from a discretionary practice on the part of the tax authorities. However, the selective nature of a measure may be justified by 'the nature or general scheme of the system. If so, the measure is not considered to be aid within the meaning of Article 92(1) of the Treaty.*

On the distinction between state aid and general measures, the Commission states as follows:[8]

"Tax measures which are open to all economic agents operating within a Member State are in principle general measures. They must be effectively open to all firms on an equal access basis, and they may not de facto be reduced in scope through, for example, the discretionary power of the State to grant them or through other factors that restrict their practical effect. However, this condition does not restrict the power of Member States to decide on the economic policy which they consider most appropriate and, in particular, to spread the tax burden as they see fit across the different factors of production. Provided that they apply without distinction to all firms and to the production of all goods, the following measures do not constitute State aid:

- *tax measures of a purely technical nature (for example, setting the rate of taxation, depreciation rules and rules on loss carry-overs; provisions to prevent double taxation or tax avoidance),*
- *measures pursuing general economic policy objectives through a reduction of the tax burden related to certain production costs (research and development (R& D), the environment, training, employment)*

On November 26, 2003 the Commission published a report on the implementation of the notice on the application of the state aid rules to measures relating to direct business taxation[9]. In its report, the Commission concluded that the 1998 notice proved to be an adequate means. In this context, we do not intend to discuss the conclusions on indirect taxation in greater detail. As far as direct taxes are concerned, the Commission statements on the interrelationship between state aid and harmful tax competition were of greater importance. In principle, the Commission claimed that measures could be qualified as harmful even independently from them being deemed harmful or not in terms of the Code

[8] 98/C 384 / 03; OJ C 384/3 of December 10, 1998
[9] See Commission of the European Communities; Report on the implementation of the Commission notice on the application of state aid rules to direct business taxation; 26.11.2003.

of conduct, and vice versa. The Commission maintained nonetheless that the interrelationship between the Code of conduct for business taxation[10] and state aid was not to be underestimated in this context. While the Commission suggested that the current strategy in the framework of state aid was to be continued, it announced that it intended to concentrate on those cases which noticeably affected and had a particularly detrimental impact on competition and trade.[11]

2.5. The ECJ case law on direct taxes

Although tax harmonisation is not directly governed by the EC Treaty, it is indisputable that member states' tax laws need in principle be compatible with the statutory requirements of the EC Treaty. Essentially, national tax provisions have to be consistent with the four basic freedoms: free movement of goods, freedom to provide services (Article 49 et seq. EC Treaty), free movement of capital (Article 56 EC Treaty), and free movement of persons, including freedom of establishment as laid down in Article 43 and 48 EC Treaty. These basis freedoms, which are the central piece of the EC Treaty, should guarantee the functioning of the internal market.

In specialised literature and in political debate the ECJ is often referred to as the true driver of harmonisation in the field of direct taxes. This is of course only partly true, as the eliminating tax discrimination does not necessarily mean harmonising taxes. In many cases, the ECJ rulings do however result in particular requirements to which the member states need to adjust their tax legislation. Moreover, we have to keep in mind that some ECJ rulings have far-reaching effects on the tax policy of the European Union. The Marks & Spencer[12] case for example kept in suspense the member states and their finance ministers for several years. In this case, the ECJ had to decide whether a British tax provision which did not allow United Kingdom-based parent companies to offset losses sustained by their foreign subsidiaries, whereas losses sustained by United Kingdom-based subsidiaries could be offset, contravened Community legislation (freedom of establishment). The ECJ maintained that the objective pursued by the British government was legitimate and compatible with the EC Treaty and admitted that the tax regulation in question was justified by compelling raisons in terms of general public interest. However, at the same time, the ECJ it claimed that the regulation was a restriction to the freedom of establishment and contravened the proportionality principle. It stated moreover that nothing obliged the governments to allow an unlimited offsetting of the losses sustained by foreign subsidiaries. However, they had to permit an offsetting of losses in those cases where an offsetting was no longer possible in the country where the subsidiary was based.[13]

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[10] See chapter 3.4. Code of conduct for business taxation
[11] IP/03/1605
[12] ECJ, 13.12.2005, C-446/03, Marks & Spencer
[13] ECJ, 13.12.2005, C-446/03, Marks & Spencer

Looking back, we realise that until approx. 1980, there were no ECJ rulings on direct taxation. Between 1980 and 1995, the number of rulings increased, and from 1995, there has been a sharp rise in ECJ rulings in the field of direct taxes.

Period	Number of ECJ rulings	Period	Number of ECJ rulings
1960 – 1979	2	2003	11
1980 – 1989	4	2004	17
1990 – 1994	7	2005	12
1995 – 1999	33	2006	33
2000	12	2007	12
2001	6	Pending proceedings	39
2002	13	In total	201

Source: TAXUD, June 2007; ECJ rulings on direct taxation and rulings which are of great importance for the area of direct taxation.

The table very clearly shows the sharp increase in judgements on direct taxes. It is moreover interesting that it was not until 1990 that the ECJ dealt with cases on direct taxation on a regular basis and that there has been a strong increase in ECJ rulings only since 1995. Out of a total of 201 rulings and pending proceedings, only 46, which is less than a quarter, concerned the years before 2000.

In the last few years, the public has become increasingly aware of the tax issue. This can be explained by the growing number of rulings on direct taxation on the one hand and by the greater explosiveness of the rulings on the other hand. Today, it seems as if the member states have taken quite a long time to grasp that the basic freedoms also apply to tax law. And once they realised that the ECJ rulings may have considerable implications for national tax regulations, they were the more concerned.

The ECJ case-law underlines on a regular basis that *„although direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law. (…) The Court has consistently held that the rules regarding equal treatment forbid not only overt discrimination by reason of nationality but also all covert forms of discrimination."*[14] According to the definition of the ECJ, there is discrimination if different regulations are applied to comparable situations, or if the same regulation is applied to different situations[15].

In general, the ECJ uses a three-stage procedure for its rulings. In the first stage, the court examines whether the discrimination resulting from the member state's regulation falls within the technical scope of one of the four basic freedoms. In the second stage, it checks whether the discrimination is justified or not. If the ECJ establishes that the discrimination is justified, it examines in a third stage whether the scope of the measure is proportional to the aim that it pursues.

[14] ECJ, 14.2.1995, C-279/93, Schumacker
[15] ECJ, 29.4.1999, C-311/97, Royal Bank of Scotland

In the past, the ECJ often used to apply a very strict interpretation of Community law when it examined whether a particular regulation resulted in discrimination and if this was the case, whether the discrimination was justified or not. It has to be noted that in principle, the ECJ rulings also apply retrospectively. Moreover, any ruling may of course be relevant to other member states' tax regulations. And last but not least, we must not forget that the rulings can have considerable implications for the member states tax revenues. During the Marks & Spencer[16] proceedings for instance, Germany was worried to lose a considerable amount of corporate tax revenues and to be moreover obliged to refund taxes to companies. At that time, an amount of up to € 50 billon was under discussion.[17] In the case Banca Popolare di Cremona[18], which dealt with the question whether the Italian value added levy IRAP complied with Community law or not, Italy could have suffered important tax losses or could have been obliged to refund taxes of up to € 120 billion. In this case, the ECJ ruled that the Italian IRAP was consistent with Community law.

Although the ECJ did not admit it in its judgement justifications, it cannot be denied that the ECJ judgement was to some extent a political decision. As regards the issue of cross-border offsetting of losses, it has to be stated that since 1975, the Commission has tried to elaborate a proposal for a directive to settle this question and which would be accepted by all member states alike. Between 1975 and 1995, the Commission has submitted three directives concerning the issue of cross-border offsetting of losses. As the member states refused to adopt these directives, none of them was adopted and the Commission had to withdraw them. This means that within a period of thirty years, it was not possible to find a European solution for the fiscal treatment of cross-border offsetting of losses. It is true; the ECJ has provided a more or less clear answer in its ruling on the Marks & Spender case. But even now, after the settlement of the Marks & Spencer case, we are still far away from harmonisation in the fiscal treatment of losses sustained by foreign subsidiaries.

Although in the two recent rulings referred to above, the ECJ has decided in favour of the member states concerned, we must not overlook the fact that these two rulings are quite unique and do in many parts not reflect the common case-law of the court. As early as in the Cadbury/Schweppes[19] case, the ECJ ruled that the British regulation concerning controlled foreign companies may only apply to purely artificial tax group constructions. The case was essentially about the question whether a specific British regulation, concerning a so-called CFC-Legislation[20] was consistent with Community legislation. According to these CFC regulations, the profits realised by such controlled foreign companies in which the British parent company holds more than 50% are to be added to the home-

[16] Before the ECJ finally pronounced its judgement, it was impossible to estimate the outcome of the proceedings that could have obliged the Member States allow the groups having their registered seat on their territory to offset the losses sustained by their foreign-based subsidiaries to a much greater extent.
[17] On 5.4.2005, the German newspaper Handelsblatt wrote: "The Treasury is threatened by a flood of claims" (original wording: "Fiskus droht eine Flut von Einsprüchen", Handelsblatt of 5.4.2005
[18] ECJ, 3.10.2006, C-475/03, Banca Popolare di Cremona Soc. Coop. arl; this ruling concerned in principle indirect taxes, and in particular the question whether the Italian value added levy IRAP was compatible with the Sixth Council Directive of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment (77/388/EEC).
[19] ECJ, 12.9.2006, C-196-04, Cadbury Schweppes plc & Cadbury Schweppes Overseas Ltd.
[20] Controlled Foreign Company

based parent company and taxed in the UK if the foreign tax rate amounts to less than three thirds of the rate applicable in the UK. The tax paid by the abroad-based subsidiary is taken into account when the tax payable on the profits of the UK-based parent company is calculated. As a result, the tax burden on the controlled subsidiary is the same as that in the United Kingdom. The British regulation does however provide for derogations if saving taxes in the UK by means of transferring profits abroad was neither the main objective of the controlled company nor its raison to exist. In its ruling, the ECJ maintained that companies cannot abusively or deceitfully invoke Community law. However, at the same time, it stated that creating a company in another member state in order to benefit from more advantageous tax regulations was not reason enough to insinuate that there was an abuse of the freedom of settlement. Moreover, the ECJ maintained that the British CFC regulation provided for an unequal treatment of UK-based and foreign companies, as the fiscal treatment of controlled companies depended on the level of taxation to which they were subjected. This different treatment constitutes a restriction to the freedom of establishment. According to the ECJ, such a restriction was only admissible if it applied to artificial constructions which exclusively served the purpose of avoiding taxes that would have applied under normal circumstances. The ruling of the ECJ in this matter will make it harder for member states to continue to apply their so-called CFC regulations.

Since only little progress was made in harmonising direct taxation at the European level, there have been critical voices in the recent past. These claimed that the ECJ should no longer be competent in the area of direct taxes. Otherwise a backdoor for harmonising taxes would be virtually openend to the EU which has no explicit competence in this field. Others suggested that the ECJ continue in principle to decide on direct taxes and claimed that it was critical to develop further the jurisdiction in the area of direct taxation. This standpoint is to be explained by the fact that some of the ECJ rulings have put strong pressure on member states' tax revenues. On a regular basis, the ECJ has underlined that the risk of tax losses does not justify a restriction of the four basic freedoms, and not even in the event that these tax losses take considerable proportions in the member states concerned.

In its rulings on social legislation, the ECJ recognises in principle that a restriction of the basic freedoms may be justified on the grounds of a threat to the equilibrium of social security systems. It is therefore not understandable why restrictions to the basic freedoms in the area of taxation cannot be justified on the same grounds.

Another idea is to restrict the retrospective effect of ECJ rulings on direct taxation and to provide for transition periods. As regards the rulings by national supreme courts in tax matters, the individual national legislations allow in many cases for a restriction on retrospective effect and transition periods. These transition periods, which grant the member states a period of time defined by the Court to amend tax regulations that have been considered as incompatible with community legislation, give the member states the chance to at least anticipate the new situation and to react to it. This is particularly important in the event of rulings having great financial implications for a member state.

Critical voices moreover claim that the values and principles underlying the ECJ rulings are unknown and that in most cases, it is not quite clear what strategy the ECJ actually pursues: Has the ECJ, in one or another case, just changed its usual line, or are there any particular reasons why its decisions in two apparently comparable cases are different? It would be useful and necessary to develop further the ECJ jurisdiction towards greater transparency as regards decision criteria on the one hand and the patterns underlying its decisions on the other hand.

3. Company taxation in the European Union

Although the first directives on company taxation were adopted in 1990 only, there have been attempts to harmonise company taxation in the European Union as early as in the 1960ies. These attempts were admittedly not very successful. Already the Neumark Report prepared on behalf of the European Commission in 1962 and the Tempel Report in 1970 suggested a more or less far-reaching harmonisation in the area of company taxation. The Commission – as mentioned before - also produced three proposals for directives on cross-border offsetting of losses. These proposals have never been adopted, and were finally withdrawn. In 1988, the Commission finally elaborated a proposal on harmonising the corporate tax basis. However, this proposal was never adopted as most of the member states did not want a harmonisation of tax bases at that time. At the end, the Commission did not see any chance that the proposal could one day be effectively implemented.

3.1. First legal acts on direct taxes

It was only in 1990 that the first directives on direct taxes were adopted with the so-called package of directives. This package created for the first time a certain level of harmonisation in the field of company taxation. The package, which has been adopted on July 23, 1990, includes the following Directives:[21]

- Parent/Subsidiary Directive[22]
- Mergers Directive[23]
- Arbitration Convention[24]

The Parent/Subsidiary Directive requires that no withholding tax be applied to cross-border distributions of profits within a group of companies. The Mergers Directive is to ensure that profits or capital gains resulting from cross-border mergers, divisions, or transfers of assets are not subject to taxation until they are actually realised.

[21] OJ 1990 L 225
[22] Directive 90/435/EEC, 23.7.1990
[23] Directive 90/434/EEC, 23.7.1990
[24] Convention 90/436/EEC, 23.7.1990

3.2. The Ruding Report 1992

In 1991, the so-called Ruding Committee[25], named after its President Onno Ruding, was asked by the Commission to examine to what extent the existing differences in company taxation in the various member states and the differences in the tax burden on companies resulting therefrom caused significant distortions leading to distortions in the internal market.

One year later, in 1992, the Ruding Committee finally published its findings. In its report, the Committee essentially dealt with the following three questions:

1. Do different tax regulations in the individual member states result in significant distortions in the Internal Market, and in particular as regards investment decisions and competition? In this context, the committee directed particular attention to discriminatory distortions.
2. In the event that such competition distortions exist, is it likely that these distortions are eliminated by the free interplay of market forces and tax competition alone, or is it necessary to take action at the European level?
3. Which specific measures at Community level are required to eliminate or alleviate these distortions?

As regards the first question, the committee concluded that there were significant differences in the different corporate tax systems, in corporate tax bases and in corporate tax rates. Moreover, the committee pointed out to some specific problems related to distortions of competition. Essentially, these problems concerned the fiscal treatment of cross-border distributions of dividends and interest and royalty payments. In addition, difficulties in connection with the cross-border offsetting of losses were dealt with. The committee concluded that withholding taxes applied by the source State on the distribution of dividends between associated companies was the main cause for competition distortions related to foreign direct investments.

Moreover, the committee looked into the question what role tax regulations played in the choice of business location. It claimed that in particular in the financial sector, tax regulations may present significant criteria to choose one country to locate a company rather than another. The committee had however no reliable data at its disposition to support this thesis.

When examining the second question, the committee maintained that it was unlikely that the existing tax competition resulted in a far-reaching erosion in corporate tax revenues. At the same time, the

[25] The Committee of Independent Experts on Company Taxation

committee nonetheless expressed concern about the clear trend in the member states to put into place specific tax schemes to attract particularly mobile companies (essentially companies of the financial sector).

As regards the third question, the answer provided by the committee was quite unambiguous. The committee identified distortions of competition and obstacles to the functioning of the internal market and suggested that measures be taken at the European level to solve existing problems. The committee underlined that in accordance with the subsidiarity principle, the harmonisation in the area of company taxation should in principle not go beyond the necessary minimum. The recommendations were nonetheless quite ambitious, and the following steps at EU level were considered important:

1. Take measures to eliminate discriminatory and distorting regulations for cross-border investments.
2. Introduce a minimum corporate tax rate and minimum standards with regard to the tax base in order to limit excessive tax competition which would ultimately cause an erosion in the member states' corporate tax revenues.
3. Ensure transparency to the greatest extent possible as regards tax concessions introduced by member states with the objective to promote investments. Such tax concessions should only be applicable for a short period of time and be subject to aid monitoring by the Commission.

The report's recommendations were followed by detailed explanations on measures to be taken in each particular area. These measures stretched from improvements of and necessary adjustments to the Parent/Subsidiary Directive and the Mergers Directive (the scope of application should, according to the committee, also cover partnerships), via the fixing of transfer prices, for which the Committee gave concrete recommendations, to the adoption of the proposal for a directive on the cross-border offsetting of losses. Moreover, the committee suggests that member states' operating the imputation system in the field of corporate taxation be obliged to grant a tax credit for cross-border activities, too. It recommended furthermore that the double taxation agreements between member states and between third states and member states be harmonised.

As mentioned before, one recommendation suggested that in order to avert an erosion of corporate tax revenues, in all European Union member states a minimum corporate tax rate of 30% be applied to company profits independently from them being distributed or retained. The maximum corporate tax rate should be limited to 40%. The committee recommended that minimum standards for regulations on determining the corporate tax base be introduced in each member state. These regulations should in particular include rules on depreciation/amortization methods, on the fiscal treatment of leasing companies, the valuation of inventories, the allocation of provisions, a definition of tax-deductible business expenses, the fiscal treatment of holding companies and the possibility of offsetting losses sustained by foreign permanent establishments or foreign subsidiaries. The committee's

recommendations went beyond a mere harmonisation of tax bases; it also suggested that the corporate tax systems be harmonised. However, among the committee members, no agreement could be achieved with regard to the system to be established. According to the committee, property taxes on business assets should be abolished.

From the Ruding Committee’s standpoint, a complete harmonisation was not required then. However, the committee remarked that in the long run, introducing a harmonised corporate tax system would be the most adequate solution.

The findings of the Ruding Report were not what the Commission and, after all, the member states really wanted to hear. The Commission, which had in principle supported the idea of a corporate tax harmonisation since the beginning of the 60ies but whose various attempts had never been successful, wanted to adopt a new strategy: it gave up the idea of harmonising taxes and intended to concentrate on the dismantling of fiscal obstacles and the elimination of competition distortion for the time being. The Commission had expected the Ruding Report to support its new strategy. However, the findings of the Ruding Report, which recommended a comprehensive approach and warned of an erosion of corporate tax revenues, where definitely not the ideal means to back the Commission’s new strategy. Against this background, It is not surprisingly that the report never had any greater impact on the European Union’s tax policy. Be that as it may, the report’s conclusions and recommendations remain astonishingly topical today, despite a number of contradictions and inconsistencies, and have lost little of their explosiveness 15 years after its publication.

3.3. The tax package

In April 1996, the Commission suggested a new and comprehensive approach to tax policy at the informal meeting of the Economy and Finance Council (Ecofin) in Verona. In this context, it identified three essential challenges to be met by European tax policy.

- ensure the stabilisation of the member states’ revenues
- guarantee the smooth functioning of the internal market
- promote employment

Although they knew that there would be some difficulties, the member states recognised in principle that also in the area of direct taxation, harmonisation or at least stronger coordination was required. The challenges identified in Verona were the starting point for a communication published by the

Commission on October 1, 1997: „Towards tax co-ordination in the European Union - A package to tackle harmful tax competition“[26]. The communication served as a basis for the Council’s debates on future developments of tax policy in the European Union. The communication called inter alia for a stronger coordination in the field of taxation, and on 1 December 1997, the member states’ finance ministers agreed on the so-called tax package. This tax package includes:

- the Code of Conduct for business taxation
- general principles underlying the taxation of private savings income
- an agreement on withholding tax exemption for interest and royalty payments between associated companies

3.4. Code of Conduct for business taxation

The Code of Conduct for business taxation is meant to be the first step towards eliminating distortions of competition in the European Union, avoiding significant tax losses in corporate tax revenues, averting corporate tax erosion, and creating tax structures that would ease the fiscal pressure on labour, which is extremely high compared to that on capital. The Code of Conduct applies to any measures to attract business activity, and examines laws and administrative regulations as well as administrative practices. Under the Code of Conduct, a measure is deemed potentially harmful if it creates an effective level of taxation (including zero taxation) which is significantly lower than the general level of taxation in a country. When assessing whether particular measures are harmful, the following should be taken into account:

1. *“whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or*
2. *whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base, or*
3. *whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or*
4. *whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD, or*
5. *whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way“.*[27]

[26] COM(97) 495final
[27] Cf. Report of the Code of Conduct Group (Business Taxation) submitted to the Council (ECOFIN) on 29.11.1999; p. 2 et seq.

By adopting the Code of Conduct for business taxation, the member states agreed to refrain from introducing new tax measures to be deemed harmful in terms of the Code ("standstill"). Moreover, they agreed to amend any laws or practices that were deemed harmful in the meaning of the Code (“rollback”). At the Council meeting on 9 March 1998, the finance ministers set up the Code of Conduct (business taxation) group chaired by Dawn Primarolo. This group, also called the Primarolo Group, was tasked to identify harmful measures in the member states and in their associated or dependent territories. Although the Code has no immediate legal effect, it nonetheless represents an agreement which is in some respect politically binding for the member states having signed it.

Finally, the Code of Conduct Group identified 66 harmful measures (44 in EU member states, 3 in Gibraltar, and 23 in dependent or associated territories).

What was particularly striking was that most of the measures deemed harmful could be classified in the following two categories:

1. Measures that could be classified as tax concessions to holding companies and for intra-group services (administration of group headquarters, research, marketing, sales and distribution, internal counselling).
2. Measures that could be classified as tax concessions granted to undertakings in the finance services sector (financing activities, fund management, administration of royalties, insurance business and similar activities).

In principle, the measures were abolished by the States concerned. However, a so-called “grand-fathering” clause was introduced in favour of companies that had benefited from the respective tax regulations before and on December 31, 2000; under the grand-fathering clause, these benefits had to expire on December 31, 2005. However, in a number of member states and their associated and dependent territories, some of these regulations also remained effective for a fixed period beyond 2005. The work on the Code of Conduct was also extended to the ten new member states. In principle, potentially harmful measures were identified in (almost) all of them. In the ten new member states, which joined the European Union on 1 May 2004, 30 harmful measures in terms of the Code of Conduct were identified. 27 of these measures were taken back in the meantime or are being abolished at present. In Romania and Bulgaria, which joined the Union on January 1, 2007 no harmful measures were identified.

Normally, the member states would have had to immediately amend all harmful tax regulations; however, in practice transitional periods were introduced in many cases. As a result, some harmful measures extend far into the future. Malta is a case in point: certain tax concessions granted to Malta-based International Trading Companies will continue to be granted until and up to December 31, 2015 if the undertaking concerned has been recognised as an International Trading Company before the harmful measure was amended by Malta. In Lithuania, those undertakings that were recognised as strategic investors before September 1, 2001 continue to benefit from particular tax concessions until December 31, 2009.

The tax regulations for the so-called coordination centres in Belgium will not cease to exist before December 31, 2010. In Belgium, the term “coordination centre” is used for undertakings that are part

of groups with cross-border activities and that provide specific services for other companies of the same group. The Belgian tax law provides particular tax concessions for these coordination centres to which the Belgian fiscal authorities grants licences which are valid for a period of ten years. The tax concessions granted to the coordination centres consist in applying a very particular provision to them. Under these provisions they may determine their taxable profit according to the so-called “cost plus method”. According to this method, the taxable profit is determined as a certain percentage of all operating costs related to the services provided to the other group companies. What was considered particularly problematic in this context was that the Belgian tax authorities regularly assumed, independently from the economic reality, that the percentage to be taken into account for profit determination was 8% of the operating costs. Moreover, the coordination centres were exempted from withholding taxes on distributed profits as well as from land taxes. These regulations concerning the coordination centres were deemed harmful in the context of the Code of Conduct. However, at the beginning, Belgium refused to phase out or to amend the regulations in order to comply with the Code. Following the refusal, the Commission introduced a formal procedure against Belgium in February 2002 in order to examine whether the tax provisions applicable to the coordination centres were to be considered as state aid or not. In February 2003, the Commission decided that the tax provisions applicable to Belgian coordination centres were to be regarded as state aid and consequently asked Belgium to abrogate the provisions in question, to allocate no new licences and to phase out the licences already granted to companies by December 31, 2010 at the latest.

In the Netherlands, companies with cross-border activities in more than four countries or two continents benefited from a specific tax concession which allowed them to set up a non-taxable provision (a so-called “risk provision”) for 80% of their financial profits gained abroad for a 10 years period. If this provision was used for certain purposes covered by the tax regulation in question, the amount of the risk provision was either fully tax-exempted or subjected to a reduced tax rate upon its liquidation. The companies could also liquidate the provision over a period of five years and thereby benefit from a reduced tax rate of 10%. In this matter, the Commission’s standpoint was similar to that adopted in the case of Belgium: It claimed that the tax provision was to be considered as state aid and as incompatible with the Community regulations on state aid. As a consequence, the Commission decided in 2003 that the Netherlands was no longer allowed to apply the provision to new companies and that it had to be phased out by December 31, 2010 for all beneficiaries.

The cases referred to above are of course only some examples among many others. These examples are meant to draw some attention to the fact that many of these harmful measures continue to apply in spite of the basic political agreement on the rollback of harmful tax measures.

On the other hand, the examples described above also show that although the Code of conduct was not legally binding, the Commission had an effective instrument at its disposition to oblige the member states to end – against their will – the measures deemed harmful: state aid control.

Prove that despite the non-binding nature of the Code of Conduct on business taxation, the Commission was nonetheless in a position of power: By examining whether the member states complied with the rules on state aid, the Commission managed to make them end measures that were deemed harmful against their will.

When assessing whether a tax provision is harmful or not, the Code of conduct for business taxation in principle examines whether a measure constitutes a selective tax concession. However, it seems of course worthwhile to raise the question whether also general tax regulations, such as on the tax rate itself, could be harmful measures, too. In the discussion on the Code of conduct, this question was posed on a regular basis. And on a regular basis, the idea of a fixed minimum corporate tax rate was rejected on the following grounds: It was not possible to make a general statement on which tax rate was appropriate or on when the level of harmful taxation was reached. Another argument that was frequently brought forward was that even specific, selective tax concessions could be justified if they were granted to compensate for particular geographic disadvantages in particular regions or states, or if they were used to support regions with structural weaknesses. In a statement from Luxembourg, it was claimed that smaller States generally needed a more competitive environment to make up for economic disadvantages. According to this statement, these small economies, which were highly dependent from international interweavements, would need specific concessions inter alia to compensate for tax obstacles such as the double taxation risk. It is a matter of fact that tax obstacles need to be dismantled in an internal market such as the European Union. However, at the same time it is also obvious that we are in many cases confronted with a fatal interplay: Tax concessions granted in one country result in tax losses in another country, which, as a consequence, introduces countermeasures that are then considered as tax obstacles. It is therefore questionable whether specific tax concessions may be justified by the size of an economy alone[28].

Finally, the tax package was only adopted by the Council in June 2003. In addition to the before-mentioned Code of Conduct for business taxation, the tax package consisted of the Directive on the taxation of savings income[29] and of the Directive on a common system of taxation applicable to interest and royalty payments[30].

3.5. Further legal acts on direct taxes

With the adoption of the Directive on the taxation of savings income, the exchange of information on the savings income of natural persons became for the first time mandatory in the European Union. This obligation was introduced to curb existing tax evasion in this area. Belgium, Luxembourg and Austria obtained for the time being a transitional period during which they were not obliged to provide information. In return, they committed themselves to apply a withholding tax and to gradually increase their withholding tax rates to 35% by 2011. In order to prevent capital evasion to third countries, the Directive on the taxation of savings income did not enter into force until Switzerland also entered into an agreement. Switzerland basically followed the example of Belgium, Luxembourg, and Austria, and agreed to apply an adequate withholding tax. On the other hand, Switzerland does not participate in the exchange of information.

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[28] Schön (2003), p 16 et seq
[29] Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments
[30] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States

The Directive on interest and royalty payments was adopted to prevent taxes levied at source on cross-border payments of interest and royalties between associated companies based in the European Union. This Directive entered into force on January 1, 2004. The new member states partly benefit from transitional provisions as regards the date at which they will have to apply the Directive in question.

4. Harmonisation of business taxation in the European Union

4.1. Basic EU documents

In May 2001, the Commission published its tax strategy for the years to come in a communication on tax policy in the European Union[31]. In this communication, a distinction was made between general and specific objectives. The Commission basically asked the individual member states to design their tax policy in a way that the political and economic objectives of the EU can be achieved. The so-called Lisbon goals were at the very centre of the strategy. According to these goals, the European Union should become the most competitive, dynamic and knowledge-based economy of the world until 2010. The Commission concluded that this goal could not be achieved unless the entire tax burden within the European Union was reduced on a sustained basis. Moreover, the Commission claimed that the then 15 different tax systems resulted into administrative costs that prevented the companies from benefiting from all advantages offered by the internal market.

In its communication, the Commission moreover referred to some specific tax objectives, ranging from eliminating certain problems related to the taxation of cross-border pension payments to private persons to developing new strategies to resolve tax problems at the European level in the future. As regards business taxation, the Commission has announced in this context that it intended to publish a study on business taxation in the EU and its implications on tax policy. At the same time, the Commission stated that it did not strive for a full harmonisation of business taxation within the European Union, but claimed that a certain level of coordination was sufficient to solve problems related to company taxation in the internal market.

4.2. The two-track strategy of the Commission

In its communication „Towards an Internal Market without tax obstacles – A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities“ of October 2001[32], the Commission showed however greater ambition than originally announced and declared that it was in favour of a harmonised consolidated corporate tax base for companies with cross-border activities. The recommendations and suggestions in this Commission communication were to a very far extent based on the study published by the Commission under the title "Company Taxation in the Internal Market" [33]. Accordingly, the findings of the study were not very much of a surprise: In the European Union, there were substantial differences concerning the effective corporate tax rates; the variability in

[31] COM(2001) 260final
[32] COM(2001) 582final
[33] SEC(2001) 1681final

the effective corporate tax burden was, both as regards home-based and foreign-based investors, above 30 percentage points. In the study, the Commission moreover maintained that the nominal corporate tax rates had a greater impact on the effective tax rates than the tax base. In this context, it is worthwhile quoting the following statement of the communication:

„Simulating the impact of hypothetical harmonisation of particular features of taxation system in isolation shows that:

- *Introducing a common statutory tax rate in the EU would have a significant impact by decreasing the dispersion – both between parent companies and between subsidiaries – of marginal and average effective tax rates across the EU countries. No other policy scenario has such a significant impact on the dispersion of effective tax rates.*
- *Scenarios implying a common tax base or a system consisting in applying the definition of the home country tax base to the EU-wide profits of a multinational tend to increase the dispersion in effective tax rates if overall nominal tax rates are kept constant[34].“*

In principle, the Commission claimed also in this communication that general tax competition would need to be possible within the EU also in the future and that only discriminating and selective tax competition which was harmful to the economy needed to be curbed. We have to keep this in mind to understand the Commission's conclusions: On the one hand, harmonising tax bases at the EU level should be strived for. However, on the other hand, introducing a minimum tax rate or fixing a range within which corporate tax rates in the individual member states were to be established was considered neither necessary nor even useful. On the contrary, the Commission argued that harmonising the corporate tax basis and the transparency resulting from this harmonisation would automatically result into a convergence of the nominal tax rates and, as a consequence, lead to a convergence of tax rates, too.

In addition to the disparities as regards effective tax rates, the Commission identified to some other points that were potential obstacles to companies with cross-border activities and which needed to be tackled as they impede the international competitiveness of European companies as a whole. In particular, the following issues were referred to:[35]

- Problems related to the fixing of transfer prices for intra-group cross-border transactions (high compliance costs, risk of double taxation);
- Withholding taxes for cross-border payments between associated companies (withholding taxes applied to dividend payments, interests and royalties, scope of application of the Parent/Subsidiary Directive was too narrow);

[34] COM(2001) 582final, p. 9 et seq.
[35] COM(2001) 582final, p.11 et seq.

- Restrictions concerning the cross-border offsetting of losses;
- Difficulties in the framework of cross-border restructurings (scope of application of the Mergers Directive was too narrow, uneven implementation of the Directive in the individual member states);
- Risk of double taxation for companies with cross-border activities due to colliding taxation competences);
- Some taxation systems provide a preferential treatment for home-based investments.

Departing from these problems, the Commission developed a two-track strategy to find appropriate solutions. On the one hand, short or at least medium-term measures should resolve specific problems. And on the other hand, the Commission strived to provide, in the long term, a comprehensive solution to tackle all existing problems. Introducing a harmonised consolidated corporate tax base for companies with cross-border activities should be this comprehensive solution. The Commission did however not provide any details on how to redistribute the profits among the individual member states concerned. It also maintained decidedly that defining the corporate tax base should in any case remain within the responsibility of the member states; these should remain in the position to establish their own corporate tax rates also in the future. Moreover, the Commission admitted that it was perfectly aware of the fact that the objective of introducing such a common corporate tax base could only be attained in the medium or long run. Consequently, the Commission announced that it would in the first place suggest short and medium term measures of predominantly technical nature that should solve the most urgent problems. At last, the following targeted measures aiming at solving such urgent problems were referred to:

- Provide information and guidance on the most important ECJ rulings
- Amend the Parent/Subsidiary Directive
- Amend the Mergers Directive
- Provide information and guidance concerning these Directives
- Convene a „Joint Forum on Transfer Pricing"
- Adjust the existing double taxation agreements

Based on these findings, the Commission published another communication on business taxation in November 2003: "An Internal Market without company tax obstacles – achievements, ongoing initiatives and remaining challenges"[36]. In this paper, the existing two-track strategy was in principle confirmed, and the Commission also reaffirmed that the ultimate objective in the area of company taxation consisted in introducing a harmonised corporate tax base for companies with cross-border

[36] COM(2003) 726final

activities. It also suggested different models for such a harmonised corporate tax base, as the meaning of this term could be either wide or narrow. According to the Commission, a harmonised corporate tax rate could be a solution to many difficulties, but also result in a new range of problems that had to be clarified beforehand. First, some clarification was needed on how such a harmonised tax base should look like and on which principles it should be based; and second, introducing it would also raise the question how the corporate taxes levied would be redistributed between the member states concerned. As regards the first questions, the Commission identified at least the IFRS as a possible basis for elaborating a harmonised corporate tax base. This possibility was also envisaged for a simple reason: Since 2005, listed European Union-based companies were required to establish their financial statements in compliance with the IFRS provisions.

Besides, the Commission communication contained two further propositions: It suggested that a pilot project on the so-called "Home State Taxation" be launched. Moreover, it pointed out to the possibility of using the European Company (Societas Europaea- SE) as the basis for a pilot project on the introduction of a harmonised consolidated corporate tax base.

The communication also looked into the specific features which had been announced already in 2001 and which should be implemented in the short and medium run. What was interesting in this context was that here, this Commission focused on the ECJ case law on direct taxation.

In February 2005, the Commission published a new communication "Working together for growth and jobs A new start for the Lisbon Strategy" [37]. In this communication the Commission underlined once again that 25 different company taxation systems created difficulties and obstacles and accordingly high compliance costs for companies with cross-border activities; and that, as a consequence, it still considered crucial that the member states achieved an agreement on the necessity to introduce a harmonised consolidated corporate tax base. However, at the same time the Commission pointed out that defining corporate tax rates should, also in the future, remain within the responsibility of the individual member states. In its July communication „Common Actions for Growth and Employment: The Community Lisbon Programme"[38] the Commission underlined, using practically the same words as in the February communication, that it aimed at achieving an agreement on the introduction of a harmonised and consolidated corporate tax base among the member states.

[37] COM(2005) 24final
[38] COM(2005) 330final

4.3. Plans for a common corporate tax base

As explained above, the Commission had already declared in 2001 that it aimed at introducing a harmonised consolidated corporate tax base for companies with cross-border activities and/or to convince the member states that introducing such a tax base was sensible and necessary. There are of course several ways such a harmonised corporate tax base could be implemented. From the European Commission the following models were and are in general referred to as possible alternatives to existing national systems. Although these models aim at a more or less far-reaching harmonisation or at least at the simplification of systems, they may be very different in the way they are set up, and they would ultimately produce very different results. These models are in particular:

- Home State Taxation / HST (optional)
- Common Consolidated Corporate Tax Base / CCCTB (optional)
- European Corporate Income Tax / EUCIT (compulsory)
- Compulsory Harmonisation of Existing Tax Bases

The following presentation is meant to provide an insight into the most fundamental principles and implications of the concepts referred to above:

Home State Taxation	**Common Consolidated Corporate Tax Base**
Upon application, companies with cross-border activities can determine the total of their consolidated profits for corporate taxation purposes in compliance with the rules applicable in the member state where the head office of the group is located. - The Member State decides, whether it applies the Home State Taxation rules or not. - The company decides whether it applies the Home State Taxation rules or not. - The rules of the State where the head office of the group is located are applicable to all permanent establishments and subsidiaries located in the European Union. - The profits are redistributed among the member states concerned in accordance with a defined allocation key. - Defining the corporate tax rate level remains within the responsibility of the individual member states - The corporate taxes are levied by the member states concerned. - The corporate tax income is allocated to the member states concerned - Simplification for companies with cross-border activities. - New distortions of competition are produced. - Approach raises concern as regards constitutional law - Approach does not reduce tax competition	Companies with cross-border activities can, upon application, determine their consolidated corporate tax base according to new rules introduced at EU level. - The company decides whether it applies these new rules or not - The consolidated profits are redistributed among the member states concerned in accordance with a defined allocation key - The fixing of the corporate tax rate levels remains within the responsibility of the individual member states - The corporate taxes are levied by the member states concerned - The corporate tax income is allocated to the member states concerned
European Corporate Income Tax	**Compulsory Harmonisation of Existing Tax Bases**
Corporate taxes are calculated in accordance with new rules applicable in the European Union. The taxes are moreover levied at EU level and the corporate tax income flows into the EU budget. - Common tax system (tax base, tax rate) for profit determination in the entire Union. - Corporate taxes are levied at EU level by a European tax authority to be created. - Tax revenues flow directly into the EU budget - Compulsory for all companies.	Introduction of a harmonised corporate tax legislation within the European Union - Harmonised tax base - The new legislation would replace existing national tax legislations - The new rules would be compulsory for all corporations (capital companies) - Harmonised corporate tax rate

Source: TAXUD

At present, only two out of these four models are being considerated, precisely the optional Home State Taxation approach and the optional model of the Common Consolidated Corrporate Tax Base.

In this context, it has to be noted that the Commission stood up for introducing a pilot project on the Home State Taxation model. However, the member states' response to such an idea was quite

reluctant. As things stand at present, it seems unlikely that the Home State Taxation model will be implemented.

We nonetheless feel that it is worthwhile to have a closer look at both the Common Consolidated Corporate Tax Base approach and the Home State Taxation model. Comparing these approaches very well highlights the difficulties related to harmonising company taxation. At the same time, it gives an idea of the problems and consequences to be expected if the member states fail to achieve an agreement on a harmonisation and makes clear why, from our standpoint, a comprehensive harmonisation seems to be required.

4.3.1. Home State Taxation – HST

According to the Home State Taxation approach, the profits of company groups within cross-border activities within the European Union are taxed according to the rules of the country where the head office of the parent company is located. It was in 1999 when this approach was for the first time presented by Lodin and Gammie[39]. The most fundamental idea of this approach is that companies with cross-border activities should be given the possibility of determining their profits for corporate tax purposes according to the legislation of the member states where the group has its registered seat. According to its inventors and advocates, the Home State Taxation approach would thereby help companies to considerably reduce their compliance costs. Moreover, difficulties related to the fixing of transfer prices for cross-border transactions between associated companies would be eliminated, as the present practice of individually taxing the profits realised by the abroad-based subsidiaries and permanent establishments would be replaced by the taxation of the consolidated profits of the group. Both foreign subsidiaries and foreign permanent establishments would be subject to the consolidated group taxation. The profits determined according to the rules of the member state in which the group, i.e. its parent company, has its registered seat would be allocated, by means of applying a predefined key, to the member states concerned (i.e. the member state where the registered seat of the parent company is located and the member states where subsidiaries or permanent establishments are located).

The profits could either be distributed according to the share in the total of sales, on the basis of the share in the overall sum of salaries and wages or according to a key taking into account both sales and salaries. The share of profits allocated to each member state concerned would then be subjected to the different regular corporate tax rates applicable in the individual member states. This means that also if the Home State Taxation approach was applied, the fixing of corporate tax rates would remain within the responsibility of the member states alone. The authors of this model thought that in principle, bilateral or multilateral agreements between the member states interested in the idea would be sufficient as a basis for introducing the Home State Taxation scheme.

[39] Lodin, S. O. / Gammie, M. (2001)

According to the principle of mutual recognition, which applies in other legal fields, too, it should be possible, from a legal standpoint, to apply the fiscal rules for profit determination of one member state to a subsidiary or permanent establishment located in another member state.

Also Lodin and Gammie[40] maintain that basically, the Common Consolidated Corporate Tax Base approach would be the best solution for company taxation within the European Union. At the same time, however, they think that it is not very likely that the member states will achieve an agreement on the introduction of a harmonised corporate tax base. For this reason, they developed an alternative model, the so-called Home State Taxation approach, which is, according to them, more likely to be implemented one day. On the one hand, the Home State Taxation approach seems more promising because the member states would not be obliged to amend their national tax legislations upon the introduction of the scheme, and on the other hand, because a small number of member states would be sufficient to launch its implementation. Other member states could easily participate in the scheme later on. In principle, the Commission showed great interest in the Home State Taxation approach and suggested, in its communication of December 23, 2005 – "Tackling the corporate tax obstacles of small and medium-sized enterprises in the Internal Market – outline of a possible Home State Taxation pilot scheme"[41] – that a pilot project on Home State Taxation be launched. According to the Commission, the pilot project should be limited to small and medium-sized enterprises in order to keep the number of the participating undertakings low and to thereby ensure that project's scale remains manageable. The Commissions also wanted to avoid too large numbers of participants as the financial implications for the member states' corporate tax revenues were difficult to estimate beforehand. Moreover, the Commission argued that introducing the Home State Taxations scheme in the SME sector was a priority because compliance costs were proportionally higher for small undertakings with cross-border activities than for large international groups. In the European Union, SMEs are defined as undertakings with less than 250 employees, an annual turnover not exceeding € 50 million or an annual balance-sheet total not exceeding € 43 million. Both SMEs and member states should be invited to participate in the project on a voluntary basis. Moreover, the project should be limited in time and end after a five years' period. Although at the first glance, everything seemed to speak in favour of introducing such a pilot project, the member states' response was more than timid. According to our information, Germany and Austria were the only two countries that showed, at least at the beginning, some interest in the project, but it never really pursued the idea any further either (due to a lack of partners?).

Yet, examining in greater detail the possible consequences of the Home State Taxation scheme, we start to seriously question the usefulness of the model. From our standpoint, many arguments and facts speak against the Home State Taxation scheme:

- Problems as regards national constitutional laws
- Distortions of competition

[40] Lodin, S. O. / Gammie, M. (2001)
[41] COM(2005) 702final.

- Difficulties at the administrative level
- Harshening of tax competition

Although the scheme seems to be very simple at the first glance, it raises nonetheless a number of very serious questions with respect to constitutional law. After all, the Home State Taxation scheme would affect a core competence of the States – taxation. Moreover, implementing this model would, in comparable situations, result in unjustifiable inequalities in the fiscal treatment of companies. At the first glance, it is not really understandable why in one and the same member state, one company should be subjected to other fiscal rules than another, comparable company, on the grounds of the registered seat of its parent company. Of course, unequal treatment is not forbidden under constitution law. In Austria, for instance, the different fiscal treatment of capital companies and partnerships is perfectly consistent with constitutional law. Different treatment can be justified by objective factors and, in principle, economic actors are free to choose between the two legal forms of a company for their activities. However, as regards Home State Taxation, entrepreneurs do as a matter of nature not have this freedom of choice. Consequently, this unequal treatment, which also raises problems with regard to constitutional laws, results in distortions of competition.

Moreover, the member states fiscal authorities fear that introducing the Home State Taxation scheme would lead to considerable difficulties at the administrative level. In particular, the question of how to organise tax examinations seems to be tricky. If the Home State Taxation scheme was applied, the fiscal authorities would have to examine whether a subsidiary located in their country observes the regulations of the member state in which the parent company is based. Accordingly, for the fiscal authorities of the member state in which the parent company is based, it would be difficult and time-consuming to check whether the subsidiaries complied with all regulations. And language barriers must of course not be underestimated either. It is moreover questionable whether the reduction of compliance costs, which is expected in theory, would really happen in practice. It has to be assumed that companies, given the voluntary character of the scheme, would only participate if cost reductions were to be expected, which means that at the beginning, they would even have higher compliance costs. As a consequence, only companies expecting a global reduction of costs or, in other words, only companies that would benefit from the scheme in terms of their corporate tax burden would participate adhere to the scheme. In addition, we assume that the Home State Taxation model would further increase the existing tax competition as soon as all companies were allowed to apply it independently from their size. Home State Taxation would ultimately result in a competition in corporate tax basis between the member states. For the groups concerned it would be relatively easy to relocate their head office in the country which offers the most favourable tax base for the purposes of the parent company.

As things stand at present, it is impossible to estimate what impact the Home State Taxation scheme would have, but it seems most likely that the existing tax competition would be further harshened. Here, we need of course to be realistic. As long as the Home State Taxation scheme remains limited

to the SME sector, it will not really have a very strong effect, as small and medium-sized companies, as matter of nature, do not have that much room for manoeuvre. But at the same time we need to keep in mind that limiting the Home State Taxation scheme to the SME sector will not ultimately solve the current problems in the field of business taxation in the European Union.

4.3.2. Common Consolidated Corporate Tax Base – CCCTB

As becomes clear from the explanations above, the issue of tax harmonisation is essentially about high compliance costs, distortions of competition and tax obstacles (e.g. no possibility of offsetting losses sustained by abroad-based subsidiaries) with which companies with cross-border activities are confronted due to the current situation. Today, we have 27 different business taxation systems in the European Union. The Commission has tried, already since 2001, to convince the member states that it was necessary to introduce a common system for determining the corporate tax base. As regards the implementation of this idea, a number of very different models have been considered. At last, the Commission favoured the model of a common consolidated corporate tax base. Therefore, it launched a public consultation in 2003 to find out to what extent the IFRS / IAS (International Financial Reporting Standards / International Accounting Standards) could provide the basis for determining a common consolidated corporate tax base. It was clear that it was useful and possible to link the Common Consolidated Corporate Tax Base scheme to the IFRS, because according to the so-called IAS regulation[42], listed European Union-based companies are obliged to draw up and publish their financial statements in compliance with the IFRS/IAS.

The International Financial Reporting Standards are predominantly capital market-oriented accounting standards for the drawing up of financial statements. These accounting standards should above all meet the requirements of existing or potential investors.

In 2001, the International Accounting Standards (IAS) were renamed as International Financial Reporting Standards (IFRS). It was in 1973 that the International Accounting Standards Committee (IASC) was founded as an association under private law in London. Its objective was to elaborate and publish accounting standards to be recognised and applicable world-wide. In 2001, the IASC saw an extensive restructuring and reform. As a result, the International Accounting Standards Committee Foundation and the International Accounting Standards Board (IASB) were founded to set the new standards. In order to underline the new start, it was then decided to no longer call newly defined principles “International Accounting Standards”, but “International Financial Reporting Standards”, and the whole body of standards was from then on called “International Financial Reporting Standards”. Essentially, the IFRS include the framework concept, the (old) International Accounting Standards (IAS) insofar as they were not replaced by new standards, new IFRS and publications completing these IFRS (guidance for interpretation and application). (SIC (until 2002), IFRIC (from 2002)

[42] Regulation (EC) 1606/2002, 19.07.2002

As mentioned before, the financial statements established in compliance with the IFRS should in the first line provide information to existing, but also to potential investors. Moreover, in the IFRS Framework, also employees, lenders, suppliers, creditors, customers, governments and the public at large are identified as users of financial statements established in accordance with IFRS.

The conceptual framework states as follows in point 9:

....(a) Investors. The providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the enterprise to pay dividends.

….(f) Governments and their agencies. Governments and their agencies are interested in the allocation of resources and, therefore, the activities of enterprises. They also require information in order to regulate the activities of enterprises, determine taxation policies and as the basis for national income and similar statistics.

The capital market orientation of the IFRS becomes also very obvious in point 10:

While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

Accordingly, establishing the financial statements in compliance with IFRS aims above all at providing information in particular on a company's assets, financial situation and revenue structure which is relevant for decisions (buy, hold, sell?). In principle, the IFRS are based on the "going-concern" assumed, i.e. they assume that a company will continue to pursue its activity. The principle of the "accrual basis of accounting" is applied, too. Information to be published has to be consistent, reliable and relevant. In the German-speaking EU member states, i.e. in Germany and in Austria, the so-called "Maßgeblichkeitsprinzip" (principle of relevance) applies to the determination of profits for tax purposes. This means that the figures in the financial statements are also relevant for the determination of profits for tax purposes if no explicit tax rules provide otherwise.

The Commission's idea to use the IFRS as a basis for establishing the corporate tax base is severely criticised by specialised literature in Austria and Germany where experts are not at all convinced that

the IFRS are an adequate basis for establishing the tax base[43]. In this context, we do not wish to focus on this debate. But we feel that drawing the following conclusion is justified: as long as they are not adjusted, the IFRS are not appropriate as a basis for establishing the corporate tax base.

In the following, we will shortly discuss some points to make clear where specific fiscal rules are required: In financial statements established according to IFRS rules, profits are realised at a very early stage, independently from the date at which payments are actually made; in principle, the dates to be used under commercial law are relevant. The so-called valuation at fair value is very central to IFRS; this means that also here, profits or losses can be shown prematurely, before they are actually realised, and even if such profits or losses are not even to be expected. Moreover, the IFRS body provides for many application cases (these are often related to valuation questions) where book entries, without affecting the profit and loss account, are directly accounted in the assets section. Although there are some important arguments against an uncritical use of the IFRS for establishing the corporate tax base, there are nonetheless some good reasons to link assessing the corporate tax base to the IFRS. Greater detail on these reasons will be provided at a later stage.

In September 2004, the issue of introducing a common corporate tax base was thoroughly discussed at the informal Council (Ecofin) meeting. The Council reached a basic agreement on the appointment of a working group meeting at experts' level to deal with the basic principles and technical details of a common corporate tax base. On November 23, 2004 the working group met for the first time, and 10 other meetings followed (until March 13, 2007). The working group now consists of experts from the 27 member states and experts working for the Commission. As a rule, the working group members should provide their technical expertise only. Their main task consists in defining a common consolidated corporate tax base and fixing fundamental taxation principles. Moreover, they reflect upon basic elements of a common consolidated corporate tax base and other technical aspects such as the mechanism governing the redistribution of the consolidated tax base among the member states concerned. The member states do not enter into any commitment by assigning their national experts to the working group.

Despite the great number of unsolved questions to which the working group was and is confronted, good progress has been made so far. However, in many points, there are still no real solutions. At present, there is an extensive debate on the basic principles as regards the determination of the corporate tax base. For instance, the question is raised whether profits should be determined on the accrual basis of accounting or on the basis of a cash flow analysis, which is similar to the revenue and expenditure account. It seems to be likely that at the end, the advocates of the accrual basis of accounting approach, who are in favour of determining the profits on the basis of the fundamental accounting principles, will be successful. But other questions are highly important, too: How do we ultimately define a group of companies? From what level of participation can we actually use the term "associated company"? What kind of companies are to be taken into consideration? At the same time,

[43] Herzig (2004), 463ff

the working group needs to settle the questions of the consolidation method to be applied. Should the total of the individual results (profits or losses) realised by the company concerned be used? Or would it be more appropriate to apply the consolidation method used by groups to establish their consolidated financial statements?

Even if many questions are not yet resolved, the Commission communication of May 2007[44] gives an idea of how the tax base system to come could look like: The Commission assumes that applying a broad corporate tax base and low corporate tax rates would be most efficient and result in the smallest competition distortions. According to the Commission, the number of derogating provisions and tax concessions should be kept as low as possible.

As a matter of nature, the question of the method according to which the tax base would be allocated to the individual member states concerned is particularly explosive. The working group suggests two different ideas[45]: They allocation key could either be defined according to macroeconomic factors such as GNP or according to national corporate tax basis. But also a microeconomic approach based on value creation could be applied, or a key determined according to a formula taking into account turnover, overall sum of salaries and balance sheet total. For the working group, both approaches are acceptable, but there is a preference for the microeconomic approach. The working group points out to the fact that the idea of the key has already proved to work in the USA and Canada which apply such a key already today.

Although many issues are not tackled so far, the Commission still assumes that it will be in a position to present a legal act (most likely a proposition for a directive) until 2008. The proposition should be submitted after a so-called impact assessment. On the one hand, this assessment will provide a picture of existing fiscal obstacles for companies with cross-border activities in the European Union and show the loopholes for tax avoidance and tax evasion offered to companies by the current situation. At the same time, it will give an idea of how alarming the situation actually is.

On the other hand, the impact assessment will provide figures on the compliance costs for small and medium-sized enterprises in the individual member states and compare them to the compliance costs of large international companies. Moreover, different scenarios (current situation, common tax base with consolidation, common tax base without consolidation) will be analysed with regard to their impact in quantitative and qualitative terms. These objectives seem to be quite ambitious indeed, and we now have to wait and see whether the Commission will manage to meet them or not. In its report of May 2007 on the progress realised so far and the next steps with regard to a common consolidated corporate tax base, the Commissions underlined once again that defining tax rates will in any case remain the member states' responsibility. Moreover, the Commission made a very clear statement on the issue of tax competition[46]. The Commission departments underlined once more that introducing a Common Consolidated Corporate Tax Base (CCCTB) would not interfere with the member states'

[44] COM(2007) 223, p. 7 et seq.
[45] COM(2007) 223, p. 10 et seq.
[46] European Commission (2006) CCCTB/WP/046/doc/en: Progress to date and future plans for the CCCTB, p.20 et seq.

power of taxation, and in particular not with their freedom to define the tax rates that they consider most adequate with regard to their national policies. According to the Commission, introducing a common corporate tax base would not end fair tax competition between the member states, but presumably make it more transparent.

4.4. Joint Forum on Transfer Pricing

On the basis of the study "Company Taxation in the Internal Market'[47] and the Commission communication "Towards an Internal Market without tax obstacles – A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities" [48] the Council declared on 11 March that it was in favour of establishing a "Joint Forum on Transfer Pricing", which was then put into place in June 2002.

By means of establishing the Joint Forum on Transfer Pricing, current problems related to the fixing of transfer prices for cross-border transactions between associated companies should be eliminated to the greatest extent possible. The Forum should above all examine those questions that can be tackled without adopting new rules. As regards the fixing of transfer prices, the companies concerned may be subjected to double taxation if the fiscal authorities in the member states concerned cannot find an agreement on the transfer prices to be applied. According to the companies concerned, compliance costs increase because they have to provide an ever increasing package of information on the transfer prices to the member states. The efforts of the Joint Forum on Transfer Pricing finally resulted in the Code of Conduct for the effective implementation of the Arbitration Convention, which was adopted by the Council on December 7, 2004 and in the Code of Conduct on transfer pricing documentation for associated enterprises in the European Union (EU TPD)[49], adopted by the Council on June 27, 2006.

The Code of Conduct for the effective implementation of the Arbitration Convention should resolve some questions related to the mutual agreement procedure in the event of an adjustment of profits realised by associated enterprises.

The Code of Conduct on transfer pricing documentation for associated companies proposes that all companies with cross-border activities in the EU have the same standardised scheme for documenting their transfer prices. According to the Code of Conduct, there should be one common concept for transfer prices documentation throughout the European Union. This EU Transfer Pricing Documentation should in principle consist of two parts, the so-called masterfile and the information inherent to a particular member state. The Code of Conduct provides very detailed information on the technical details. The Code of Conduct in principle underlines that also here, the arm's length principle as agreed by the OECD member countries applies to determine transfer prices and that companies

[47] SEC(2001) 1681
[48] COM(2001) 582final
[49] Council 9736/06

should therefore be given the possibility of furnishing proof in their documentation that they comply with the arm's length principle.

The Code of Conduct is not legally binding for the member states. It nonetheless constitutes a political obligation. The Commission recommends that the member states make their national rules in a way to effectively implement the recommendations of the Code of Conduct. However, as long as the Code of Conduct is not effectively implemented, companies will have to continue to observe the national rules applicable in the different member states.

4.5. Coordination in the area of direct taxes

On December 19, 2006 the Commission published a communication with the title "Co-ordinating member states' direct tax systems in the Internal Market" [50]. The same day, it also published the communication "Tax Treatment of Losses in Cross-Border Situations"[51] and a working paper related to the same issue[52]. Also in these publications, the Commission underlined that it aimed at an implementation of the common consolidated corporate tax base by the member states and maintained that for the time being, as long this base was not implemented in practice, coordinating direct taxes at European level was necessary. Also in this context, the Commissions pointed out that coordinating direct taxes was required in order to dismantle tax obstacles in the area of business taxation and to avoid that a lack in coordination in the area of direct taxes, which resulted in cases of abuse and non-taxation of trans-border activities. In its communication on the treatment of losses in cross-border situations, the Commission attempted once again to enable the offsetting of losses sustained abroad, but submitted no new proposal for a Directive in this area.

4.6. Future developments in the area of taxation in the European Union

The Commission intends, as explained above, to submit a proposal for a legal act including an impact assessment on the Common Consolidated Corporate Tax Base in 2008. However, we feel that respective Directive will not enter into force in the near future. While a large majority of the 27 member states is now in favour of the planned introduction of a common corporate tax base at EU level, there is still a minority of countries that vehemently refuse such an idea. The latter group includes in particular Ireland, the United Kingdom, Estonia, the Czech Republic and Slovakia.

And even in the European Commission, there are not only advocates of this scheme, but also opponents. Whereas Laszlo Kovacs, the Commissioner for tax issues, constantly underlines that

[50] COM(2006) 823final
[51] COM(2006) 824final
[52] SEC(2006) 1690

introducing a the Common Consolidated Corporate Tax Base is important for a functioning Internal Market where tax obstacles to trans-border activities should be eliminated to the greatest extent possible, Charlie McCreevy, the Commissioner responsible for the Internal Market, is strongly opposed to this idea. On a regular basis, he strongly criticises the idea of introducing a common tax base.[53]

Developments in the European Union also show clearly that today, the situation of European tax policy is somewhat absurd. When Austria cut its corporate tax from 34% to 25% in 2005, the Austrian government argued that it had been obliged to decrease its corporate tax rate as its neighbours, the new member states Slovakia, the Czech Republic, Hungary and Slovenia, applied tax rates that were considerably lower than the Austrian one. When Germany announced that it would decrease its corporate tax rate, the United Kingdom and the Netherlands immediately responded by announcing themselves a cut in corporate tax rates. The situation is paradoxical because on the one hand, politics in the member states justify the developments in the area of business taxation with the imperatives imposed on them by globalisation and the tax competition related to it, while on the other hand, they claim that an extensive harmonisation in the field of corporate taxation in the European Union is unthinkable and not useful, as tax policy should remain in any case within the responsibility of the member states.

On a regular basis, some facts are largely ignored: It is of course formally true that tax policy is a domain of the member states. In the political practice however, the European rules have a far-reaching effect already today, and we can therefore no longer speak of independent national tax policies. As mentioned before, there is already a relatively high level of harmonisation in the field of indirect taxation in the European Union. The centrepiece of this harmonisation is VAT, but also excise duties (on energy, tobacco, alcohol) are subject to different Directives[54] providing for an extensive harmonisation in this field.

In contrast, there is only a relatively small number of legal acts on direct taxation and, as a consequence, only very few European tax regulations that have to be applied by the individual member states. The Directives on direct taxation aim in the first line at reducing the most important distortions of competition and at dismantling tax obstacles to companies with cross-border activities. These Directives include in particular the Parent/Subsidiary Directive[55], the Mergers Directive[56] and the Directive on a common system of taxation applicable to interest and royalty payments made

[53] http://www.tax-news.com/asp/story/story_open.asp?storyname=21683

[54] Directive 2003/96/EC of 27 October 2003, Directive 2002/10/EC of 12 February 2002, Directive 92/83/EEC of 19 October 1992

[55] Council Directive 90/435/ECC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States

[56] Council Directive of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States (90/434/EEC)

between associated companies of different member states[57]. Although the Code of Conduct for business taxation is not a legal act as such, which would be binding for the member states adhering to it, its implications for the member states must not be underestimated, as the definition of harmful measures in the meaning of the Code of Conduct is in many cases very similar to the definition of prohibited forms of state aid as set forth in the EC Treaty. In the event of a failure to observe the Treaties, competition law is a very effective means of the Commission to proceed against a member state. In addition to the legal acts in the area of direct taxation, the member states also have to comply with the dispositions of the EC Treaty. This means in particular that they have to guarantee the four basic freedoms also in the field of taxation, to the same extent as the provisions on state aid, as explained above. The ECJ case-law on direct taxation shows very clearly that these four basic freedoms need to be taken into account. As mentioned at an earlier stage, the ECJ uses a very narrow definition of "justified discrimination" in its rulings. This makes clear that while taxation remains officially within national responsibility, the member states' room for manoeuvre in the area of taxation is much smaller than one would expect. And it is obvious that in many cases, the member states are perfectly aware of this fact.

During the past years it has become obvious that many problems can no longer be resolved at the national level. And community principles and regulations with which the member states have to comply further complicate the situation rather than facilitating solutions. In this contact, the future of business taxation might be the most important challenge for European tax policy, and it seems to be evident that also in this field, we really need a solution at EU level. As we mentioned before, the pressure on the member states to reduce their corporate tax rates and to offer at the same time selective tax concessions noticeably increased in the last few years. The level of the corporate tax rates and the effective corporate tax burden are not the most important criteria in the companies' choice of a business location. However, it becomes more and more apparent that especially international groups attach ever-greater importance to corporate tax criteria, even if their decisions on business location do not predominantly depend on the corporate tax burden in a country. This is in particular to be explained by the fact that for these large groups, it is relatively easy to structure the whole group in a tax-friendly way as they can easily relocate the so-called "mobile company functions" (such as financing functions, administration of group participations or other intangible assets) to countries offering considerable room for manoeuvre for such kind of fiscal constructions. In this context, the Code of Conduct for business taxation, which is no doubt a first step in the right direction, cannot be considered as an effective means to completely curb (harmful) tax competition. It is true, thanks to the Code of Conduct and by means of invoking the Community rules on state aid, the Commission could impose that the so-called coordination centres in Belgium and the regulations concerning international financial services in the Netherlands be terminated by the end of 2010. However, we must not overlook the fact that in the meantime, both the Netherlands and Belgium have introduced new rules providing another bundle of very selective tax incentives to international groups that relocate their mobile functions.

[57] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States

These tax incentives are granted by the so-called “notional-interests“ rules[58] in Belgium and by the “group-interest-box“ regulation in the Netherlands.[59]

There are many more examples for cases where the limits of the Code of Conduct become apparent. In Ireland, for instance, the general corporate tax rate was cut from 24% to 12.5% after some tax concessions (“Dublin Docks”, and others) had been identified as harmful tax measures in the meaning of the Code of conduct. In addition to its low corporate tax rate, Ireland offers a great number of selective tax concessions to companies.[60]

As a matter of fact, similar tax incentives exist, in various forms, in all EU member states. The companies which ultimately benefit most from these tax incentives are multinational groups. These new developments put a lot of pressure on the member states’ tax policy. This pressure is then passed on immobile factors such as labour and consumption, as well as to the profits realised by companies that cannot transfer their profits in another country as easily as international groups. Consequently, the member states’ autonomy in fiscal matters exists rather in theory than in political practice.

The member states’ room of manoeuvre in fiscal policy is further limited by the ECJ rulings. It is true that at last, the outcome of the very much quoted Marks & Spencer case[61] has been quite acceptable for the member states, and in particular for the United Kingdom and Germany. Before the judgement was finally pronounced, the outcome of the case was everything but clear. It was quite surprising that very obviously, the ECJ had strongly taken into account the member states’ revenue situation, even if it did not explicitly admit it in its judgement. In earlier rulings, a member state’s revenue situation has never been considered as sufficient grounds to justify fiscal restrictions.

The situation was quite similar In the Banca Popolare di Cremona [62] where the ECJ examined whether the Italian value added levy IRAP was consistent with Community law. In this case, the ECJ ruled that in principle, the IRAP did not contravene Community legislation, despite the opinion by Advocate-General Stix-Hackl who maintained that the IRAP was incompatible with Community law. The judgement led to great relief in the Italian government as a phasing out of the levy would have had very serious financial consequences the country. [63]

Although these two judgements did not have the effects that the parties hoped for or were afraid of, depending on their position, they perfectly show once again that the ECJ case-law limits the member states’ room in fiscal matters. Since the ECJ rulings do not always follow the same lines of argumentation and do not always reflect the same logic, it becomes ever-harder for governments to anticipate them. These two judgements, which are generally considered as political decisions, make clear that the European Union and the ECJ have arrived at the boundaries of their possibilities. As a rule, Supreme Courts have to make sure that the laws in a country are consistent with the provisions

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[58] The Euromoney Corporate Tax Handbook (2007

[59] http://www.ey.nl/download/publicatie/Finalclarificationsindutchtaxreform.pdf

[60] The Euromoney Corporate Tax Handbook (2007)

[61] ECJ, 13.12.2005, C-446/03, Marks & Spencer

[62] ECJ, 3.10.2006, C-475/03, Banca Popolare di Cremona Soc. Coop. arl

[63] In the event of a phasing out, Italian would have had to pay back a high amount of taxes, depending on the judgement. Some experts spoke of an amount of € 120 billion.

and principles of the constitution. In many of its judgements on direct taxes, which were likely to have severe effects on the revenue situation of the member states, the ECJ has somewhat pushed the envelope. This problem is that in the field of direct taxation, the ECJ has to apply the same principles and provisions as in any other area. If all existing tax obstacles are phased out while the member states fail to agree on a respective harmonisation, a levelling down of tax revenues will be the ultimate consequence.

At the same time, national governments often use the ECJ in order to introduce particular tax rules. Austria is a case in point: When it reduced its corporate tax rate from 34% to 25% in 2005, it also introduced new group taxation rules.[64] These rules replaced the then applicable regulation on the single entity for tax purposes ("Organschaft"). An essential element the new regulation was that groups of companies were allowed to offset losses sustained by foreign subsidiaries against the profits realised by the Austrian-based parent company. In this context, we do not intend to discuss the Austrian regulation in greater detail, but want to underline that the new Austrian regulation goes far beyond the requirements of the respective ECJ ruling. This is a fact, independently from one's standpoint on the cross-border offsetting of losses. The Austrian government then in place justified the introduction of the new group taxation rules as follows: The former rules on the single entity for tax purposes were no longer in line with modern group taxation standards the old regulation was, against the background of consequences to be expected due to the outcome of the Marks & Spencer case, no longer consistent with Community legislation.

So far, the European Union has not really made any noticeable progress in harmonising direct taxes. It is a matter of fact that in the field of fiscal policy, the current situation results in a vacuum, which is to a certain extent responsible for the problems described above. This vacuum is to be explained by several facts: First, decisions in the area of direct taxation can only be taken unanimously. Second, it the Union's tax policy is closely linked to its general approach in economic policy. In the framework of this study, we do not intend to give a detailed description of the economic orientation of the European Union, which can be considered as supply-oriented in many cases. In the area of taxation, this signifies in principle that the primary aim of European tax policy has to be the elimination of existing tax obstacles. Besides, the European Union advocates the idea of a slim, efficient state where the tax burden should be generally low. In addition, some member states, and in particular the new ones, advocate a consumption-orientated tax system. At present, demand-oriented approaches only play a minor role in the European Union.

In its paper „Tax revenues in the European Union: developments and economic issues"[65] of March 2007, the Commission examined to what extent the structural developments and challenges of the last few years, which resulted from the economic integration and the increasing mobility of capital, impacted on the tax structure of the individual member states. In this paper, it also raised the question whether the current shift in the tax burden from mobile factors to immobile factors such as labour and consumption jeopardised the financing of the member states' social models. The Commission stated that there is very obviously a trend towards ever-decreasing corporate tax rates and that this tendency

[64] Cf Article 9 of the Austrian Corporate Tax Law.
[65] ECFIN/E/3/D(2007) REP/51718

was strongly aggravated by the new member states. The paper did however not provide a clear answer to the question whether the decreasing corporate tax rates really resulted in an erosion of the member states' corporate tax revenues and to what extent the term "harmful tax competition" was justified with respect to company taxation. The Commission stated that in principle, despite the decrease in nominal tax rates, the relationships between corporate tax revenues and GDP was relatively stable since 1980. However, analysing this relationship did not provide satisfactory results. On the one hand, the Commission argued that the decrease in corporate tax rates was been partly compensated for broader corporate tax bases. But on the other hand it pointed out to the fact that the decrease in corporate tax rates may have resulted in shift as regards the legal form of companies: It seemed that partnerships, which were liable to personal income tax, had to a large extent been replaced by capital companies, which were liable to corporate tax. This shift would have contributed to compensating the decrease of corporate tax rates. Accordingly, an erosion in personal income tax revenues could be observed. Altogether, also the Commission arrived at the conclusion that it was not possible yet to estimate the effects of tax competition. Although the erosion of corporate tax revenues was not really noticeable so far, it could not be excluded that sooner or later, extending the corporate tax base would reach its limits and arrive at a point where broadening it further would no longer compensate for the tax losses caused by the decrease in tax rates.

Getting back to the Commission's plan to elaborate a legal act on the Common Consolidated Corporate Tax Base by 2008, we underline that we support this plan in any case. However, there is little reason for hope that the Common Consolidated Corporate Tax Base will really be introduced at EU level in the near future. As things stand today, at least some member states, above all the United Kingdom, Ireland, Slovakia and the Baltic States, are strongly opposed to introducing a common tax base. In this context, we must not forget that against this background, the common tax base has no chance as decisions in fiscal matters can only be adopted unanimously.

If no EU-wide agreement can be reached, the member states will have to decide whether they abandon the idea of introducing the Common Consolidated Corporate Tax Base model at EU level, or whether the model could work in a number of countries interested in harmonising their corporate tax bases, by means reverting to enhanced cooperation.

We nonetheless need to regard the Common Consolidated Corporate Tax Base model critically, as even in the event that some member states succeed in introducing it, companies would not be obliged to apply it, but they would be invited to participate on a voluntary basis. The number of corporate tax systems in the Union would increase from 27 to 28. In the first time, compliance costs for companies would therefore not decrease, as companies would have to examine whether the old or the new system is more advantageous for them. And since only those companies that can expect tax advantages from the new system would finally apply it, the revenue situation in the member states would not really improve for the time being. And, last but not least, nothing would prevent the member states from arranging their old corporate tax systems in the way they do at present.

We have to keep in mind that introducing a common corporate tax base would not result in harmonising the corporate tax rates. As we explained above, the corporate tax level would remain within the responsibility of the member states alone, even if these apply the Common Consolidated Corporate Tax Base model. As a result, there would be a shift in tax competition from the tax base to nominal corporate tax rates.

5. Corporation taxation and tax competition in the European Union

5.1. *The basic principles of corporate tax*

The corporate tax covers the income of legal entities, primarily capital companies. As – in principle - also the profit distribution to the shareholders is income subject to taxation, double and multiple taxation is a consequence here as long as no measures are taken against it. In principle, one can distinguish between three corporate tax systems, depending on the way how to prevent said double taxation: The classic corporate tax system, corporate tax systems minimising double taxation and corporate tax systems avoiding double taxation at all.

Besides, it has to be differentiated how to treat profit distribution between (associated) companies. Here, in principle one distinguishes between the so called imputation method and the exemption method. Primarily, this distinction is important in case of cross-border distribution of profits.

The exemption method exempts the profits from the liability in the state in which the head office is located. Thus, taxation is carried out in the source state according to the tax burden in the source state. This is referred to as capital import neutrality, because all profits are taxed equally, no matter if the source of income is a domestic or a foreign one.

The imputation method also includes taxation in the state in which the head office is located when profits arise in the source state. However, the tax paid in the source state is charged against the tax debt in the state in which the head office is located. This leads to the so called capital export neutrality, because all of the profits – no matter if made at home or abroad – are subject to the same national tax burden.

5.2. *Corporation Tax in the European Union*

The development of the corporate tax rates in the European Union shows a completely clear picture. The corporate tax rates have been reduced drastically within the last 30 years in all member states. In any case we experience a tax competition. In addition to the competition of the tax rates a tax competition of the tax bases becomes obvious. Tax competition has in particular become both topical and explosive due to the enlargement of the European Union by now twelve new member states. Now the European Union consists of 27 member states. In addition to the founding states - Belgium, Germany, France, Italy, Luxembourg and the Netherlands - Denmark, Great Britain and Ireland acceded in the course of the first enlargement in the year 1973. Afterwards, Greece followed in a

second step in 1981 and Portugal and Spain in a third step in 1986. Finland, Austria and Sweden became members of the European Union in 1995. The fifth and biggest enlargement until now took place on May 1, 2004 when Estonia, Latvia, Lithuania, Malta, Poland, the Slovakia, Slovenia, the Czech Republic, Hungary and Cyprus joined the European Union as new member states. On January 1, 2007 again two states acceded to the European Union: Romania and Bulgaria.

Foundation / Enlargement	**Year**	**Country**
Founding members	1952/1958	Belgium, Germany, France, Italy, Luxembourg, the Netherlands
1. Enlargement	1973	Denmark, Great Britain and Northern Ireland, Ireland
2. Enlargement	1981	Greece
3. Enlargement	1986	Portugal, Spain
4. Enlargement	1995	Finland, Austria, Sweden
5. Enlargement	2004	Estonia, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia, the Czech Republic, Hungary, Cyprus
6. Enlargement	2007	Bulgaria, Romania

Thus, the enlargement process has not come to an end as also Croatia (2003), Macedonia (2004) and Turkey (1987) applied for accession. Finally, on October 4, 2005 official accession negotiations have begun with both Croatia, which acquired the status of an acceding candidate in 2004, and Turkey. All the discussions about the last and future accessions often forget the fact that the first enlargements have seen some difficulties, too. The United Kingdom for instance already applied for the first time in 1961, but was then rejected due the opposition of France. France under president de Gaulle feared that an accession of the UK would slow down the integration process and increase the US influence on European politics. Finally, the UK could only accede to the Community in 1973. The accessions of Greece, Portugal and Spain gave rise to big discussions, too; here, the former member states feared that the acceptance of the then young democracies in Southern Europe would result in serious economic problems[66].

From the viewpoint of tax competition, in particular the last enlargement sessions of 2004 and 2007 are important, as these enlargements resulted in a total of 27 member states, as compared to the former number of only 15 member states.

As a result of the two last enlargements, the population within the European Union increased from 388 million inhabitants by 103 million inhabitants to 491 million inhabitants, which corresponds to an increase in population of about 27%. However, this population growth results in a GDP increase of approx. 12% only[67]. This clearly shows that these enlargements made two economic worlds clash together. This difference becomes clearly obvious if one compares the GDP per capita. Thus, the GDP per capita is about 26.100 PPS in the 15 old member states while the GDP per capita is only as high

[66] Cini (2003), p. 212 et seq.
[67] GNP based on purchasing power standards.

as approx. 12.100 PPS in the 12 new member states. For us it is understood that the enlargement of the European Union is of historical importance, and we do not intend to play the old member states off against the new ones, nor the big member states against the small, but nevertheless an evaluation from the tax law perspective must also take into account the economic situation and development of the European Union. In particular the issue of business taxation and tax competition has a dimension, which goes far beyond mere legal considerations.

In addition to the economic component, the political dimension of these enlargements must not be underestimated either. If one considers that decisions in tax matters can only be taken unanimously due to the regulations of the EC Treaty[68], one can imagine that decision-making with 27 member states is even more difficult than with 15 member states[69].

5.3. The development of the corporate tax rates

The discussion about the development of the corporate tax rates has now lasted for 20 years. When the example of Ireland, which set off the tax competition by reducing of its tax rate to a then unimaginably low rate of 10% in the 1980s, was followed by the Thatcher policy in the United Kingdom, the other European countries were obliged to seriously reconsider their own tax policy.[70]

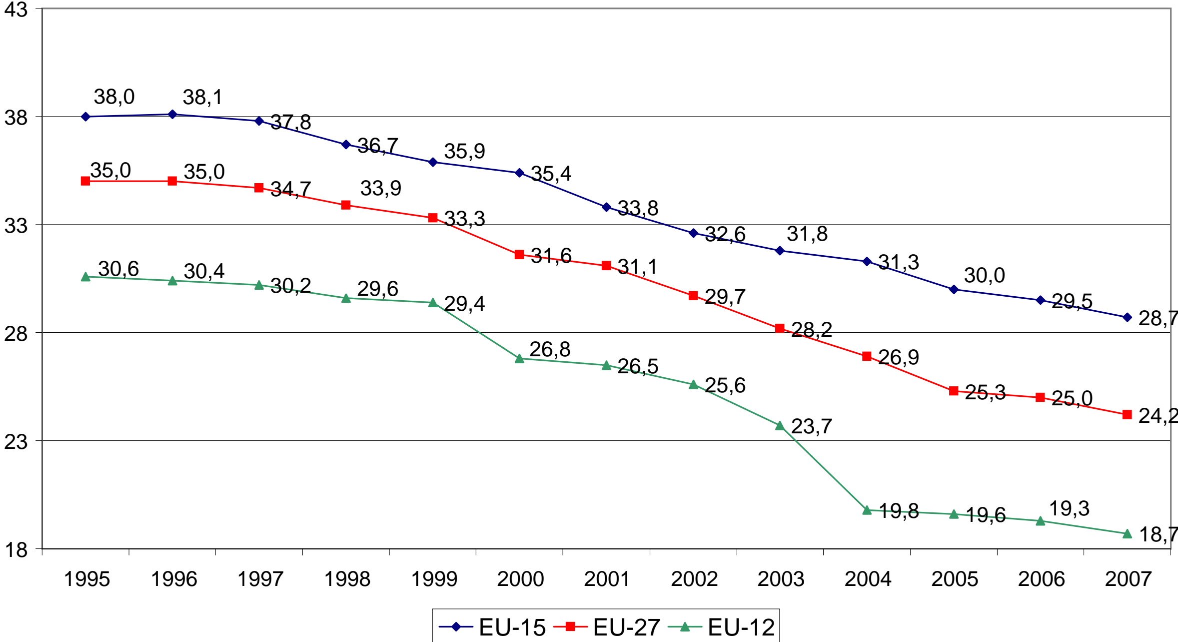
Comparing the nominal corporate tax rates of the individual member states of the European Union, one gets aware that there is a broad spectrum, which starts at 10% in Cyprus and ends at 38.36% in Germany. If we look at the individual member states, the same strong tendency of decreasing corporate tax rates becomes obvious. In the course of a much discussed tax reform in 2004, Slovakia decreased its corporate tax rate from 25% to 19%. In 2004, Latvia decreased its corporate tax rate from 19% to 15%, and in 2003, Poland followed and reduced its corporate tax rate from 27% to 19%. On 1 January 2005, Austria cut its corporate tax rate from 34% to 25%. Hungary reduced its corporate tax rate to 16% in 2004. Estonia does not tax non-distributed profits at all. The latest tax reform in Germany will bring a corporate tax rate below 30% from 2008 on. This radical reduction of rates of nearly 10 percent, which is essentially due to the low rates in the neighbouring countries, will also have its effects in some of the “old” 15 EU member states, such as in France or Italy.

Nominal tax rates play a relatively important role in political discourse. Here, the national legal tax rates are often compared without the provisions on profit determination or the differences in the individual tax systems being taken into account. Accordingly, the findings of this kind of discourse is only partly true, as the real tax burden cannot be estimated based on the nominal tax rates alone, although their psychological effect must not be neglected. Furthermore the process of profit shifting is

[68] Art. 94 EC Treaty is mainly applicable for direct taxes.
[69] The EU constitution summit in Berlin at the end of June 2007 also showed how difficult it has become to agree on a European level, when e.g. Poland was represented by its negotiating team of 50 people from legal experts to mathematicians in Brussels to be able to immediately calculate all proposals submitted at the summit.
[70] Cf. Büttner (2007), p. 46.

determined by the nominal tax rates. Already before the 2004 enlargement, tax competition in the area of nominal tax rates could be observed. Figure 1 shows that the decrease in tax rates has even been intensified since 2004 when ten new member states acceded.

Fig.1 : Reduction of corporate tax rates



Source: trends of the taxation system in the EU, 2007

The following table shows the development of tax rates within the period 1993-2007. As we can see in the table, the average corporate tax rates of the EU-15 in the last years have decreased from 38 % in 1993 to 28 % in 2007. The average rate of the new EU-12 (partly EU-10) member states shows a reduction on a lower level from 30,4 % in 1995 to 18 % in 2007. Besides, we do not mean to discriminate the member states by distinguishing between EU-15 and EU-12. This distinction is considered necessary as the ten or twelve new member states of the EU bring a unique historical development altogether, but above all the one of tax systems to the “old“ member states.

Fig. 2 Nominal corporate tax rates 1993 – 2007

Country	1993	1995	2000	2003	2004	2005	2006	2007
Austria	39.00	34.00	34.00	34.00	34.00	25.00	25.00	25.00
Belgium	40.17	40.17	40.17	33.99	33.99	33.99	33.99	33.99
Denmark	34.00	34.00	32.00	30.00	30.00	28.00	28.00	28.00
Finland	25.00	25.00	29.00	29.00	29.00	26.00	26.00	26.00
France	33.33	36.66	36.66	34.33	34.33	33.83	33.33	33.33
Germany*	59.67	59.00	51.60	39.58	38.29	38.31	38.34	38.36
Great Britain	33.00	33.00	30.00	30.00	30.00	30.00	30.00	30.00
Greece	35.00	35.00	40.00	35.00	35.00	32.00	29.00	25.00
Ireland	40.00	38.00	24.00	12.50	12.50	12.50	12.50	12.50
Italy	52.20	53.20	41.25	38.25	37.25	37.25	37.25	37.25
Luxembourg	39.39	40.29	37.45	30.38	30.38	30.38	29.63	29.63
The Netherlands	35.00	35.00	35.00	34.50	34.50	31.50	29.60	25.50
Portugal	39.60	39.60	37.40	33.00	27.50	27.50	27.50	25.00
Spain	35.00	35.00	35.00	35.00	35.00	35.00	35.00	32.50
Sweden	30.00	28.00	28.00	28.00	28.00	28.00	28.00	28.00
Bulgaria		30.00	25.00	23.50	19.50	15.00	15.00	10.00
Cyprus		25.00	28.00	15.00	15.00	10.00	10.00	10.00
Czech Republic		41.00	31.00	31.00	28.00	26.00	24.00	24.00
Estonia		26.00	26.00	26.00	26.00	24.00	23.00	22.00
Hungary		18.00	18.00	18.00	16.00	16.00	16.00	16.00
Latvia		25.00	25.00	19.00	15.00	15.00	15.00	15.00
Lithuania		29.00	24.00	15.00	15.00	15.00	15.00	15.00
Malta		35.00	35.00	35.00	35.00	35.00	35.00	35.00
Poland		40.00	30.00	27.00	19.00	19.00	19.00	19.00
Romania			25.00	25.00	25.00	16.00	16.00	16.00
Slovakia		40.00	29.00	25.00	19.00	19.00	19.00	19.00
Slovenia		25.00	25.00	25.00	25.00	25.00	25.00	23.00
Japan	52.40	51.60	42.00	42.00	42.00	40.69	40.69	40.69
Norway	28.00	28.00	28.00	28.00	28.00	28.00	28.00	28.00
Switzerland	28.50	28.50	25.10	24.10	24.10	21.30	21.30	21.30
USA	40.00	40.00	40.00	34.00	34.00	40.00	40.00	40.00
EU 15	38.02	37.73	35.44	31.84	31.32	29.95	29.54	28.67
EU 12	-	30.36	26.75	23.71	19.83	19.58	19.33	18.67
EU 27	-	34.61	31.58	28.22	26.93	25.34	25.01	24.22
OECD	38.00	37.70	34.10	30.60	29.50	28.80	28.50	27.80

*Corporate tax rate 25 %, incl. solidarity tax contribution 5.5% of the tax amount, without trade tax.
In 2003 flood contribution 1.5%. The tax reform of 2007 reduced the corporate tax rate to 15 %.

Sources: OECD 2006, KPMG 2007, European Commission 2007.

The general trend of reducing the corporate tax rates indicates that the tax rates will be zero in the middle of the century, continuing trend provided.[71] Specialised literature, depending on its theoretical basis, shows very different positions concerning the effects of tax competition in the EU. Representatives of the New Political Economy or the Public-Choice-approaches in principle consider the state as a mammoth which is increasing expenses (Brennan/Buchanan 1980), on the other hand literature states that too strong tax competition has increasingly negative consequences. From an international point of view the effective corporate tax burden is irrespective of the different tax structures approximately the same (between 21 and 23%). This is due to the high mobility of capital and the international corporate tax competition.

Today, it is neither contested by theory nor by empirical data that there is competition between the member states with respective to taxation factors and bases and that this competition has been increased since the Eastern enlargement as mentioned. [72] From an economic point of view, it is undisputed that the mobility of financial capital is considerably higher than that of real capital.

5.4. Tax concessions in the member states

As already mentioned, a clear competition in the area of tax bases becomes obvious in addition to the competition as regards tax rates. The development of the corporate tax rate can be presented quite easily. This is less true for the corporate tax base. While it is easy to communicate the amount of tax rates to the public, the case of the tax base is more complicated. It is hard to impress the public, except for some experts, with statements on concessions concerning the corporate tax base. In order to get a clear picture of tax competition, one also needs to identify the most important tax concessions in the member states, as for a company's effective tax burden, the corporate tax base is at least as relevant as the tax rate.

In principle, one has to ask to which extent the amount of the corporate tax has an influence on the choice of location of an enterprise. Here, it is important to know that corporate taxes are primarily costs for an enterprise. In relation to the turnover, the amount of the corporate tax is rarely more than 2%, that is to say the corporate tax burden is not very important in relation to the total costs. As a matter of, enterprises seek to maximise their profits, but in this context, it is essential not to overestimate the role of corporate taxation. Looking at different studies or interviews granted by managers on the factors influencing the choice of location, we realise that the corporate tax level is only of minor importance. Decisions on the location of a company are only rarely taken on the basis of the corporate tax burden alone.

[71] see Weichenrieder (2005), p. 2.
[72] On this issue, see Martinez-Mongay (1995); Baker&McKenzie (1999); Oesterreichische Nationalbank (2005); Buijink et al. (1999); Devereux et al. (2002a); Devereux/Griffith (2003), 7; Sørensen (2006).

However, it has to be taken into account that the branches in international enterprises are not equally mobile, thus, tax incentives can really be the decisive factors influencing the location for the relocation of these branches. Basically, we can state that using tax arbitrage for economic reasons can make sense for international groups, and of course there are fields in these groups of enterprises which react very sensitively to tax factors. These are fields which are essentially important for the cross-border transfer of profits within a group of companies. As mentioned in the chapter about tax planning, there are different methods to transfer profits between the member states. Thus, it is obvious that in particular holding companies, finance companies, assets administration and exploitation companies, companies holding immaterial assets as well as distribution companies and other companies dealing with financial services in the broadest sense react very sensitively to tax incentives. For these companies, tax concessions are relevant in their choice of location. This special form of tax competition for holding and finance companies was already identified as threatening danger in the Ruding Report, and also the Code of conduct clearly showed that this form of tax competition has reached an important dimension. A major part of the concessions classified as harmful in the Code of conduct were tax concessions provided to such holding or finance companies, as well as incentives for the provision of intra-group services.

The Ruding Committee also mentioned selective tax incentives in this connection. The member states still show a huge number of such concessions.

Tax regulations in Belgium, Ireland, Cyprus or Malta reveal a clear trend. In these countries it is easy to found companies in order to drastically reduce the total tax burden of international groups of companies. These companies often have harmless names such as “International Holding Company”, “International Trading Company” and the like, and these companies permit a transferring of profits to tax shelters, without special economic activities being undertaken in these countries. At the same time these regulations allow to retransfer the profits in questions which remain subject to a very low tax burden, to the countries of origin or to the countries where the parent company or the shareholders have their registered office (repatriation of profits). Here, one has to bear in mind that often these countries cannot be identified as tax shelters at first sight. Malta, where the nominal corporate tax rate is 35%, is a case in point.

5.5. Theoretical approaches and methods to determine the effective tax burden

5.5.1. Trends

The „Ruding Report“[73], which was written on demand of the EU Commission, investigated into the question whether the differences in national taxation schemes where detrimental to the domestic market. In the event it established that this was the case, which it did[74], it should examine whether market forces alone could counterbalance the situation (which the report denied) or whether Community action was required[75]. As regards the third point on the requirements of Community action, the report suggested a long list of legal measures to be taken in order to eliminate tax obstacles and to level out national differences in taxation which distorted competition.[76] The key message of this Report was related to the competition-distorting effects of the different national corporate tax regulations. Moreover, it is recommended a harmonisation of the corporate tax systems, the tax bases and the corporate tax rates alike[77]. The report had however no greater impact, which is mainly to be explained by the diverging positions in the Commission itself.

Detailed comments on the report can be found in specialised literature according to which there is definitely an interrelationship between the tax burden and decisions on business location and foreign direct investments (FDI).[78] Whereas older economic studies did not see a significant connection between corporate tax level and FDI, new analyses increasingly argue, on the basis of empirical data, that a interrelationship exists. Different methods applied are probably the reason for the different findings. Whereas older studies relied on strongly aggregated data, most of the newer analyses work with more detailed panel data.[79]

The tax systems in the individual member states of the EU are highly different, thus, it is hard to make a statement on the effective corporate tax burden based on the nominal rates. The differences in determining the tax bases (tax allowances, possibilities of deduction, modalities for depreciation and amortisation, provisions, reserves, etc.) are quite considerable in some cases and consequently distort a direct comparison of the tax rates. The Lisbon Strategy was the starting point for the process of improving competitiveness for enterprises. In order to implement the objectives identified, tax obstacles should be eliminated by a Common Consolidated Corporate Tax Base (CCCTB). At the same time, the Common Consolidated Corporate Tax Base scheme should also help decrease the costs of companies with EU-wide activities insofar as it addresses problems related to the fixing of

[73] Cf. Ruding Report (1992).
[74] Cf. Ruding Report (1992), p. 192 et seq.
[75] Cf. Genschel (2002),p. 211 et seq.
[76] Cf. Ruding Report (1992), p. 202.
[77] The Report recommends a minimum rate of 30 %.
[78] Cf. Sørensen (1992), p. 324 et seq; Aiginger (2004), p. 30.
[79] Cummins/Hubbard 1995; Cassou 1997; Easson A. 1999, p. 15.

transfer prices to facilitate a tax consolidation of profits and losses[80]. Thanks to the scheme, questions related to cross-border restructurings and different double taxation procedures could be simplified at the international level, which would contribute to eliminate various forms of discrimination and obstacles. Here, the CCCTB aims primarily at simplifying the taxation of companies with cross-border activities in the internal market. The issue of tax competition is of minor importance.[81]

The effective corporate tax burden can be assessed by using either macroeconomic or microeconomic approaches. For the macroeconomic approach, aggregated economic parameters such as the GNP or the total tax revenue are compared to the corporate tax revenues of a state. For the microeconomic approach, the corporate tax paid by individual companies is compared to the profits according to their annual accounting reports. In the following, the indicators are examined either based on fictious[82] or factual[83] indicators. Fictious indicators relate to estimations on future tax burdens and are referred to as „forward-looking“[84]. In contrast, factual indicators refer to the real tax burden from the past; this approach is referred to as „backward-looking“-method[85]. Basically, the empirical analyses found in literature can classified based on these two methods[86]; economists disagreeing on the best approach to be chosen. Nicodème (2001) shows individual strengths and weaknesses of the different methods, depending on the respective requirement.

5.5.2. Different business taxations by international comparisons

One of the „early“ relevant, but comprehensive analyses of all EU countries based on effective average tax rates was carried out at the University of Maastricht.[87] This study maintained that a high difference between the nominal tax rate and the average tax rate indicated high tax concessions. In the following table, the tax burden on company profits in Europe is not only shown by the nominal, but also by the effective corporate tax rates, which are more significant (see below).

[80] COM(2006)157, p. 8.
[81] Cf. Büttner (2007), p. 49.
[82] Among them there are nominal tax rates, fictious microeconomic effective marginal and average tax rates and regulations on the determination of the tax base.
[83] Factual microeconomic average tax rates or factual macro-economic indicators such as company quota or implicit tax rates. Implicit tax rates are defined as relation between aggregated tax revenues and the corresponding income in the economy – there are different, approaches, partly described above, to measure the tax burden (e.g. backward-looking indicators or forward-looking indicators).
[84] Cf. e.g. the comprehensive investigation of the European Commission (2001)582.
[85] Cf. Nicodème (2001), p. 12.
[86] Cf. Devereux et al. (2002a); Nicodeme (2001) 5; Schratzenstaller (2004), 46; Reding et al. (1999), 488 et seq.
[87] Cf. Buijink (1999).

Fig. 3 Nominal tax rates and average tax rates

Country	Order nom. (eff)	Difference nom. and effective in %	Order acc. to effective tax rate	Country	Effective tax rate
Italy	1 (2)	15.16	1	Germany	38.53
Germany	2 (1)	11.52	2	Italy	35.32
Belgium	3 (11)	19.29	3	Luxembourg	34.09
Luxembourg	4 (3)	5.31	4	France	32.82
Portugal	5 (14)	22.10	5	The Netherlands	31.80
Austria	**6** (13)	18.35	6	Finland	29.82
Denmark	7 (7)	6.38	7	Denmark	29.40
Spain	8 (10)	11.19	8	Great Britain	29.00
The Netherlands	9 (5)	3.20	9	Sweden	27.47
France	10 (4)	1.88	10	Spain	24.11
Finland	11 (6)	4.20	11	Belgium	20.99
Great Britain	12 (8)	4.35	12	Greece	20.85
Greece	13 (12)	11.68	**13**	**Austria**	**17.67**
Sweden	14 (9)	1.07	14	Portugal	17.19
Ireland	15 (15)	8.08	15	Ireland	13.86
EU average		9.59			26.86

Source: Buijink et al. 1999; own calculations.

Finally, to companies, not the legal nominal tax rate, but the real share of the tax in gained profits and the result after making use of fiscal possibilities and funding is relevant. Countries which – due to their nominal rates – would be classified as high-tax countries are tax shelters if the effective tax rates are compared. The partly considerable differences between the nominal and the effective tax rates, such as in Portugal, Belgium or Austria, should not be neglected, either.

A comparative study by KPMG (2004) on the effective corporate tax burden in Austria, the Czech Republic, Slovakia and Hungary analysed the annual financial statements drawn up by production enterprises and commercial undertakings in three consecutive years. The study was inter alia intended to examine what implications the different national taxation levels had for Austria as a business location. The findings of the study on the different markets were very surprising, particularly as the high-tax country Austria turned out to be highly attractive, even for purely fiscal considerations. Only

Slovakia offers small advantages in same areas as compared to Austria.[88] Due to the nominal corporate tax rates one could assume that Austria is not the most interesting business location. If decisions on location or investment are made, the effective tax burden in a country is taken into account, as already mentioned before. However, other location factors are regarded as much more important, such as the composition of human capital, infrastructure or legal systems – just to mention a few.

In the political discussion about the competition of business locations and the resulting competition in corporate tax rates, a certain contradiction becomes obvious: On the one hand, decision-makers justify their decisions by referring to European requirements; but on the other hand, the same arguments are inconsistent with the national sovereignty strongly defended by governments at national level. This contradiction is partly the reason for the deadlock as regards European harmonisation of direct taxation, which has already lasted for decades. Now, sticking to national tax policy appears to be counterproductive: While the member states keep their fiscal sovereignty, tax competition prevents them from using the room for manoeuvre of national tax policy. This problem could be overcome by a joint approach of all member states to regulate tax competition. However, they would have to agree on harmonising business taxation. Some suggestions can be found in the paper on the implementation of the Code of conduct as mentioned. While Uhl (2007a) believes that the member states' room with respect to fiscal policy is limited by European requirements; he sees a clearer progress in European fiscal integration than observed in scientific and political discussion.[89]

The Eastern enlargement set off a debate on the terms “harmful“ and “healthy“ tax competition, which were created by the Commission. According to the Commission’s definition, harmful tax competition exists if certain industries, or without adequate reason, certain regions, are favoured or if domestic or foreign enterprises are favoured unilaterally. If, however, the general tax rate is reduced, this is considered as healthy competition. Measures are considered harmful only if they differ from the general taxation level of the respective country or if they are granted only to foreign-based companies that are not connected with any economic activity in the country. A low tax rate or even a zero rate is not considered harmful as long is it applies to all subjects liable to taxation. Today, the “good“ effects of tax competition are increasingly questioned, in particular by scientists, and arguments in favour of tax competition are less and less substantiated.[90]

Tax competition is not only a problem for high-tax countries, but also for all the other countries participating in it. The differences between the different countries with respect to the taxation of mobile business functions result in tax avoidance reactions (transfer of profits to other countries, tax planning arrangements to “realise” profits at a later stage, other technical tax arrangements). These reactions further decrease the tax revenues in the countries concerned.[91] The empirical proofs of these fiscal effects are abounding according to analyses by Huizinga and Laeven (2005). Adapting and avoiding

[88] Cf. KPMG (2004) p. 3 et seq.
[89] Cf. Uhl (2007a), p. 20.
[90] Cf. Kellermann/Zitzler (2007), p. 2.
[91] Cf. Büttner (2007), p. 47.

reactions show different aspects depending on the tax systems, as we mentioned before in the context of business location and investment decisions and the transfer of profits of international groups. Büttner and Wamser (2006) analyse inter alia the consequences of tax avoiding reactions on the economic capacity of high-tax countries, where immobile business sectors suffer from productivity losses resulting in income losses, unemployment and loss of value.

The following table shows the implicit tax rates on labour and capital applicable in the EU member states. In the new member states (EU 12), the implicit tax rates on capital are generally on a low level and are only conditionally comparable to those in the old member states (EU 15). Despite some systematic weaknesses of these data, they nonetheless show the development of implicit tax rates on capital which can be observed in countries such as Germany or Finland, which are neighbours of new member states. The same trend exists in Austria bordering new member states, too. It can be expected that large countries such as France or Italy will follow the examples of Germany, Finland and Austria.

Fig. 4 Implicit tax rates

	Capital			Labour		
Country	1995	2000	2005	1995	2000	2005
Austria	20.5	21.6	19.5	38.7	40.2	40.9
Belgium	16.9	19	22	43.8	43.9	42.8
Denmark	21.3	24	33	40.1	40.9	37.3
Finland	22.7	31.5	21.2	44.3	44.1	42
France	14.6	20	19.4	41.2	42.1	42.1
Germany	17.8	24.5	19.3	39.4	40.7	38.7
Great Britain	19.5	24.5	22.5	25.8	25.3	25.5
Greece	15.8	3.8	6.2	39.1	37.8	33.1
Ireland	18	24.2	29.2	29.7	28.5	25.6
Italy	17.2	22.5	21.5	37.8	43.2	43.1
Luxembourg	19.1	23	-	29.3	29.9	29.5
Netherlands	15.7	14.8	15.1	34.4	34.3	30.7
Portugal	13.5	24.1	-	28.1	27	-
Spain	13.7	20.9	23.7	28.9	28.1	30.1
Sweden	12.3	29.8	-	48.4	49.2	46.4
Bulgaria	-	10.5	-	-	38.8	34.2
Cyprus	-	-	-	23.1	22.3	24.6
Czech Republic	22.6	17.4	20.7	40.5	40.7	41.3
Estonia	9.1	15.4	-	34.1	38.2	38
Hungary	-	-	-	42.6	42	40.5
Latvia	-	6.7	-	39.2	36.7	36.2
Lithuania	11.3	6.7	9.3	34.5	41.2	35.9
Malta	-	-	-	19	20.5	22.1
Poland	15.4	16.5	16.4	35.9	36.1	35.5
Romania	-	-	-	-	-	26.7
Slovakia	30.5	16.7	12.1	39.5	38.7	33.7
Slovenia	-	-	-	38.9	37.7	38.5
EU 15	17.3	19.2	19.4	36.7	37.0	35.7
EU 12	16.6	19.4	19.3	35.1	35.9	34.9
EU 27	17.3	18.8	19.4			35.2

Source: European Commission 2007.

For high-tax countries, a harmonisation of corporation tax on an EU level with uniform regulations would mean lower costs for financing public services, in contrast to tax shelters which would suffer higher costs. Accordingly, without fiscal transfer an approval by the last mentioned group of countries towards harmonisation is unthinkable. This is also a reason why harmonisation is not seriously discussed.[92] For the Commission, it is much more important to simplify cross-border business activities by means of harmonised tax bases; however, the Commission does not aid at harmonising the tax rates of the individual countries. The differences between the countries' tax systems do of course have effects on investments and the desired unlimited mobility of capital. However, the tax systems only slowly take into account these basic changes.

On the part of the EU Commission, approaches were made to prevent harmful tax competition[93]. The „Code of conduct" is one part of the 1997 tax package. In the report by the Primarolo Group (2000), the Code of conduct for competition policy including the regulations in all member states, is explicitly listed. According to the Code of conduct, the member states should not introduce new harmful measures or tax practices. In principle, we consider that the „Code of conduct" is be considered positively; however, we remain critical on particular measures suggested in it. For instance, the problem of implementing the abolishment of harmful measures remains[94]: Regulations are not effective if the member states cannot impose sanctions. Limited pressure can however be exerted on the member states, or they can at least be obliged to justify cases of non-conformity insofar as they have originally agreed on the Code and have explicitly committed themselves to respecting it.

5.6. Effects in the context of tax harmonisation

A part of the literature about tax theory and politics considers tax harmonisation unavoidable if the European or international integration and capital mobility increases.[95] If no minimum level exists for the taxation of capital, considerable tax competition between the states is to be expected. This is the traditional view of the Heckscher-Ohlin model according to which the capital flows into the country where the highest returns are expected, provided that the countries are equally or similarly developed.[96] The tax rate of the mobile factor thereby approaches zero, while the immobile factor – labour – has no possibility to avoid tax.[97] If we have a look at the development in the "poorer" and "richer" EU states in the period 1965-2000, we realise that in the core countries (founding states), the tax quota are higher than in the periphery countries („cohesion countries"). From the 1970ies on the tax quota have converged. Baldwin/Krugman (2004) try to explain this phenomenon with the theory of the „New Economic Geography" founded by Krugman in 1991. According to this theory, States with different starting conditions compete with each other in the area of taxes, with highly developed

[92] Cf. Büttner, p. 49.
[93] Cf. Primarolo Group (2000), 168 et seq.
[94] Cf. Genschel (2002), 225 et seq
[95] Zodrow (2003) Tax Competition and Tax Coordination in the European Union, International Tax and Public Finance, different approaches to a tax cooperation and harmonisation offers a literary survey.
[96] Cf. Krugman/Obstfeld (1999).
[97] Cf. Breuss/Schratzenstaller (2004), p. 646.

countries having agglomeration advantages as they are in a position to offer public services of better quality, such as infrastructure, education, etc. and, this is important, a well-working legal system. Moreover, “rich“ countries have sufficient demand for goods and services, and they also have the corresponding purchasing power. These agglomeration advantages result from economic returns, which exist only in the core countries and which can therefore be appropriately taxed to a certain extent, without an important loss of capital.[98] According to Baldwin/Krugman, tax competition between unequal countries is one-sided and harmful for all participating countries.

Based on the traditional standard model of tax competition developed by Zodrow and Mierzkowski (1986), the effects of increasing capital mobility on the tax rates of corporate taxation are identified. The empirical evidence of Garretsen and Peeters (2006) supports these theoretical balance models of tax competition. In concrete, the model maintains that smaller countries generally apply lower tax rates than larger countries. If we apply the model to two countries with two production factors (labour and capital), labour being the immobile and capital the mobile factor between the two countries, and if we assume that unlimited competition, constant economies of scale and perfect goods markets exist, [99] the resulting balanced tax rate should be lower than the rate determined by the government. The gap between the two rates will be widened if international capital mobility increases. Basically, this result confirms that increasing factor mobility results in a “race to the bottom“ of tax rates. Even the much stricter assumptions of the pure standard model are applied, the “race to bottom“ principle can no longer be rejected if the taxes on labour and capital differ, primarily if the tax burden is simply shifted to the factor labour due to the increasing mobility of capital.

A reason for the different tax rates could be the more elastic tax base.[100] On the one hand small countries can be attractive for high amounts of new capital, on the other hand the costs are low on a low level of income of a low capital stock. However, large countries have more extensive capital reserves; and in order to compensate for the loss of income, reduced tax rates must attract much more new capital. This is also the economic reason why tax havens generally exist in small countries rather than in large ones. Bucovetsky (1991) includes the asymmetry of the countries in the balanced standard model and shows that larger countries bear a higher balanced tax rate as they can more easily cope with the resulting capital loss than smaller countries. Any capital flow between two unequal countries provided, a change in the tax rate has a greater impact on the smaller country. The theory of the “New Economic Geography“ mentioned above deals with questions of the distribution of economic activities different regions.[101] Generally, it becomes obvious that the connection between mobility of capital and corporate tax rates is much more complicated than the general balanced model of tax competition suggests.

However, the thesis of the “race to the bottom” cannot by convincingly refuted by the relative stability to be observed in the relation between income and GDP over a long period of time.

[98] Cf. Baldwin/Krugman (2004), p. 19.
[99] Cf. Garretsen et al. (2006), p. 3 et seq
[100] Cf. Weichenrieder (2005), p. 3.
[101] Cf. Garretsen et al. (2006), p. 5.

The increasingly important role of capital companies in Austria and Germany – and, presumably also in other countries – shows a distorted image of tax competition if we look at a country's corporate tax revenues in isolation.[102] The forward-looking methods of effective tax burden developed by Devereux and Griffith (2003) point in the same direction, They also show very clearly that the effective average corporate taxes have decreased since the 1980ies in most countries. Having this in mind, we have to conclude in a next step that corporate tax seems to be a dying species. This consequently leads us to the question of additional costs due to the loss of the instrument of corporate taxation in the tax competition process. There are many arguments in favour of maintaining business taxation. Why should companies be allowed to benefit from certain advantages offered by a country (e.g. a functioning legal system), its infrastructure or public services without making their contribution at all? Moreover, corporate tax is required as an equivalent to personal income tax to which partnerships are liable. Moreover it has to be kept in mind that corporate taxation is needed to make our tax systems work. The absence of corporate taxes would ultimately lead to an erosion of personal income and capital taxes, thus in the taxation of labour.[103]

In literature the importance of the corporate tax is explained both by economic and political reasons.[104] Last but not least, corporate taxation serves purposes of the redistribution policy without financing and investment decisions being influenced. Corporate taxation is absolutely necessary in the tax systems, because if abolished, profits of capital companies would be tax-free as long as the rules on personal income taxation are not changed. Moreover, if corporate taxation was abolished, pressure on assessed personal income tax and wage tax would increase, as we explained earlier.[105]

Numerous empirical analyses show a connection between business taxation and investments of multinational groups. Experts however disagree on the extent to which business taxation and investment decisions are linked. [106] According to the estimations of Devereux et al. (2002a), the states definitely react to tax policy conducted by their competitors. The authors moreover point to an interesting phenomenon, which is also observed by the „New Economic Geography" approach: large countries have higher corporate tax rates than small countries.

If now countries use their tax policy as strategic instrument to attract enterprises or direct investments, tax competition arises as enterprises react to tax policy, thereby forcing other states to take action. Here, it has to be mentioned that not all member states are affected to the same extent by the existing tax competition. This is also a reason why there is still no harmonisation at EU level. Uhl and Rixen (2007b) found that small states are the "winners" of tax competition, because they can attract a relatively high foreign tax basis in relation to their relatively low national tax basis. Thus, they can increase their tax revenues even if they decrease their tax rate. Here, the best-known examples are Ireland and Great Britain in the 1980ies, which conducted such policy under Margaret Thatcher. As a matter of course, the new member states are encouraged by these examples which seem to promise

[102] Cf. Weichenrieder (2005), p. 6.
[103] Cf. Gordon and Slemrod (2000); Weichenrieder (2007),p. 13.
[104] Cf. Nowotny (1999), p. 336.
[105] Cf. also DeMooij (2003) and Nicodème (2007) on the „backstop" – the role of the corporate tax for the income tax.
[106] Cf. Markusen (2002); Hirschler/Finkenzeller (2004); Devereux et al. (2002a); DeMooij et al. (2003) on FDIs.

them a successful economic development as long as they consequently apply their tax-decreasing policy. The incoming foreign capital brings increased welfare for small countries; on the other hand, large countries suffer losses of welfare, and these losses are more considerable than the gains of the small countries.[107] In concrete terms, the issue is primarily about rearranging the state's tax revenue structure, as constant decreases of tax rates could only be compensated for by means of expanding the bases in order to avoid drastic losses of tax revenue. However, these measures result in shifts in as regards the states tax revenues. Broader bases favour highly profitable investments which are subject to a low tax burden, while stronger strain is put on capital which is not as profitable. As a result, the pressure on labour increases and a shift towards indirect taxes takes place. This means moreover that the tax burden decreases for large multinational companies, whereas the pressure on small and medium-sized enterprises, but also on employees, increases. Consequently, the whole tax system threatens to ultimately collapse, as corporate tax competition undermines progressive taxation of corporate income tax. In many cases, there is also a wide gap between corporate tax rates and the top personal income tax rate. It is obvious that corporate tax competition has lead to great pressure on personal income tax. A policy of progressive taxation aiming at redistribution becomes increasingly more difficult. This clear discrepancy between „old“ and „new“ member states as regards the slow tax strategy does not facilitate the harmonisation in the area of taxation. As decisions of the European Council require an unanimous vote, each of the 27 member countries has a certain power to veto initiatives.

Nicodème (2007) contributes to the more recent discussion on cross-border activities of enterprises in the EU and asks if large companies ultimately benefit from lower effective corporate tax rates than small undertakings. The analysis is based on firm-related data from 21 different countries referring to the period 1992-2004.The findings of the study confirm that large companies are favoured. It proofs that there is a striking negative correlation between the number of the employees and the effective corporate tax burden of the companies. The thesis of the study according to which small firms have cost and information disadvantages in comparison to large companies is undisputed. Huizinga and Nicodème (2006), who examine the relation between taxes and total capital, come to the same result.[108]

Nicodème (2006) moreover finds that the effects of tax rate decreases did not result in falling revenues from taxes on profits. This could probably be explained by the fact that states limited the number of exceptional regulations as regards the tax base. However, one day, all exceptions will have disappeared, and the present argument according to which tax rate decreases have no effect on the revenue, will consequently become obsolete.[109] The profits of the large groups have an important share in the constant tax revenue of states. The trend of transforming partnerships into capital companies remains unchanged. Although corporate tax rates have continuously decreased over the last decades, the states' corporate tax revenues remained relatively stable; at the same time, losses in

[107] Cf. Uhl et al. (2007b), 6; and Bucovetsky 1991; Wilson 1991; Dehejia/Genschel 1999.
[108] Cf. Nicodème (2007), p. 5.
[109] Cf. Nicodème (2006); or Schratzenstaller (2006), p. 86.

personal income tax revenues are to be observed. This indicates that while cutting tax rates, the states have broadened their tax bases („tax cut cum base broadening“).[110]

Becker and Füst (2007) believe that the stability of the states' corporate tax revenues is to be explained by the increase in company profits before taxes due to globalisation. Finally, Devereux et al. (2004) claim that the expansion of the finance sector could probably have resulted in higher company profits as a whole and, as a result, in additional corporate tax revenues.

The stability of corporate tax revenues with tax rates being reduced could also be explained by the fact that the share of capital companies compared to partnerships increased in many investigated countries.[111] For enterprises the lower corporate tax rates, but also the greater flexibility concerning the base are reasons to change their form of company. If this is the case, the consequences of corporate tax cuts do not become obvious in the states' corporate tax revenues, but in its dwindling personal income tax revenues. Here, empirical analyses, which were principally carried out in the USA, confirm the assumptions described above. For Europe, there are only very few investigations in this area. We should also keep in mind that advantages of capital companies are not limited to tax planning possibilities. In addition to the advantages conferred by tax law, capital companies have the possibility of limiting risks related to the personal liability of persons. As long as the (non tax-related) advantages prevail compared to the corporate tax burden, the decisions on the form of company will be made in favour of a capital company. The empirical studies of Gordon and MacKie-Mason for the USA for the period 1970-1986 show that non tax-related factors are more important for such kind of decisions than tax-related factors. Studies on capital companies carried out by Goolsbee, MacKie-Mason and Gordon point in the same direction.[112] The study by Alstadsaeter on the situation in Norway, one of the few European studies, shows a clear shift towards corporations as form of company. However, in this study, Alstadsaeter does into explicitly investigate into the effects of fiscal factors on the form of company.[113] To conclude, we generally state that there is a positive correlation between the number of capital companies and the difference between corporate tax and personal income tax rate. The analyses carried out in the USA and Norway show that approx. 10% of the relation corporate tax/GDP is due to the shift in the state's revenues towards corporate tax in the early 1990ies. In the last few years, the relation between corporate tax revenues and GDP has increased to 17%.

Finally, there were numerous unsuccessful attempts to harmonise the corporate tax base in the European Union, starting with a first approach of the Commission in the field of loss deduction in 1984[114]. Essentially, the various debates resulted in three Directives on business taxation: the Parent-Subsidiary Directive, the Mergers Directive and the Directive on a common system of taxation applicable to interest and royalty payments. As regards associated companies, only steps to eliminate the must urgent problems encountered in the event of cross-border activities by groups of companies

[110] Cf. Devereux et al. (2002b).
[111] Cf. Weichenrieder (2005); Sørensen (2006).
[112] Cf. Mooij et al. (2007), p. 4.
[113] Ibid, p. 6.
[114] Cf. Genschel (2002), 201 et seq.

have been taken so far. Thus, one cannot speak of a real harmonisation of business taxation on a European level. The measures taken so far have only been targeted at eliminating double taxation in the event of cross-border transactions. These measures were doubtless right and necessary.

In principle, there are several ways of harmonising corporate taxation. In current debates in this area, the models described earlier are being taken into consideration: Home State Taxation (HST), Common Consolidated Base Taxation (CCBT), European Corporate Income Tax (EUICT), and Compulsory Harmonisation of Existing Tax Bases.[115]

Continuing competition provided, the tax revenue situation of the individual states will probably be aggravated. A decrease in public revenue jeopardises the European social model; the states will no longer be in a position to provide services, or will only provide them to a lower extent.

The different tax burden on the production factors causes asymmetry in the tax systems as a whole and results in difficulties as regards the redistribution policy. Here, it has to be assumed that the tax burden will remain on immobile production factors or will be transferred to indirect taxes. Consequently, the shift from capital to labour taxation will continue to take place.

As we mentioned earlier, the role of the ECJ rulings is an important one in the context of the business taxation issue. The primary aim consists in ensuring the smooth movement of capital in the internal market, which is reflected by the ECJ rulings on tax regulations. Companies must for instance be allowed to offset the losses sustained by their foreign-based subsidiaries if losses sustained by home-based subsidiaries can be offset. In this context, states have to comply with the Code of conduct, which forbids the introduction of new unfair tax regulations aiming in particular at foreign investors and at companies with activities which are not associated with real economic activity.

Ganghof and Genschel (2007) conclude from their analysis that the corporate tax competition in the EU does not only have a direct, but also a remarkable indirect effect on the progression and the revenue potential of personal income taxation. The authors believe that a general democratic deficit in the EU is the reason for these indirect effects.[116] At the international tax conference[117] on a common consolidated corporate tax base in Berlin on 15 and 16 May 2007, EU Commissioner Làszlò Kovàcs explained the current progress report on tax harmonisation in the EU. The companies operating in the European market have to deal with 27 different tax systems. A common tax base for all member states would mean uniform provisions for the determination of profits. Common tax bases would curb the so-called harmful tax competition and thereby ease pressure on national budgets.

Against the background of the accession of the ten new member states, the idea of harmonising tax rates, fixing minimum levels or common tax bases is perfectly justified. This idea is however

[115] Cf. COM(2001)582.
[116] see Ganghof et al. (2007), p. 5.
[117] http://www.bundesfinanzministerium.de/cln_03/nn_54/DE/Steuern/Veroeffentlichungen__zu__Steuerarten/Internationales__Steuerrecht/005.html.

problematic from a political standpoint as tax legislation is national competence and as at the Council, unanimity is required for tax-related decisions.

Considering the present situation of business taxation, we wonder of course how the future of business taxation will look like. If we consider that corporate tax revenues account for an only relatively small part of the overall tax revenues in the European Union, we could assume that a decrease in or even an abolishment of corporate tax should not have significant effects on the member states' tax revenues. However, we have to look a bit further and bear in mind that corporate tax is also a central element of the income tax systems in nearly all member states of the European Union. A change of the corporate tax will have serious effects on the income tax system. If corporate tax was abolished, undistributed profits of capital companies would not be taxed at all. Corporate tax is a necessary element of the personal income tax system. If for example the corporate tax was strongly cut and as a result much lower than personal income tax, entrepreneurs would, to the greatest extent possible, choose a legal form which is subject to corporate taxation for their economic activities. Doing so, they would avoid personal income tax and benefit from the more favourable corporate tax regulations. Additionally, the pressure to decrease the personal income tax will also grow, as also those that cannot choose the legal form of a capital company due to their economic activities would call for similar tax decreases. As a result, we would also see an erosion of the personal income tax. This development can already be empirically proved, too. In a study carried out in 2007, Mooij and Nicodème[118] wondered why the share of corporate tax revenues in the GDP has increased since approx. 1980 despite the important cuts in corporate tax rates. They came to the conclusion that the relative increase in corporate tax revenues was to be explained by a shift towards forms of companies which were liable to corporate tax. Accordingly, they observed that personal income tax revenues decreased. In their study they found that due to these shifts, the share of corporate tax revenues in the GDP has increased by about 0.2% since the early 1990ies.

5.7. Tax Policy and tax planing by companies

The present situation of 27 different corporate tax systems, corporate tax rates and rules on profit determination in the European Union implies both positive and negative aspects for international companies. On the one hand, the multitude of different provisions entails higher compliance costs[119]. But on the other hand, it is also this gap between the different tax provisions in the individual member states that allows the companies to plan their taxes very effectively. Thanks to this gap, the tax burden can be minimised for the whole group.

Thus, it is not surprisingly that large groups with cross-border activities now fill their services with qualified experts who are exclusively in charge of decreasing the group tax quota. In addition, these groups benefit from extensive external expert knowledge provided by large accountancy and tax

[118] Mooij R., Nicodème G. (2007)
[119] Compliance costs are additional costs arising for companies with international activities as they have to comply with and apply the legal provisions (which are quite complex in most cases) of all countries concerned in order to determine their corporate taxes.

advisory companies, which very much work on the issue of tax saving. The group tax quota is the relationship between a group's tax expenses and the annual group profits before taxes.

Group tax quota = group tax expenses / annual group profits before taxes

The tax expenses are the sum of real tax expenses and latent tax expenses. Although the significance of this figure is questionable, the group tax quota becomes increasingly important in company practice.

Companies can choose among many ways to arrange taxes. In this context, we cannot go into greater detail as the issue of taxation is very complex indeed. To say it simply, international groups and companies in general aim at decreasing their total costs in order to maximise their profits (after taxes). As in the end also the corporate tax means costs for companies, these seek, as a matter of nature, to keep the corporate tax as low as possible. Thus, international tax planning consists in making taxable profits, which are the basis for determining the corporate tax to be paid, arise in those countries where the tax burden on profits is the lowest. Put simply, there are several systems and methods to transfer profits into other member states. These are in particular:

- Determining transfer prices
- Group financing
- Outsourcing of functions
- Outsourcing of intangible assets

Since, as a matter of nature, the economic and financial interdependencies within groups of companies are very tight, there are corresponding possibilities to transfer profits within the group. The term "transfer prices" refers to the prices for intra-group supplies of goods and services. Transfer prices are calculated in a way that group companies located in tax shelters charge very high prices for the goods and services they deliver, whereas they are charged very low prices for goods and services they receive. These prices can of course not be determined arbitrarily, but in practice it is often very difficult to check whether the prices calculated for the supply of goods and services are really adequate. In principle, intra-group supplies of goods and services are subject to the so-called arm's length pricing method. This means that prices applied for intra-group transactions have to be the same as those that would apply between independent companies for the same goods or services. This approach was basically agreed upon by the OECD member states. The OECD also published the so-called OECD Transfer Pricing Guidelines, which describe in great detail which practical requirements have to be fulfilled.

Besides, the second major element in every group tax planning is group financing. Also here, companies with cross-border activities have numerous legal possibilities of minimising the group tax quota. If we put things as simple as possible, the following picture can be drawn: Group companies in tax shelters are provided with high equity capital. In the following, the companies based in tax shelter

provide companies in high-tax countries with capital in the form of debt capital (shareholder's loan). In return, the equity capital quota of the companies based in high-tax country is very low in most cases. This has the advantage that the interests paid to financing companies by these companies are deductible as operating expenditure in the companies concerned. Accordingly, these minimise the taxable profits. On the other side, the interest payments are an operating revenue for the financing company and accordingly increase its profits.

In the past, some member states made it even easier for companies to proceed as described above as they introduced tax schemes which provided tax concessions for holding companies in general and for financing companies in particular. As a result, the tax planning methods described above became the more attractive from a tax perspective.

As the existence of tax competition can no longer be denied, every now and then the discussion arises whether it would be more sensible to have a system based on the taxation of consumption rather than the current system of income taxation, which primarily means taxation of profits or capital. Although such tax systems based on consumption cannot be found in a pure form in the European Union, some of the new member states, such as for example the Baltic states or Slovakia, have tax systems showing some aspects of consumptions-oriented systems. Slovakia has a tax system which applies the a uniform tax rate of 19% for income tax, corporate tax and also value added tax.[120] Estonia in turn does not tax retained profits of capital companies at all.[121] Only the distribution is subject to a corporate tax in the amount of 22 %. A shift towards a more consumption-oriented tax system would be a step in the wrong direction, as households would then have to bear the negative consequences of the tax competition. The introduction of a consumption-oriented tax system would lead to undesired redistribution effects, and the principle according to which taxes are to be proportional to the capacity of the households or companies would be abolished. Moreover, domestic demand would decrease.[122]

[120] This uniform tax rate of 19% was introduced within a broad tax reform in 2004. However, in the meantime this has been softened and Slovakia introduced a reduced value added tax rate of medicine in the amount of 10 %.
[121] This regulation is in conflict with Community law, as not compatible with the Parent-Subsidiary Directive. However, in the course of the EU accession, Estonia was granted a transitional period to expire by 31.12.2008 In the meantime, Estonia can continue to apply its current system
[122] For further details, cf. Nowotny (1999), p. 250 et seq.

6. Demands on the tax policy of the European Union

6.1. The harmonisation of business taxation

Analysing the present situation of business taxation in the European Union clearly, we realise that there is urgent need for action with regard to the further proceeding in the field of business taxation. For this reason, we assume that only a broad harmonisation of business taxation within the European Union can ultimately bring the results desired. For us, broad harmonisation means a common consolidated corporate tax base and a common corporate tax rate for internationally operating groups of companies. Moreover, the common consolidated corporate tax base must be compulsory for all member states and companies concerned. As tax competition favours above all large groups with international activities, we believe that it is not absolutely necessary for SMEs to participate in this common tax scheme. It is also thinkable that the member states keep their autonomy when determining the corporate tax rate for their SMEs.

As regards the question about what corporate tax base system to chose, we think that "the one and only good system" just does not really exist. It is clear that the choice of the system will ultimately also be a political decision. If the common consolidated corporate tax base is only introduced for large capital companies, most of these companies will be listed and therefore have to draw up their annual accounts according to the International Financial Reporting Standards. Thus, also the corporate tax base should in principle be based on the IFRS regulations. Adjustments will be required in any case. Using the IFRS for the purpose of determining taxable profits would have one big advantage in comparison to a system where profits are determined exclusively on the basis of fiscal rules. If companies, in order to determine their profits for tax purposes, can or must apply particular provisions which strongly differ from those used for establishing the annual accounts published, their only aim will be to keep their taxable profits as low as possible. In contrast, listed companies will aim at showing as high profits as possible in their annual accounts, which are published and read by investors and potential investors. We would in principle welcome a system where the accounts published are taken into account when determining the corporate tax base, as in such a system, companies would not artificially become "poor" when it comes to determining profits, and they would no longer publish excessively exaggerated results in order to be more attractive at the capital market. In the end, this would also protect potential investors from unrealistic expectations based on exaggerated accounts.
As we argued earlier, a corporate tax base that would be completely identical with IFRS is not desirable. In any case, appropriate adjustments of IFRS-based accounts will be required for determining the corporate tax base. Here the greatest transparency possible should be applied by means of publishing, together with the annual accounts, all adjustments made for tax purposes.

Besides, the question naturally arises of how to define a group of companies: At what stage can we talk of "associated companies"? Which companies are to be included? In the end, the level of

participation requiring group consolidation will be subject to a political decision. If a company holds 50% of another company, group consolidation could make sense. If it holds 75% or more, group consolidation should be a must in any case.

It is also important that partnerships which are part of a group are included in any case to limit tax planning arrangements.

Opponents of using the IFRS as a basis for determining the corporate tax base often claim that the IFRS are inappropriate as they are only compulsory for a minority of capital companies (listed companies). As establishing annual accounts in compliance with IFRS requires relatively extensive technical knowledge, they argue that small and medium-sized enterprises would have great difficulties. If the common corporate tax base was only applied to large capital companies with world-wide activities, the argument above against a use of the IFRS as starting point for the determination of taxable profits, would no longer substantiated, as the majority of these companies would have had to prepare IFRS-based annual accounts anyway.

If a common consolidated corporate tax base for EU-based companies with trans-border activities was introduced, the question would arise how to apply the common tax base in the event that third countries are concerned, too. We assume that the majority of the companies concerned would also be operating in third countries. As a result, there would be associated companies or permanent establishments in third countries, too. Also these companies would have to be taken into account. Corporate tax paid in third countries would have to be offset against the taxes payable in the European Union (imputation system leading to capital export neutrality)

6.2. The corporate tax to finance the EU budget

There are plans to finance, from 2014 on, the EU budget at least partly directly via the member states' national taxes of the member states. The corporate tax based on the common consolidated corporate tax base could be this tax to flow (at least partly) directly into the EU budget. As it is not foreseen to grant the European Union powers in the area of taxation, the member states would levy the corporate tax as they do today. This would have several benefits: first, already existing structures would be used, which would be less costly than creating new administrative units. Second, the know-how of the member states' fiscal administrations could be used, too. However, the corporate tax revenues generated should not completely flow into the EU budget. The member states would also keep their share, on the one hand, to make sure that also the national fiscal administrations are interested in an effective levy of the corporate tax and on the other hand, because corporate tax, which is based on profits, is naturally subject to stronger economic fluctuations than for example the value added tax. For this reason the share of the corporate tax income in the EU budget should not be excessively high. Assuming that at present, the revenues in the EU budget are about € 125 bn per year, we think that a share of 25% to be financed by corporate tax income would be appropriate. This would correspond to revenues in the amount of approx. € 30 bn per year. If we assume that the total corporate tax

revenues throughout the European Union account for more then € 230 Bn, it seems to be realistic that this amount of tax revenues can be achieved. If we take the revenues which could actually be obtained by means of applying this common corporate tax base and divide it by the approximately € 30 bn, we get the percentage of the corporate tax revenues to flow into the EU budget. The remaining 75% should be distributed among the member states. At the same time, the question arises how to allocate the corporate tax revenues to be distributed among the member states to the individual member states concerned. We believe that here a key based on micro-economic factors would make sense. This key could take into account turnover, number of employees and balance sheet total, as suggested by the Commission.

Opponents to harmonising taxes within the European Union argue that harmonisation is always accompanied by a higher general level of taxation.

Limiting the common corporate tax base to large international groups means harmonising corporate taxes for those companies which benefit most from the common market. In other areas, where the effects of tax competition are less noticeable, member states have always been in a position to define taxes and fix their level of taxation relatively autonomously. This means that in areas where European solutions are required, tax policy should be made at EU level; in those areas, where tax-related decisions have implications for the member states concerned only, the member states would continue to define their own tax policy.

If this model is only applied to large capital companies with world-wide activities, the question arises how to proceed with those undertakings which are organised as capital companies, but which are not subject to the common consolidated corporate tax base. Here, we assume that these companies do not have that many cross-border activities anyway. Moreover, it has become obvious that today, in particular large companies benefit from the existing tax competition, which helps them reduce their tax burden. The tax planning methods described earlier are very rarely applied by small and medium-sized enterprises, as these methods would entail high compliance costs and just not pay from an economic standpoint. Also here, it would in principle make sense to harmonise regulations, but as these enterprises have lower compliance costs due to their small international focus and do not excessively use tax avoiding strategies, the need for action is less urgent.

Taking into account the statements by the European Commission and the OECD according to which labour is very highly taxed as opposed to other factors, we feel that would be logical to introduce at least a minimum rate for national corporate taxes. This would offer greater room for manoeuvre the states in making their budgets and would therefore allow for reducing the fiscal pressure on labour.

6.3. Further development of ECJ jurisdiction

As already mentioned, the existing tax competition is further aggravated by rulings of the European Court of Justice on direct taxes. We do however believe that ECJ should in principle keep his competence as regards direct taxes. However, there are some good reasons for developing further the principles of jurisdiction on direct taxes as at present, the level of harmonisation in the field of direct taxes is not very high on a European level. This is why we maintain that the ECJ, when ruling on direct taxation, should also take into account the revenue situation of the member states (and in particular when a state is threatened by considerable tax losses) and recognise the state's revenue situation as a justification for restrictions to the basic freedoms. Moreover, the jurisdiction on direct taxes should provide for the possibility of limiting the retroactivity of judgements and grant transitional periods. In order to allow member states to plan national tax regulations, it seems to be absolutely necessary to make the jurisdiction of the Court of Justice of the European Union more transparent with respect to the values and evaluation schemes upon which its judgements are based.

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