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**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE
EUROPEAN PARLIAMENT AND THE EUROPEAN ECONOMIC AND SOCIAL
COMMITTEE**

**An Internal Market without company tax obstacles
achievements, ongoing initiatives and remaining challenges**

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1. INTRODUCTION

Company taxation matters for economic progress in the EU. The European Union is currently endeavouring to achieve its self-set objective of becoming the most competitive and dynamic knowledge-based economy in the world capable of sustainable growth with more and better jobs by 2010. This strategic goal, which was set by the European Council in **Lisbon** in March 2000¹, has been confirmed by subsequent Councils. **Company taxation** in the EU has a key role to play in achieving this objective and in reinforcing the necessary supportive economic framework.

Commission 'two-track' strategy defines the way forward. It was in this context that the Commission, in its Communication² of October 2001, presented a **two-track strategy** aimed at tackling the tax-related inefficiencies and obstacles to cross-border economic activity in the Internal Market. The Communication was based on the results of a detailed Commission services study³. It presented in detail both targeted immediate solutions and steps towards a longer-term goal of providing companies with a common consolidated tax base for their EU-wide activities.

The debate has received new impetus and good progress has been made ... This Communication and the follow-up activities since have given **new impetus** to the reform of EU company taxation. Whilst **good progress** has been made with the implementation of many initiatives it is, however, more difficult to advance in some other areas. Moreover, **new developments** have taken place since 2001. The case law of the European Court of Justice on tax matters is gaining in importance. The prospect of a continued unanimity requirement for decision-taking in EU tax matters will obviously also affect the scope for further progress, particularly when enlargement is taken into account.

but implementation of the strategy must now be adapted to new conditions and challenges. The present Communication is intended to **assess the results of the Commission strategy** as of today and to consider the prospect of future implementation of its various parts. In presenting the Communication, the Commission is fulfilling its promise made in the above-mentioned Communication of 2001 to "report on its [...] **policy conclusions** by 2003".

2. THE CONTINUING NEED TO ADAPT COMPANY TAXATION IN THE EU

The basic company tax The company tax strategy proposed by the Commission in 2001 was based on two fundamental considerations. First, economic operators are

¹ Point 5 of the Presidency Conclusions from the Lisbon European Council, 23 and 24 March 2000.

² COM(2001)582: "Towards an Internal Market without tax obstacles. A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities"

³ Company Taxation in the Internal Market' [SEC(2001)1681]. The study has also been published in book format and is being sold (for 31 €) by the Office for Official Publications of the European Communities in Luxembourg (ISBN 92-894-1695-5); for more information see http://publications.eu.int/general/en/publications_en.htm

strategy of 2001 still provides the right answers to the tax problems of the Internal Market and broader economic developments.

still hindered by tax arrangements from exploiting the full benefits of the Internal Market. It is imperative to change this. Second, the overall economic framework has undergone important changes in recent years such as the appearance of e-commerce and the increased internationalisation of companies through cross-border mergers and other restructuring operations. These considerations have major implications for the functioning of corporation tax systems in the EU and both are still valid and topical. The imminent enlargement of the EU will accentuate the problems further. There is, therefore, **no reason to cast doubts on the basic rationale of the Commission strategy** and the Commission confirms its commitment thereto.

Compliance costs and substantial tax obstacles are still at the core of operators' preoccupations within the Internal Market.

The **tax obstacles** identified by the Commission in 2001 are still highly topical. In particular, the need for companies to deal with 15 and soon 25 or more different tax systems clearly remains the ultimate cause of most of the tax problems within the Internal Market and of high compliance costs. The Commission thus confirms its view that the two-track strategy is necessary and, in particular, that the **common consolidated corporate tax base for the EU-wide activities of companies** is the *only* means by which companies in the Internal Market can overcome these difficulties in a systematic way and true Internal Market conditions can be established in the corporate tax field. To the extent possible, work towards this objective should also seek to address the specific tax problems of non-incorporated businesses which are not subject to corporate income tax.

Business Test Panel Survey on company and value added taxation

The Commission recently launched a very comprehensive **compliance cost survey** of more than 2 000 EU companies. The aim of the survey is twofold. First, to gain a better understanding of how the need to cope with 15 separate tax systems impacts on companies, in particular on their compliance costs and their decision making. Second, to try and quantify the costs and how they differ between companies and types of activity. It is hoped to collect a great deal of useful information on both company taxation and value added taxation which will require careful and detailed analysis.

When the survey is completed and the results analysed a full report will be published separately. The results should give a general indication of whether, and if so the extent to which, companies do feel it is more difficult to comply with the administrative aspects of company and value added taxation once they become active 'cross-border'. The results should also indicate whether, and if the extent to which the lack of cross-border loss relief and the difficulties associated with transfer pricing and mergers and acquisitions are seen as obstacles. They should also indicate the extent to which, if at all, company taxation issues influence companies' decisions as regards their corporate and financing structures – which could of course lead to sub-optimal decisions for the economy as a whole.

Quantifying compliance costs has traditionally been extremely difficult due mainly to the problem of collecting data which is often considered to be commercially confidential. The Survey requests extensive and detailed data but will not release any individual company data. The Commission is therefore confident that sufficient data will be forthcoming and that when the analysis has been completed it will provide a comprehensive and detailed picture of company tax and value added tax compliance costs across the EU.

The substance of the Commission's long-term strategy is widely accepted ...

but the political process is slow.

Member States should take a constructive stance!

The idea of a common consolidated EU tax base has been quickly and widely accepted and even welcomed in the business community and among tax experts as a logical and coherent correlative for the Internal Market, at least in the longer term. However, today, the reactions to the Commission strategy of 2001 give rise to **new political considerations** and **many Member States are currently sceptical**, both for political and technical reasons. Some even query the basic rationale of the concept. While the Commission disagrees with this, it acknowledges the political ambition and certain technical difficulties of the comprehensive approaches under consideration. The Commission nevertheless remains convinced that, as a measure designed to improve the Internal Market, the common tax base is necessary and should ideally be decided on a qualified majority voting basis. However, the existing unanimity requirement should not be treated as an excuse for failing to address the obstacles that the lack of a common tax base creates. The Commission will continue to pursue the project further and will consider measures both where unanimity is required and where other approaches are possible. Some Member States seem to be **hesitant about concrete steps** towards the long-term goal. In this respect, the Commission recognises that, to the extent possible, the assessment of the practical impact on Member States and operators of the various measures needs to be refined.

At the end of the day, only Member States can ultimately agree and subsequently implement any measure in this area. It is high time that they did so. One should not overlook the fact that over the last few years EU tax policy makers have been mainly concerned with stabilising Member States' tax revenues. In particular, the Code of Conduct on business taxation has essentially been implemented and corresponding work is under way concerning the acceding countries. Thus, the harmful and economically undesirable forms of **tax competition** (and only these) are being tackled. Such harmful tax measures were an important reason for Member States' reluctance to **tackle the tax obstacles in the Internal Market** but those concerns are now no longer valid. Therefore, **priority** must be given to other important and generally accepted objectives of EU tax policy, notably those of contributing to the smooth functioning of the Internal Market and promoting employment and sustainable economic growth and welfare in the EU.⁴ As the Commission stressed in its Tax Policy Communication of May 2001,⁵ it is now necessary "to put much more emphasis on the concerns of the EU taxpayer."

The Commission believes that it is only the **systematic approach** put forward which will ultimately adequately protect **the legitimate financial interests of Member States** and enable them to take their

⁴ These overall objectives were originally agreed at the Informal ECOFIN-Council in Verona in April 1996. See Commission Communication "A package to tackle harmful tax competition in the European Union" [COM(1997) 564] for additional information.

⁵ "Tax policy in the European Union - Priorities for the years ahead" [COM(2001)260]

Without fundamental reform, Member States' tax revenues may suffer.

revenue-raising capacities into account when implementing tax policy. At the moment there are potential problems in some Member States as some aspects of their tax policies appear to contravene the principles of the Treaty. If individual Member States delay corrective action until these contraventions are confirmed in ECJ decisions they are then faced with having to make hurried and uncoordinated changes to their tax systems. This approach is inefficient, fails to address the fundamental problems, and often leaves open tax planning opportunities. Furthermore, inasmuch as investment decisions are driven by such 'tax engineering' considerations, rather than by expectations about the pure economic return, this is also particularly detrimental to an optimal allocation of capital and thus the above-mentioned 'Lisbon-objectives'.

In the absence of political co-ordination, tax obstacles will be addressed by the ECJ.

Finally, even if Member States take no action, many of the obstacles under consideration will be referred to the European Court of Justice (ECJ). In recent years, the **number of important corporate tax cases** submitted to the Court has been significantly increasing. In its judgments the Court has insisted on the 'four freedoms' (free movement of goods, persons [including the right of establishment], services and capital) in EU direct tax matters. EU law as interpreted by the Court, in almost all cases supported by the Commission, not only prohibits any form of discrimination, it also is opposed to restrictions. The Court rarely accepted justifications invoked by Member States. However, a piecemeal approach to tax obstacles by way of litigation could lead to new problems in Member States' tax legislation and perhaps even – in the worst case – prove harmful for the completion of the Internal Market.

3. PROGRESS WITH THE TARGETED MEASURES FOR TACKLING THE TAX OBSTACLES IN THE INTERNAL MARKET

Commission work programme has been implemented.

The Communication of October 2001 presented a work programme of specific measures which the Commission would undertake following a clearly defined timetable in the years 2002 to 2004. The Commission has implemented this programme as announced and invested considerable resources in the required, often complex and lengthy technical work. The following section reports on the state of play of the various initiatives (following the order in which they were presented in the 2001 Communication) and presents some conclusions for the years to come.⁶

3.1. Guidance on the implementation of the case law of the European Court of Justice and monitoring the implementation of EU law in taxation

Legal

The decisions by the ECJ sometimes have **asymmetrical effects**. The

⁶ Detailed information is also available at the "Company Taxation Pages" of the relevant web-site: http://europa.eu.int/comm/taxation_customs/taxation/company_tax/index.htm. The web-site is regularly updated.

developments in the EU tax arena must be accompanied by a constructive political process.

full ramifications of rulings involving just one country's laws for other Member States are not always clear and therefore each State tends to revise its national rules in different ways which are not necessarily favourable to the objectives of the Internal Market. The Commission, in its 2001 Communications on Tax policy and on Company Taxation, proposed dealing with this problem by way of pro-active co-ordination of those features of Member States' tax systems that are or are likely to be in conflict with EU law.

There are various 'hot' issues relating to company taxation in the pipeline.

The Commission first adopted this approach with regard to the tax treatment of occupational pensions⁷ and investment funds.⁸ In the corporate tax field, a **tentative discussion at working group level on the consequences of the ECJ decision in the 'Lankhorst-Hohorst' case [C-324/00]** on thin-capitalisation rules revealed that although support for a co-ordinated approach has increased some Member States still remain reluctant to go down this path. This is despite the fact that the decision is generally expected to have far-reaching implications for most Member States' corporate tax systems and not only for the Member State directly involved in this case. Many others are currently reflecting on how to re-design their thin-capitalisation rules so as to comply with the judgment and eliminate unequal treatment of resident and non-resident EU companies.

This reluctance on the part of certain Member States to co-ordinate their tax systems can only lead to more and more decisions by the Court which the Member States concerned might perceive as 'destructive'. In any event the Commission will continue to insist on the unequivocal respect of the EU Treaty in taxation and it will design its policy for launching appropriate infringement procedures in a more targeted and pro-active way. The Commission hopes, therefore, that its future initiatives to promote **active discussions among Member States on important legal tax matters** and to develop guidance on the broader implications of ECJ jurisprudence will be welcomed with a more constructive stance. The reaction to the forthcoming Commission Communication on Dividend Taxation Systems⁹ will be a first test of this.

⁷ See Communication COM(2001)214 and the infringement procedures launched by the Commission against various Member States subsequent to the failure of preceding discussions.

⁸ Following appropriate discussions with Member States which did not lead to the necessary legislative changes infringement procedures were launched against various Member States.

⁹ Existing ECJ jurisprudence raises questions as to the compatibility with the EC Treaty of certain types of dividend taxation systems in cross-border situations (e.g. Verkooijen case (C-35/98), Manninen (C-319/02), Schmid (C-516/99), Lenz (315/02) on free movement of capital).

Current legal issues and pending cases with potentially far-reaching consequences for Member States' tax systems

The ECJ has recently given its judgment in the case *Bosal Holding BV* (C-168/01). In a nutshell, it held as contrary to the fundamental freedom of establishment a Netherlands rule that made the availability of a tax relief for the costs of financing a subsidiary located in another Member State conditional upon such costs being indirectly instrumental to making profits in the Netherlands. Many other Member States may indeed have similar restrictive rules, so this decision opens up new legal possibilities for tax planning and could create further difficulties for Member States. It would appear obvious that Member States could mutually benefit from an exchange of views on the consequences of the case and a co-ordinated reaction thereto. Another good example where the Commission approach could be expected to provide good results is the jurisprudence on cross-border loss offset (see below). Other important issues and pending cases include the case *CLT-UFA S.A.* (C-253/03) on possibly discriminatory corporation tax rates for permanent establishments and the case of *De Baeck* (C-268/03) on the potentially discriminatory treatment of sale of substantial participation to foreign company.

Another interesting ongoing debate of relevance here concerns 'exit taxation'. Most Member States consider a transfer of company's registered offices to another Member State as a taxable event and either charge exit taxes or tax the unrealised capital gains by assuming liquidation of the company for tax purposes. However, the Advocate-General's opinion in the pending '*de Lasteyrie du Saillant case*' [C-9/02] favours an 'unconditional' understanding of free movement of persons in the area of personal income tax. If that approach is confirmed by the Court, it cannot be excluded that a similar reasoning would be applied to corporate tax. Moreover, the tax implications of company law cases '*Überseering BV*' [C-208/00] and '*Inspire Art*' [C-167/01] are currently under discussion (right of establishment).

3.2. Revision of the Merger Directive and the Parent-Subsidiary Directive

The Merger Directive and the Parent-Subsidiary-Directive will be considerably improved.

There are still numerous tax obstacles in the Internal Market to business re-structuring operations across borders and to dividend payments between associated companies. Following intensive preparatory talks with Member States, therefore, the Commission recently presented **proposals for directives for the revision of the Merger Directive, 90/434/EC, and the Parent-Subsidiary Directive, 90/435/EC.**¹⁰ **The amendments** seek to extend the scope of the Directives, relax the conditions for companies to benefit from them and resolve some of the shortcomings which have arisen in the application of these Directives.

The tax problems of European Companies are being

The amending proposals would also include the **European Company Statute** (*Societas Europaea SE*)¹¹ and the Statute of the European Cooperative Society (*Societas Cooperativa Europaea SCE*)¹² within the scope of the two Directives. Moreover, the revised Merger Directive would contain appropriate tax rules for the transfer of the registered office of a SE or a SCE to another Member State, thus addressing one

¹⁰ COM(2003)462 and COM(2003)613

¹¹ Council Regulation (EC) No 2157/2001 and Council Directive 2001/86/EC on employee involvement.

¹² Council Regulation (EC) No 1435/2003 and Council Directive 2003/72/EC on employee involvement.

addressed.

of the most pressing tax problems relating to these new legal forms. The most immediate tax problems in particular for the SE are thus being addressed by the Commission.¹³

A pragmatic approach was chosen with a view to speedy progress.

The Commission wishes to emphasise that, in devising the proposals, it had to **strike a balance** between the need to provide companies with the best possible fiscal conditions to benefit from the Internal Market and the need to safeguard Member States' legitimate financial interests and revenue-raising capacities. Therefore, both proposals contain numerous improvements for businesses but do not tackle all the issues that many tax experts would consider relevant in this field. It is hoped that this approach will lead to the speedy unanimous adoption of both proposals for Directives, essentially in time for the entry into force of the European Company Statute in October 2004.

3.3. Cross-border loss-offset

Offsetting losses cross-border may be difficult to accept for Member States but it remains very important for businesses

The current limits to cross-border loss relief within the EU, in particular as regards subsidiaries, can lead to (economic) **double taxation** and constitute **significant obstacles** to economic activity in more than one Member State. However, experience shows Member States are reluctant to consider any EU initiative in this area. The Commission has withdrawn its proposal of 1991 on cross-border loss compensation which the Council was not willing to adopt and which, after more than a decade, was, in some respects in need of technical revision.

... and the EU Treaty must also be respected in this respect!

The Commission is nevertheless still committed to organising a new round of technical preparatory meetings with Member States with a view to identifying innovative ways of dealing with what continues to be considered a **fundamental obstacle to the proper functioning of the Internal Market** in the tax field. The Commission services have started their internal analysis of the existing legislative options in this area and a Commission initiative in this field is now scheduled for 2004. In particular, the Commission hopes that **recent and forthcoming developments before national Courts¹⁴ and the ECJ¹⁵** will provide additional clarification of the legal situation and contribute to an increasing acceptance of the need for action in this area among European tax policy makers. The **Commission initiative will therefore concentrate on deepening the analysis** of the issue and try to develop guidance on Member States' respective obligations under the EU Treaty.

A Commission initiative is planned for 2004.

EU group taxation may be

EU group taxation based on the example of the **'Danish 'joint taxation system'** is still among those models which deserve attention from a

¹³ The scope of the recently adopted Interest & Royalty Directive (49/2003/EC) will also be amended accordingly.

¹⁴ For instance, Pirelli [UK High Court case n° HC01C02529] and Ö VwGH [Austrian Administrative High Court -Reference number 99/14/0217]

¹⁵ For instance, in the decided cases Futura [C-250/95], Baars [C-251/98], AMID [C-141/99], Mertens [C-431/01] and the pending cases Ritter [C-152/03] and Marks&Spencer [C-446/03].

the way forward.

Commission perspective. This system enables, in certain cases, Danish parent companies, their branches and also their foreign subsidiaries to be taxed jointly in Denmark, thereby enabling the parent to take into account losses incurred not only by their foreign branches but also their foreign subsidiaries. Some other ideas have also been presented by tax experts. For example, it has been suggested that extensive use could be made of a credit mechanism for devising a Europe-wide consolidation system in the form of a 'European Tax Allocation System' (ETAS).¹⁶ The Commission will also consider these ideas.

3.4. The 'EU Joint Forum on Transfer Pricing'

Progress is under way in the transfer pricing field.

The "EU Joint Transfer Pricing Forum" announced in the 2001 Communication has been created and it is working intensively. The Forum has established a working programme until 2004 and several meetings have already taken place. The Commission considers this genuinely new type of mixed working group consisting of high-level tax experts from Member States' administrations and the business community to be a promising and successful development. It is indeed the first time that such a joint tax working group at EU level has been established.

An intermediate report by the Forum on its activities so far and on pragmatic, non-legislative recommendations to solve the problems in the application of the Arbitration Convention and the mutual agreement procedures under double taxation treaties is planned for early 2004. The Forum also discussed the practical problems for companies resulting from the fact that the Arbitration Convention has not been in force since 1 January 2000 because not all Member States have ratified the Prolongation Protocol signed in 1999. Future work will focus on documentation requirements and on possible preventative measures to avoid double taxation in the area of transfer pricing (e.g. Advance Pricing Agreements). While the Commission is satisfied with the constructive and professional atmosphere characterising the work of the Forum, it is somewhat concerned about the relatively slow progress compared to the work programme agreed by the Forum itself in 2002. It is hoped that it will be possible to accelerate the pace of the future work on the remaining items on the Forum's work plan.

3.5. Double Taxation Treaties

The Commission services are looking closely into the **varied and complex problems relating to the bilateral and multilateral double taxation treaties** in the Internal Market and are in the process of assessing the various options set out in the 2001 study for tackling these. An initiative in this field, which will provide a **legal analysis and**

¹⁶ Hernler, Jörg, *ETAS – Das European Tax Allocation System für eine einheitliche Ertragsbesteuerung Europäischer Unternehmen*, in: *Der Betrieb* 2003, p.60-65.

*Double taxation
Treaties will be
a priority in the
coming years.*

interpretation of the relevant ECJ rulings,¹⁷ is planned for 2004. Possible approaches for advancing in this area include, *inter alia*, the development of an EU model tax treaty or the conclusion of a multilateral tax treaty between all EU Member States. . Moreover, it is noteworthy that many of the targeted measures are to some extent interlinked. This could have repercussions for Member States' double-taxation treaties.

Particular attention will need to be paid to the enforcement of the equal treatment principle of the Treaty, which seems to conflict with the current distinction between residents and non-residents in many treaties, also in relation to Member States' double taxation treaties with third countries ("limitation on benefits clauses"). The same goes for triangular cases. It will become necessary to examine in detail whether some form of '**most-favoured-nation**' clause between EU Member States might be required at some stage in the future. **First discussions with Member States** on these issues at working group level will be held shortly.

*Co-ordination
is the way
forward.*

The double-taxation agreements of Member States will continue to be subject to review by the ECJ. In particular, the problems resulting from the current lack of co-ordination in this area, notably **in triangular situations and with regard to third countries**, will increase even further. Without Community action, there may be important political and economic repercussions for Member States' policies in this area. Therefore, the Commission hopes that its approach of gradual and measured co-ordination of treaty policies will eventually gain support and meet with a constructive attitude from Member States.

4. ADVANCES TOWARDS A CONSOLIDATED CORPORATE TAX BASE FOR THE EU-WIDE ACTIVITIES OF COMPANIES

4.1. A new impetus to the debate in the EU

*An intense
debate on the
reform of EU
company
taxation
continues as a
result of the*

The general need for a fundamental reform of company taxation in the EU and in particular Commission pressure for some form of common consolidated tax base in the EU is now one of the single biggest issues dominating the debate in the EU tax arena. The **European Company Tax Conference**¹⁸ organised by the Commission in April 2002 gave rise to a constructive discussion on the relevant issues. It marked the beginning of a **series of similar events** organised by expert federations¹⁹ and research institutes.²⁰ Moreover, the Commission

¹⁷ E.g. in the case Saint-Gobain [C-307/97] See also the pending case D. v. Rijksbelastingdienst [C-376/03]

¹⁸ For more information (programme, papers, summary, etc.) see:

http://europa.eu.int/comm/taxation_customs/taxation/company_tax/conference.htm

¹⁹ For example: Round Table "Company Taxation and Europe – Today and tomorrow" organised by the European Federation of Accountants (FEE) on 16 October 2002 and the CFE Forum on "Direct

Commission strategy. concepts have been broadly taken up in tax **expert literature** and **independent working groups**.

The Commission has supplemented its strategy with concrete initiatives. Since early 2002, work has been carried out on various concrete initiatives in order to advance with this longer-term project. The Commission services have **consulted widely** on two important issues in this field.²¹ These concern

- (i) the possible experimental application of "Home State Taxation" to small and medium-sized enterprises in the EU and
- (ii) the implications of the introduction of International Accounting Standards (IAS) for the introduction of a consolidated tax base for companies' EU-wide activities.

"The devil is in the detail" – also as regards the common EU tax base. Despite the considerable interest and the intense debate, differences of views remain on the details of how the common consolidated EU tax base can be reached. However, there is a **convergence of views as regards specific points or projects** (e.g. the 'Home State Taxation' pilot scheme). Even among business representatives and within industry opinions still differ on important questions. Work on the technical aspects of the longer-term EU tax agenda therefore needs to be intensified.

4.2. Home State Taxation as a way forward for small and medium-sized enterprises (SMEs)

Small and medium-sized enterprises should be allowed, in a test phase, to apply the home state company tax rules everywhere in the EU. The Company Tax Study of 2001 identified one of the four models for a common EU tax base under consideration, "**Home State Taxation**" (HST), as a possible solution that would be **particularly beneficial for SMEs**²² and floated the idea of launching in an initial phase a pilot scheme which would apply this approach to SMEs as a test case. The purpose of such a possible pilot scheme is **simplification** and the **reduction of tax compliance costs** for companies. The idea won considerable support in the discussions following the presentation of the Commission strategy. The Commission services therefore organised a workshop and held a public consultation on the issue. These initiatives provided significant **technical input** and revealed **broad convergence on the basic rationale** and desirability of the pilot scheme idea. Detailed reports on the outcome of these activities are publicly available.²³

Taxation: IAS - a way to harmonize taxation in Europe?" organised by the *Confédération Fiscale Européenne* on 10 April 2003 (both held in Brussels).

²⁰ For example, the related events and working parties organised by the Centre for European Policy Studies (CEPS).

²¹ Detailed information is available on the following web-site:

http://europa.eu.int/comm/taxation_customs/taxation/company_tax/consultations.htm

²² see for instance section IV.B.11.1 and section IV.C.15.6 and 16.5.2.

²³ For detailed information see:

http://europa.eu.int/comm/taxation_customs/taxation/consultations/home_state_sme.htm

"Home State Taxation" for small and medium-sized enterprises in the EU - basic rationale of the pilot scheme and potential benefits for SMEs and EU economy

The concept of "Home State Taxation"²⁴ applies the Internal Market principle of mutual recognition to company taxation. It provides, in simple terms, that the profits of a group of companies active in more than one Member State should be computed according to the rules of one company tax system only, the system of the Home State of the parent company or head office of the group. Each participating Member State would continue to tax at its own corporate tax rate its share of the profits of the group's business activities in that State.

This approach addresses precisely the tax issues which hamper SMEs most in their cross-border activities. Compliance costs (resulting from tax formalities, bookkeeping requirements etc.) appear to be regressive to company size and are thus often disproportionately high for SMEs. Similarly, the difficulties with the cross-border offsetting of losses hit SMEs particularly hard, especially as regards start-up losses that occur almost by definition in the first years of an international investment. Many of the problems linked to the Home State Taxation approach are in practice less important if not irrelevant for SMEs (e.g. on double taxation treaties). Tax planning is not to be feared as it is usually easy to identify the "Home State" in the case of SMEs and possible changes in the Home State regime are less likely.

SMEs which are currently only active in their domestic market and wish to expand for the first time in another Member State would benefit most in relative terms from the introduction of the pilot scheme. Moreover, these cases would be easier to handle for both administrations and businesses and avoid transition problems. Therefore, the scheme would de facto essentially target SMEs which 'go international' for the first time. There is, however, no systematic reason to exclude SMEs which are already active in more than one Member State from the possibility of participating in the scheme; this could even be considered discriminatory.

The Commission will try to take the pilot scheme further.

The pilot scheme project is quite enthusiastically supported by **the interested parties** and federations and academics are very willing to co-operate actively. These parties generally emphasise the **efficiency and simplification gains** of a pilot scheme for SMEs. This strengthens the **Commission's determination to go ahead with the scheme** and to endeavour to win the support of Member States on the issue. Such action is also in line with the employment guidelines on job creation and entrepreneurship which call for initiatives to focus on simplification and reduction of the administrative and regulatory burden for SMEs. A particular example in this respect concerns R&D activities which are often pursued in small companies.

Are there really discrimination issues?

There is, however, a **risk of discrimination and/or competition problems** with the pilot scheme.²⁵ The Commission services are studying this issue in depth, in particular in order to resolve potential State Aid issues.

A pragmatic

On the basis of the contributions received and the information gathered,

²⁴ Lodin, S.-O. and Gammie, M., Home State Taxation, IBFD Publications, Amsterdam, 2001.

²⁵ Some observers even refer to possible constitutional problems in specific Member States.

approach is needed.

the Commission considers it **preferable to devise a relatively narrow but realistic pilot scheme rather than 'overloading' the experiment** and thus jeopardising its prospect of acceptance and success. It concludes that a pilot scheme in this field could be usefully designed along the following lines:

Key points for the design of an HST pilot scheme for SMEs

- 1) The pilot scheme must be designed as a practical test. Only work with **real-life data** would allow experience to be gained and justify the efforts involved in the pilot scheme.²⁶
- 2) The scheme's scope should be defined by the existing **EU definition of SMEs**.²⁷ However, the Commission is mindful of the fact that Member States would probably prefer a somewhat smaller scope for a scheme. Therefore, thought could be given to proportionate reduction of the figures in this definition.
- 3) The test run period should be sufficiently long to allow it to be analysed thoroughly and to justify the changeover cost. The Commission considers at least **5 years** as a suitable **timeframe**.
- 4) Other types of **limitations** (e.g. to specific regions) do not appear to be desirable or necessary.²⁸ Third-country income would fall outside the scope of the pilot scheme and would have to be accounted for under the normal rules.
- 5) Special rules for **exceptional cases** would be necessary (e.g. change of ownership, business fluctuations, business expansion). A business which, while participating in the pilot project, organically grows beyond the limits set out in the SME definition should not for this reason be excluded from the project.
- 6) Given the technical difficulties it seems that **partnerships** could only, if at all, be included in the scope of the scheme in **exceptional cases**.
- 7) **Taxes other than corporation taxes** (notably VAT and local profit taxes) should **not be included** in the scope of the scheme.²⁹ However, Member States could continue to apply national (profit-related) surcharges on the corporate tax as established under the conditions in the pilot scheme.
- 8) As such, the pilot scheme would conflict with existing national **tax incentives** for SMEs, and these could be **transformed into tax credits**.
- 9) For the purpose of the relatively small-scale pilot scheme it seems that **a simple formula**, either payroll (or alternatively the number of employees) or perhaps a three factor formula (1/3rd each for payroll, sales, property of the SME in the countries concerned), could be applied for apportioning the tax base between the participating Member States on a trial basis. The ongoing research efforts in this area (see below) will also provide additional insights in this respect.
- 10) Participating companies should be obliged to file a **tax return** only in their home state, although the other states concerned should receive copies. Tax **audits** would be carried out by the home state authorities, if need be jointly with the partner administration. The general rules for mutual assistance in the EU would apply.

²⁶ If desired, additional economic simulations could be carried out at Member State level as only national tax administrations have access to the data needed for an exercise of this kind.

²⁷ Commission Recommendation 2003/361/EC of 6 May 2003 concerning the definition of micro, small and medium-sized enterprises. This definition distinguishes between:
medium-sized enterprises [headcount < 250 / turnover ≤ € 50 million or balance sheet total ≤ € 43 million]
small enterprises [headcount < 50 / turnover ≤ € 10 million or balance sheet total ≤ € 10 million]
micro enterprises [headcount < 10 / turnover ≤ € 2 million or balance sheet total ≤ € 2 million]
Moreover, enterprises which are part of a larger grouping, and could therefore benefit from a stronger economic backing than genuine SMEs, do not fall under the scope of this definition.

The basis for further technical work has been laid.

The above key points are obviously only a first guide to further discussions with interested parties and Member States. Moreover, in some areas the technicalities of the solutions would have to be refined further, for instance as regards the allocation formula, double taxation treaty issues, tax incentives, opt-in and opt-out clauses for companies, record keeping and the link to company law requirements (e.g. concerning financial accounts).

Mutual recognition and soft law can help to implement the scheme.

In principle, Member States could apply the principle of mutual recognition embedded in the Home State Taxation approach in a bilateral or multilateral framework. However, the Commission is of the opinion that an **EU framework for the pilot scheme is necessary**. This could usefully be done by "**soft law**" in the form of a Commission Communication or, following an appropriate Commission proposal, a Recommendation by the Council and the European Parliament. Member States' tax administrations could then, via an appropriate "**enabling clause**" in their respective tax law, invite companies to volunteer to participate in the 'pilot scheme'. In any event, no Member State would be obliged to take part in the scheme.

Economic data on SMEs and the potential effects of the HST pilot scheme

SMEs constitute one of the key drivers in economic growth and job creation in the EU. The implementation of the pilot scheme would improve their business conditions and foster their survival rate (e.g. via cash-effective possibilities setting off foreign losses against domestic profits) and development possibilities (e.g. via cross-border expansion) in the Internal Market. This would over time generate economically beneficial growth and employment effects. General Commission research on SMEs in the EU,³⁰ and in particular the preliminary findings of the European Network for SME Research (ENSR) survey on the internationalisation of SMEs,³¹ show that only very small numbers of SMEs are currently active in other Member States than their own.

The revenue consequences of the scheme for Member States would depend on its precise design, the number of participating SMEs and, not least, the details of the apportionment system chosen. It is true that a reduction of the tax liability could theoretically occur due to differences in the tax base according to the different Member States' rules and sometimes also due to quicker compensation of start-up losses. However, reducing the tax liability of SMEs in a lasting way is not the objective of the scheme and given the characteristics of the approach, notably the apportionment mechanism, this effect should not occur systematically. Based on the statistical figures of SMEs which are internationally active and bearing in mind the very small proportion of corporate taxes paid by SMEs domestically, the amount of tax 'at stake' for Member States can safely be expected to be very low. It is therefore very hard to see why the scheme should not at least be tested by Member States. It could provide potentially important economic benefits at a cost

²⁸ For instance, there is no need for the exclusion of specific sectors except those which are subject in any case to specific tax rules, e.g. shipping, banking and insurance.

²⁹ The Commission is nevertheless working on other similar specific initiatives in order to facilitate compliance in the field of VAT mainly for SMEs, see for instance Commission Communication "Review and update of VAT strategy priorities" COM(2003)614

³⁰ 'SMEs in Europe, including a first glance at EU candidate countries' No 2, DG Enterprise publications. For more information see the "Observatory of European Enterprises" run by DG Enterprise of the EC Commission: http://europa.eu.int/comm/enterprise/enterprise_policy/analysis/observatory.htm

³¹ EIM Business & Policy research, Overview of the ENSR Enterprise Survey 2003, EIM Zoetermeer, August 2003 (survey held in the framework of the 8th Observatory of European SMEs)

that could be very low! The Commission services intend to intensify their research work on this issue when the pilot scheme is conceptualised in more detail.

Continuous monitoring of the pilot scheme is of paramount importance.

From the start of the pilot scheme, the Member States concerned would need to monitor their operations and should, in due course (e.g. after three years), provide the Commission with an evaluation report. For this purpose, a **monitoring group** should be created to consider all issues of relevance to the pilot scheme and to discuss the evaluation reports. This group, chaired by the Commission, should consist of representatives of all Member States and acceding countries.

A firmer Commission initiative could be envisaged in 2004.

The Commission wishes to **establish close co-operation** with interested parties and Member States in order to discuss its conclusions, and the above-mentioned key points, concerning experimental application of "Home State Taxation" to small and medium-sized enterprises in the EU. It will therefore take appropriate steps, involving representatives of business and interested Member States, in order to address any remaining technical issues and to develop the detailed arrangements of a pilot scheme. On this basis, a political initiative in this field could be envisaged for **2004**.

4.3. Developing a common EU tax base

The application of IFRS could help pave the way for a common tax base

The above-mentioned Company Tax Communication and Report in 2001 highlighted the move towards common accounting standards arising from the IFRS/IAS Regulation.³² Although only the consolidated accounts of some 7 000 companies are directly affected, the IFRS influence is much wider. All the subsidiaries of the 7 000 companies will have to maintain IFRS records, credit institutions can be expected to press for IFRS style information, some Member States are already permitting wider usage and national accounting standards are confidently expected to converge towards IFRS. This emphasis on common accounting standards and consolidation together with the demands for a common consolidated tax base have raised the possibility of linking the new tax base directly to the IFRS accounts. **If EU companies are reporting profits according to a common standard why not use this common measure of profitability as a starting point for taxation purposes?** Over the last two years the Commission Services have examined this idea in some detail, including by way of a public consultation for views. The results of that consultation have already been published separately.

³² The compulsory use of International Financial Reporting Standards (IFRS) from 2005, formerly known as International Accounting Standards (IAS), was introduced by Regulation (EC) No 1606/2002 (OJ L 243, 11 September 2002) ("IFRS Regulation")

Public Consultation on the tax implications of the application of International Accounting Standards (IAS)/(IFRS)³³

In February the Commission launched a public consultation on the application of IAS and the implications of introducing a consolidated tax base for companies' EU-wide activities. On the basis that **the IFRS accounts would represent at most a starting point for arriving at a tax base, and not the tax base itself**, a number of areas of particular interest were identified for comment. These included *inter alia* questions concerning: the general principles of IFRS and their relevance and applicability to taxation, the number of companies likely to adopt IFRS, the possible use of *consolidated* financial statements, the mutual dependency of accounting and taxation, the possible legislative framework for introducing a common tax base and the possibility of a pilot project for the *Societas Europaea* (SE).

Over 40 written responses were received expressing a range of opinions on the specific issues raised and in some cases covering more general aspects of EU tax policy. In general, support for the concept of a common tax base was widespread but opinion was divided as to how useful IFRS could be. However, it was also stressed that IFRS could provide a neutral starting point around which discussions on the base could be developed.

There is a need to establish a more formal framework for progressing discussions

Before the possible detailed provisions of a common tax base can be agreed a framework for these discussions must be established. In principle two main approaches can be distinguished. The 'IFRS approach' starts with a common accounting position and seeks to define what adjustments would be required to arrive at the tax base. An alternative is to attempt to reach agreement in isolation on tax principles, and only subsequently to address the issue of how to ensure their application.

The current review of some IFRS should not be an excuse for delaying work

The IFRS route is complicated by the fact that the rules are new for many companies and under the IFRS Regulation only apply to the consolidated accounts of a limited number of companies. The current wide ranging review of the existing IFRS by the IASB³⁴ further complicates the analysis of the tax implications of individual accounting policies. It has been suggested that further work should be suspended until companies and Member States have implemented and gained experience of IFRS reporting. **Although it might be tempting to 'wait and see' this would risk IFRS being implemented in a fragmented manner across the Community, which could make it even more difficult to establish a common tax base in the future, particularly as regards the 'dependency' issue.** On the other hand, the 'tax principles' route might, at first sight, appear to provide the 'perfect' solution but risks becoming a long drawn out academic exercise which fails to provide a pragmatic and workable solution within an acceptable

³³ The Consultation Document and a summary of the results are available on the following web-page: http://europa.eu.int:8082/comm/taxation_customs/taxation/consultations/ias.htm

³⁴ IASB – International Accounting Standards Board, the body which issues IFRS

time scale.

Some general IFRS principles require particular attention

Some aspects of IFRS require particular attention. The general principles of materiality and substance over form are clearly not entirely in keeping with existing tax principles and adjustments would be required in order to arrive at the tax base. Materiality in accounts is essentially defined as a threshold or cut-off point beyond which an omission or misstatement could influence economic decisions taken by users, but for tax purposes more precision would usually be required. Giving greater precedence to the substance of a transaction rather than its legal form (for example, concerning leased assets) is common in accounts but this principle is not so uniformly applied for taxation purposes. Both principles might require adjustments. Similarly, where 'fair value' accounting applies (for example, where assets are re-valued to market value and the increase in value treated as 'profit') these unrealised gains should not be subject to taxation and thus further adjustments would be required. More generally, the work on the tax base possibilities of IFRS has highlighted a question which concerns all possible forms of a common tax base: the relationship between financial accounts and taxation, commonly known as 'dependency'.

In principle the consolidated tax base should be available to all companies, which means all companies should be able to use IFRS

Although a common consolidated tax base could be introduced in a series of steps, perhaps initially as a pilot scheme and/or without consolidation (i.e. it would be available on a national basis within each Member State), **it would have to be available in the longer term to all companies.** For a base derived from IFRS this would mean that all companies would have to be able to use IFRS. There is generally **wide support for the extension of IFRS beyond the consolidated accounts** of the approximately 7 000 companies to which the Regulation applies. Indeed, some Member States have already indicated that they will make the option available to all companies. Even where the use of IFRS is not permitted the national standards are expected to converge, leading to 'de facto' common IFRS reporting. This would not only ensure that any derived tax base was available to all companies, thereby avoiding discrimination and ensuring equal treatment, it would also enable groups to apply a single set of accounting standards across the Internal Market. In this context it is also important to note that the IASB is currently actively looking into possibilities to address concerns about the particular problems which the application of the IFRS might pose for small and medium-sized enterprises.

The relationship between tax and accounts (dependency) is key to any common tax base

Regardless of whether IFRS accounts form the starting point or not, **a common tax base requires a detailed re-assessment of the relationship between a company's statutory accounts and its tax accounts (dependency).** Currently, as Member States have different tax bases and accounting bases they can choose whether or not to permit or require adjustments. However, once a common tax base were introduced each Member State would have to arrive at the same tax base. In theory this could be achieved by the existing methods: either by adjusting the accounting base to arrive at the tax base or by establishing

an accounting base which equals the tax base. However, for companies permitted to use IFRS the latter method would no longer be tenable.

Companies should not be expected to apply more than one set of accounting standards

All Member States that wanted to establish an accounting base which equalled the tax base would in effect have to establish the same accounting base as for IFRS. Accounting standardisation is developing via both the IFRS Regulation and the EU Accounting Directives and national accounting standards are expected to move closer to IFRS. However, it is unrealistic to expect that this standardisation will ever fully meet the requirements of the tax base. Either adjustments will have to be permitted (less dependency) or Member States will have to continue with their own national accounting requirements in addition to IFRS and the Accounting Directives. Since many companies will have to apply IFRS in their own consolidated accounts, or will have to apply IFRS in order to supply their listed parent companies with the appropriate data for consolidation **there will be pressure to reduce accounting duplication and permit a wider use of IFRS in individual statutory accounts.**

IFRS represents the only available neutral starting point for discussions

Under this scenario making use of a common accounting base as a starting point for a common tax base makes sense. **IFRS statements represent a neutral starting point for considering a common tax base.** Individual Member States are already dealing with these issues domestically as the ‘lists’ of adjustments between financial and tax accounts grows and it makes sense for these efforts to be directed in a more co-ordinated way across the EU in order to avoid unnecessary duplication of effort.

The private sector status of the IASB need not be an obstacle

A resolution of the dependency issue would also remove one of the objections to using IFRS as the starting point. Concerns have been raised over the private sector status of the IASB and the hypothetical implications of that body rather than Member States deciding upon, and amending, the tax base. However, if IFRS is only the starting point then any changes to standards would not necessarily affect the tax base itself. For example, if future IFRS were to be unacceptable for tax purposes they would not necessarily affect the tax base but might give rise to further adjustments as agreed by the Member States. It is clear that, although the **concept of a common tax base for companies operating in the EU now seems to be well established** as a long-term goal for EU tax policy and generally widely supported, some parties in both business and tax administrations remain totally opposed to it as a matter of principle. Even among its supporters cross-border tax *consolidation* is perceived by some as a step too far to contemplate at present.

Some doubts have emerged over consolidation

But consolidation remains the ultimate aim

Regarding **consolidation** the Commission is still of the view that it is the most efficient way of resolving tax obstacles and is an essential aspect of a common tax base in the long term. In its consultation document, the Commission asked for views on whether the **consolidated IFRS accounts** could provide a useful starting point for a tax base but most responses supported the Commission’s view that this

is **unlikely to be the best way forward**. Although it might appear superficially attractive, and would of course fit in with the IFRS's Regulation which applies only to consolidated accounts, there are a number of drawbacks. The definition of the consolidated group for accounting purposes is unlikely to be satisfactory for tax purposes and many consolidated accounts would also include the results of non-EU subsidiaries. Adjusting consolidated accounts to exclude some companies while including others, and so on, would be complex and time consuming and unlikely to lead to any savings in compliance work.

A tax-specific method of consolidation is preferable to relying on the accounting rules for consolidation

Providing for consolidation is one of the most difficult aspects of establishing a common tax base, not least because it requires an apportionment mechanism for dividing the EU base between individual Member States (see below). Given the drawbacks of starting from consolidated financial accounts a **tax specific method of consolidating group companies' accounts seems to be the best approach**.

The Commission concludes

Conclusions of this section:

- Accounting dependency is key to the concept of a common tax base, regardless of whether or not it is derived from IFRS, and should be more fully explored.
- Whilst the final basis for a common tax base remains undetermined the IFRS accounts provide a useful neutral starting point for discussing the tax technical issues. Detailed technical work can usefully be based around IFRS as a common EU starting point.
- Even if it emerges that there is another more preferable starting point for a common tax base, work done within this IFRS framework will still be relevant.

Commission proposals for progress in developing a common EU tax base

- **Accounting dependency:** (Applicable regardless of whether a tax base is defined in relation to IFRS or derived independently)
A detailed external or internal study (depending on Commission resources) **should be conducted** of the relationship between current accounting rules and the tax base in all Member States. The results should be discussed with a group of Member States' experts and include discussions on the possible movement away from accounting dependency. The work of this expert group could be extended to include **technical work on the tax implications of IFRS**. This work would address the taxation implications of individual IFRS under the current tax systems and seek to find a Community solution in place of fifteen, or twenty five, separate solutions.
- **The detailed tax principles to be applied:** (Applicable to any common tax base, but to be viewed through the IFRS perspective as a neutral starting point)
 Establish an **Expert Group** to discuss individual aspects of the tax base, for example, tax depreciation. Participation in the group to vary depending on the topic to be discussed; in other words, a sort of "revolving participation and representation". Each topic to be discussed by experts from each Member State; the accounting sector to be consulted for specific IFRS input.

It should be emphasised **that without adequate support from Member States** (who have little to lose and everything to gain from more active participation) **little progress can be made**. Furthermore, private sector involvement should be secured by the participation of EU professional and trade associations in the Expert Group.

4.4. Allocating the tax base between Member States

A mechanism for sharing the tax base is essential

Central to the establishment of a consolidated tax base **is the mechanism for sharing the tax base between Member States**. This mechanism would have to be equitable and transparent and be as administratively straightforward as possible. It would both have to satisfy sound economic principles and meet with the political approval of Member States. Currently a group of companies is forced to calculate a separate tax base in each Member State. The transfer price for each individual cross-border transaction between group companies is important because it helps to determine the sharing of the taxable profits and has to be set on a notional 'arm's length basis' and accepted by the respective tax administrations. The 'EU tax base' is thus essentially shared by this use of separate accounting, under which individual national tax bases are computed separately and the cross-border transactions between the related entities are recorded on an arm's length basis. One of the potential advantages of a consolidated tax base is the removal of the need for separate accounting within the Internal Market as the sharing of the 'EU tax base' between Member States is calculated in a different way. The group would establish only the single EU tax base for its EU-wide activities and this overall base would be allocated or 'apportioned' to the Member States concerned via a simple key. This formula would be composed of economic factors the choice and weighting of which is subject to current Commission research. Both separate accounting and formulaary apportionment are vulnerable to potentially inappropriate manipulation but there is considerably less scope under apportionment and any such manipulation would be easier to detect.

Sharing at the micro level – value added or formula apportionment

Although the sharing of the tax base could theoretically be carried out on a macro level, i.e. at the level of Member States, **work has concentrated on sharing at the micro level, i.e. at the company level**. At this micro level two main possibilities exist: either a value-added basis or a formula-based system.

A value added basis might work in the EU

Within the EU, **the opportunity to apportion the tax base on the basis of value added demands attention because of the existing value added tax (VAT) system**. Much of the information required is already collected by companies for VAT purposes but adjustments would be required for imports, exports and depreciation. Similarly, labour costs would have to be included and a value added system would essentially be an origin-based one, including exports in the exporter's added value, rather than the existing destination-based VAT system. However, there is little experience of such an allocation system and

research is less well developed.

Identifying the key issues relating to FA

The **main focus of attention has been the formula apportionment approach**, which is already used in several countries, the most developed example being that used in the USA. **Work has centred on identifying the main principles and areas of doubt which need to be resolved.**

Further explanation of some of the terms used

Consolidation - The amalgamation of a number of corporate entities into a group. A group may be defined simply in terms of legal ownership or the definition may also include a management and control test.

Unitary Taxation and Combined Reporting - A 'subset' of consolidation, going beyond the legal definition of a consolidated group to combine within the consolidated group only those entities or operations which are economically integrated. The combined entity files a single combined report.

Economic integration – as part of unitary definition - A subjective concept capable of varying definition and interpretation. Business activities must be integrated and/or contribute to each other. It may require, in addition to economic integration or interdependence, operational integration. It has also been expressed as 'the three unities test' (ownership, operations and use); and extended to include in addition the requirement for functional integration, centralised management, and economies of scale. For example, a manufacturer may have a highly developed treasury operation which effectively operates as a bank: should all the treasury activities be included in the combined reporting?

The definition of the consolidated group is complex and may go beyond just the legal ownership

The advantages of consolidation have already been covered in detail in previous Commission documents but **the precise definition of the consolidated group remains open**. Simple legal ownership via the establishment of thresholds, for example 50% or 100%, is unlikely to be sufficient as it is too open to manipulation and additional management and control tests may be required. However, the more conceptually attractive unitary taxation, extending the definition to include tests related to the degree of economic integration, introduces an element of subjectivity which could lead to uncertainty and complexity which might eventually outweigh the advantages.

Not all the income should necessarily be subject to sharing by formulae

Beyond the group definition, **the definition of the income itself also requires attention**. It is not necessarily appropriate to share or apportion all income and hence income to be shared or apportioned (business or 'active' income) must be distinguished from income which is simply allocated (non-business or 'passive' income). One example would be income from intangibles, such as patents which, under some formula apportionment systems, may be allocated to the entity which holds the patent rather than shared across the group. Whether this is the best approach or not, and whether potential manipulation can be controlled, remains open and is perhaps the most unsatisfactory aspect of formula apportionment.

The factors and weightings in any formulae will have to be the same across the whole of the EU

Although the USA example illustrates that formula apportionment can work without standardised factors and weightings, it is now generally accepted that this is not ideal. Accordingly, **it is assumed that across the EU the same factors and weightings would be applied.** This would not mean that all industries would necessarily use the same formulae but that any sector-specific formulae would apply across the EU. The complexity of the issues involved also suggests that although theoretically a world-wide apportionment mechanism might be preferable, research should be directed towards an EU system (sometimes referred to as ‘water's edge’). Although this would require a distinction to be made between EU and non-EU activities it would be unrealistic at this stage to pursue a global system.

The choice of factors and weightings requires careful consideration

The choice of factors and their weightings is fundamental. Taxation via formula apportionment is effectively a tax on the factors and therefore must reflect the source of income generation as closely as possible. The traditional three factor formula – sales, capital and labour – presents a useful starting point to examine the potential distortions which a formula might introduce. All three factors represent the capacity to generate income, although all three are of course vulnerable to potential manipulation (as is transfer pricing under separate accounting), and achieving the appropriate balance is difficult.

The economic effect on individual Member States would have to be established

Even if these issues were resolved on a theoretical basis, i.e. if the income and the group were defined, and the factors and their weightings identified, **the effect on Member States’ ‘shares’ of the tax base would need to be understood.** Whereas the effect of different factors and definitions, etc., can be modelled on a discrete basis two aspects remain particularly difficult to research. One concerns the dynamic effect – how would companies react and change their investment strategy or corporate structure faced with different models of formula apportionment? The second, which is partly dependent on the first, concerns how the distribution of the ‘EU tax base’ between Member States would differ as compared with the current distribution.

Member States would need to be able to compare their existing share of the tax base with their likely share under any new system

The first is not a new issue – possible company behaviour in the face of changing tax legislation already has to be factored into tax policy and, indeed, with a uniform system of formula apportionment tax competition between Member States would be more transparent and arguably easier to predict. However, the second aspect – understanding how a move to a new method of sharing out the ‘EU tax base’ would impact on individual Member States – is more difficult. It could be argued that if a sufficiently fair and robust mechanism could be agreed then changes in the distribution could simply be described as corrections to the current system based on separate accounting. However, **it would be unrealistic to expect Member States to enter into negotiations on a new method without a comparison between the old (separate accounting) and the new (formula apportionment).**

Making the comparison will require the close co-operation of companies and Member States

Unfortunately, to date, it has not been possible for the Commission to make such a comparison. The current distribution of the tax base, at the individual company level, is not publicly available. Even if it were, the amount of work required in recalculating real company data to arrive at the new tax base distribution is daunting. Some data is available commercially, but **part of the answer seems to lie with companies and the Member States themselves**. If such data were made available, and not necessarily on a individual company basis by Member States but perhaps by sector, then some progress could be made.

Commission proposals for progress in developing a mechanism for allocating the tax base between Member States

Research should be extended to include the possibilities of a 'share out' based on value added.

Research into formula apportionment should be continued, in particular into:

- Group and income definitions
- Formula factors and weightings

This research should include the construction of a theoretical economic model.

Discussions with Member States and companies on how 'real' data can be obtained on the current EU tax base distribution should be started.

The financial implications of various mechanisms should be modelled using the above theoretical model with 'real' data.

4.5. A European Tax regime for the Societas Europaea?

Initial reactions to a pilot scheme for the European Company were very positive ...

At the above-mentioned European Company Tax Conference in April 2002 the Commission's idea of **piloting the common consolidated EU tax base with the European Company Statute/Societas Europaea** (SE) appeared to win considerable support. First, the view seems to be that the application of the new system to a limited group of companies would **allow useful practical experience to be gained** before consideration of far-reaching general implementation. Second, business representatives almost unanimously argue that **without proper EU tax rules the European Company Statute will be unlikely to be of any practical benefit**.

... but now a more complex assessment of pros and cons emerges.

The ensuing **debate**, notably via the workshop and the consultation on the suitability of the IAS for the development of such a tax base, revealed a **more divided picture**, ranging from outright rejection of the idea as a matter of principle to cautious support. In particular, many observers felt that the choice of the SE for the pilot scheme was somewhat arbitrary and not justified by any substantial feature of the new legal form. Companies which factually or legally cannot easily transform themselves into an SE would be discriminated against. There are nevertheless **several advantages to the pilot scheme** idea which remain largely undisputed. While the issues to be resolved are exactly the same for an SE as for any other company, in particular as regards

Still, there are attractions to the idea.

the necessary **allocation mechanism**, it is acknowledged that the transitional issues should be easier to deal with for a new legal form which in many respects will have to start with a "clean sheet". Moreover, the possible avoidance of **consolidation issues** could provide a practically important advantage in the context of the pilot scheme.³⁵

The Commission services are examining potential discrimination issues in various facets.

Potential problems with **competition and discrimination issues** could **'make-or-break'** the pilot scheme for SEs. However, whether or not such situations really occur and if so, whether this gives rise to legal problems, are **essentially open questions**. Again, opinions in the debate and in tax literature vary significantly. This is why the Commission has contracted out an external study which is expected to provide a detailed **legal expert opinion** on these issues and all the relevant ramifications.³⁶ In particular, it is important to ascertain whether a **scheme** that is optional could avoid these problems. The result of this study is expected by early 2004.

The pilot scheme and option for a common tax base would not be available to the SE right from the start ...

The Commission continues to believe that the **idea** of a suitably designed pilot scheme which would provide companies created under the European Company Statute with a common consolidated tax base at EU-level **deserves to be analysed further**. Advances will now depend, on the one hand, on the technical progress in other areas (notably the devising of the tax base rules and possibly an apportionment key) and, on the other, on the Commission's final assessment of the discrimination issue. This means that it will effectively be impossible to have fully developed and operational EU tax base rules in place by the entry into force of the European Company Statute on 8 October 2004 and **decisions in this respect must be postponed to 2005**. It would therefore be premature to commence detailed work on the practicalities of a possible pilot scheme at this stage.

... but the idea will be pursued further

... and the creation of European Companies will be facilitated by EU tax law.

Nevertheless, as confirmed above, European Companies will be facilitated as far as taxation is concerned, subject to the Council assuming its decision-taking responsibilities, by **appropriate technical adaptations of the current body of EU company taxation law by 1 January 2005**. A certain delay on the 'grand design' solution will thus not hinder or put at an undue disadvantage this new legal form.

5. CONCLUSION AND PRIORITIES FOR COMING YEARS

The overall

In an overall assessment of its strategy the Commission concludes that its **'two-track' company tax strategy** after two years of work remains the **best approach** to the current tax problems in the Internal Market

³⁵ An SE could operate as a single entity across the EU without needing to produce separate branch accounts for consolidation.

³⁶ It goes without saying that the study will by no means prejudice any position or decision to be taken by the Commission in this area, in particular as regards the compatibility of a future SE tax regime with the Treaty rules.

assessment of the 'two-track' company tax strategy presented by the Commission is positive ...

and the Commission has delivered the actions and initiatives that were promised. The **targeted measures are 'on track'** and progress with these now depends to a significant extent on the other EU institutions and in particular the Council. The remaining issues will be tackled in 2004. This concerns, in particular, initiatives on double-taxation treaties and on the cross-border offset of losses. Moreover, the Commission will pay increasing attention to the developments before the European Court of Justice and strengthen its related policy initiatives.

but ultimately its success depends on the willingness of all players to contribute constructively.

The longer-term work on the **'comprehensive' approaches** has understandably progressed at a slower rate. This is partly due to the reluctance by Member States which are understandably cautious about such relatively long-term and far-reaching plans. Technical difficulties relating to some of the concepts advocated by academics and/or representative business organisations in 2001 still need to be resolved. The Commission still believes there will be no major breakthrough in the immediate future but **advances in specific areas** may now be possible (e.g. the HST **pilot scheme** for SMEs) which would allow for technical refinements and the acquisition of practical experience. The technical **work on this long-term objective** of the common consolidated EU tax base will **continue to be developed** and depending on the degree of political support **could even be stepped up**. In this respect, developing **'enhanced co-operation'**³⁷ mechanisms between a subgroup of Member States could facilitate further progress. When the relevant proposals are more elaborated it may well be that, when agreement between all twenty-five Member States is not possible, 'enhanced cooperation' will prove useful for the implementation of the measures.

In this light, and bearing in mind the economic importance of EU company tax reform for the improvement of the EU Internal Market as a whole, and for promoting economic growth and employment creation, the Commission remains committed to a continuing thorough technical analysis and constructive political debate. Both elements will be key to achieving satisfactory progress.

³⁷ Art. 43-45 EU-Treaty ("Nice Treaty") and Art. I-43, III-322-329 of the Draft constitutional Treaty.