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Report

drawn up on behalf of the Committee on Budgets

on the proposal from the Commission of the European Communities to the Council (Doc. 228/75) for a directive concerning the harmonization of systems of company taxation and of withholding taxes on dividends

Rapporteur: Mr Jochen van AERSSEN

By letter of 14 August 1975 the President of the Council of the European Communities requested the European Parliament to deliver an opinion on the proposal from the Commission of the European Communities to the Council for a directive concerning the harmonization of systems of company taxation and of withholding taxes on dividends.

On 2 September 1975 the President of the European Parliament referred this proposal to the Committee on Budgets as the committee responsible and to the Committee on Economic and Monetary Affairs for its opinion.

On 16 September 1975 the Committee on Budgets appointed Mr Artzinger rapporteur.

It considered this proposal at its meeting of 18 March 1976.

Following Mr Artzinger's resignation, Mr van Aerssen was appointed rapporteur on 16 March 1977.

At its meeting of 22 September 1977 the committee considered the report and adopted it unanimously with one abstention.

Present: Mr Bangemann, vice-chairman and acting chairman; Mr van Aerssen, rapporteur; Lord Bruce of Donington, Mr Dalyell, Mr Mascagni, Mr Meintz, Mr Notenboom, Mr Radoux, Mr Schreiber, Mr Shaw, Mr Spinelli and Mr Yeats.

The opinion of the Committee on Economic and Monetary Affairs is attached.

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A

The Committee on Budgets hereby submits to the European Parliament the following motion for a resolution together with explanatory statement:

MOTION FOR A RESOLUTION

embodying the opinion of the European Parliament on the proposal from the Commission of the European Communities to the Council for a directive concerning the harmonization of systems of company taxation and of withholding taxes on dividends

The European Parliament,

- having regard to the proposal from the Commission of the European Communities[1],
- having been consulted by the Council (Doc. 228/75),
- having regard to the report of the Committee on Budgets and the opinion of the Committee on Economic and Monetary Affairs (Doc. 291/77),

(a) whereas the European Parliament, as long ago as 1970, called for the harmonization of the systems of company taxation in the Member States in implementation of the objectives of Article 100 of the EEC Treaty,

(b) whereas a free and common capital market permitting the unimpeded movement of dividends is a basic prerequisite for the elimination of distortions of competition in connection with the investment and location decisions of undertakings and for the neutral taxation of shareholders,

(c) whereas the Council resolution of 22 March 1971 set a clear political objective,

1. Approves the Commission's proposal;

2. Draws particular attention, in view of the fact that not all Member States are equally willing to accept integration, to the need, in an initial stage, to embark only on the harmonization of systems in a way which will not affect revenue, and to leave to a later stage the approximation of bases of assessment, taxation rates and tax credits;

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[1] OJ No. C 253, 5.11.1975, p.2

3. Endorses the rejection of the 'classical' system as a European solution, since the former would:

   (a) tend to give too much encouragement to self-financing and financing through loans by equating distributed and non-distributed profits;

   (b) run counter to the principle of fiscal neutrality for the various legal forms of undertaking in view of the double taxation of companies as opposed to partnerships and other economic entities; and

   (c) increase the opportunity for tax evasion by failing to provide adequate safeguards in the form of deductions at source;

4. Regrets that, in its proposal, the Commission has not given sufficiently detailed consideration to the alternatives of full imputation, split rates and primary dividends;

5. Nevertheless agrees with the Commission, for the reasons indicated below, that partial imputation is the only system likely to yield satisfactory results at Community level:

   (a) in view of the high maximum rates of income tax in certain Member States, and on the premise that corporation tax would have to be based on these maximum rates, the full imputation system would inevitably lead to losses of revenue for the exchequers concerned;

   (b) the split-rate system does not permit flexible tax relief, since any such relief under this system automatically affects all shareholders alike; and

   (c) the system of preferentially taxed primary dividends has always been a rare feature of European company tax law;

6. Takes the view that the advantages of the partial imputation system could make satisfactory application feasible at Community level because:

   (a) it represents a realistic compromise between the 'classical' system and the system of full relief which, once implemented, would make it possible to prevent isolation of the European financial markets and to achieve maximum neutrality with regard to competition;

   (b) it largely guarantees fiscal equity for the various forms of undertaking but at the same time tends to cancel out the advantage of limited liability capital accumulation by taxing companies more heavily than partnerships; and

   (c) by favouring small investors, it should have a positive effect on share markets and thus take account of the social desirability of a broader spread of production capital;

7. Calls on the Commission to draw up, in the light of the present directive, the intended directive on investment funds and to submit it without delay;

8. Takes the view that the withholding tax also proposed is absolutely essential, even though the additional collection of taxes might to some extent complicate the system;

9. Warns against the danger of underestimating the practical difficulties of partial imputation as regards parent corporations and their subsidiaries and tax compensation between the Member States, since such difficulties could call into question the feasibility of the entire harmonization effort; therefore recommends a number of technical improvements relating to tax credits and their application and to fiscal compensation and the relevant implementing provisions;

10. Feels that the directive should include express provisions to ensure that the non-imputation of credits against income tax in third countries does not lead to protectionist discrimination against non-Community investors; accordingly emphasizes the need for tax agreements to be concluded with third countries on this matter;

11. Stresses that the proposed tax harmonization must neither undermine nor invalidate the principles and objectives contained in the Accession Treaties and associated acts;

12. Consequently requests the Commission to make the following amendments to its proposal pursuant to Article 149, second paragraph, of the EEC Treaty.

TEXT PROPOSED BY THE COMMISSION OF THE EUROPEAN COMMUNITIES[1]	AMENDED TEXT

Council directive on

harmonization of systems of company taxation

and of withholding taxes on dividends

Preamble and recitals unchanged

Articles 1 to 3 unchanged

Article 4	Article 4
1. A dividend distributed by a corporation of a Member State shall confer on its recipient a right to a tax credit at the rate referred to in Article 8, provided: a) that he is resident in a Member State, and b) that he is subject to a tax on income or profits in such a way that the full amount of the dividend increased by the tax credit is taken into account in arriving at the amount of his taxable income or profits.	1. Unchanged
2. By way of derogation from the provisions of paragraph 1 b), the tax credit may be granted to a person resident in a Member State who is exempt from all tax on income or profits either in respect of the whole of his income or in respect of that part of it consisting of dividends, provided that the person in question is an institution which is of public interest. If use is made of this option, the tax credit shall be granted whatever the Member State in which the dividends have their source.	2. Unchanged
3. By way of derogation from the provisions of paragraph 1 b) the tax credit may be granted to the recipient of a dividend where, for reasons of administrative convenience, final taxation is levied, whether by means of a withholding tax or otherwise, on the amount of the dividend not increased by the tax credit.	3. Unchanged

[1] For complete text see OJ No. C 253, 5.11.1975, p.2

TEXT PROPOSED BY THE COMMISSION OF THE EUROPEAN COMMUNITIES	AMENDED TEXT
4. The Council, acting by qualified majority on a proposal of the Commission, shall in case of need adopt any measures necessary for the application of the provisions of paragraph 2, first subparagraph, and paragraph 3.	4. The Council, acting by qualified majority on a proposal from the Commission, shall adopt any administrative measures necessary for the application of the provisions of paragraph 2, first subparagraph, and paragraph 3.

Article 5 unchanged

Article 6	Article 6
By way of derogation from the provisions of Article 4, paragraph 1, tax credits may, pursuant to double taxation agreements, be granted in whole or in part to persons resident in third countries. In no circumstances, however, may such persons be treated more favourably than persons resident in the Community.	1. By way of derogation from the provisions of Article 4, paragraph 1, tax credits may, pursuant to double taxation agreements, be granted in whole or in part to recipients of dividends resident in third countries, with due regard to possible reciprocal arrangements.
The Member States shall co-operate with each other and with the Commission with a view to adopting a common position on this matter.	The Member States shall cooperate with the Commission with a view to adopting a common position which will facilitate imputation between Member States and third countries.
	2. Recipients of dividends resident in third countries shall not receive more favourable treatment than residents in the Community.

Articles 7 to 23 unchanged

B

EXPLANATORY STATEMENT

I. Introduction

1. The Commission took its first practical steps towards the harmonization of direct taxes as long ago as 1969, when it submitted proposals for directives on the common tax arrangements applying to mergers, divisions and contributions of assets between companies in different Member States[1] and on the common tax arrangements applying to parent companies and subsidiaries in different Member States[2].

The European Parliament delivered detailed opinions on both of these proposals[3,4]. However, the Council has not yet adopted either of the directives, arguing *inter alia* that systems of company taxation should be harmonized first.

2. These specific proposals suggested that the Commission would soon submit a comprehensive proposal for the harmonization of systems of company taxation, especially since, in its resolution of 22 March 1971[5], the Council called on the Commission to submit such a proposal for harmonization. At the end of 1972 it was learned that the Commission of the Six had decided in favour of the 'classical' system of company taxation.

After many years of investigations and consultations the Commission subsequently changed its views and submitted the present proposal for a directive, which is based on the 'partial imputation system'.

The importance of this Commission proposal cannot be overestimated. It is a first decisive step towards the elimination of the fiscal distortions of competition facing undertakings in the Common Market. The proposal has far-reaching implications not only for fiscal law but also for competition and company law. It therefore calls for detailed consideration[6].

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[1] OJ No.C 39, 22.3.1969, p.1

[2] OJ No.C 39, 22.3.1969, p.7

[3] ARTZINGER report, Doc. 206/69, 3.2.1970

[4] ROSSI report, Doc. 195/69, 2.2.1970

[5] OJ No C.28, 27.3. 1971

[6] The Committee on Budgets has been considering the proposal for a directive since March 1976. The Committee on Economic and Monetary Affairs delivered its opinion on 26 January 1977 (draftsman: Mr COUSTE - PE 42.703/final).

3. First and foremost, it should be pointed out that the Commission proposes the following two stages for its project:

1. Harmonization of systems
2. Harmonization of rates.

The proposal for a directive under consideration relates <u>only</u> to the harmonization of systems, i.e. the <u>purpose</u> is not yet to harmonize bases of assessment, provisions on the determination of the profits of undertakings or tax rates.

Articles 3 and 8 of the proposal merely lay down maximum and minimum limits for rates of corporation tax and for tax credits, leaving the Member States a sufficient amount of latitude.

Thus, the scope of the proposal is restricted to the introduction of a harmonization system which only sets a quantitative framework for the actual taxes themselves. This system is not intended to provide tax cuts or rebates. National budget revenues will remain unaffected. If a Member State wishes to impose heavier taxes or provide greater tax relief, it will still be able to do so.

II. The need for harmonization

4. The following systems of company taxation are applied in the Community:

- the partial imputation system or similar systems in Belgium, France, the United Kingdom and Ireland;
- the full imputation system in the Federal Republic of Germany; and
- the 'classical' system in Denmark, Italy, Luxembourg and the Netherlands.

The coexistence of these very different systems has many adverse effects of the Common Market.

(a) The aim of the Treaty

5. The criteria for deciding whether the legislation on direct taxation, and in particular company taxation, stands in need of harmonization and, if so, what system should be adopted are based first and foremost on the EEC Treaty itself. In addition, the general principles of fiscal law common to all the Member States should also be taken into account. Under Article 100 of the EEC Treaty, the prime consideration is the '<u>functioning of the Common Market' in conditions of undistorted and equal competition</u>. An important factor

in this connection is the general legal principle of fairness and uniformity of taxation. The Common Market will function at its best internally when the relevant free movement of capital (Articles 67 and 69 of the EEC Treaty) is also ensured through the elimination, by means of the approximation of legislation, of indirect obstacles to trade in the form of fiscal barriers.

6. Thus, the approximation of legislation on company tax has the following two main objectives: liberalization, i.e. the elimination, for the purposes of the free movement of capital, of differences in legislation which constitute barriers to trade; and economic non-discrimination, i.e. the guaranteeing, by means of economically neutral non-discriminatory conditions, of equality of competition between limited companies themselves and between such companies and partnerships and other economic entities. Thus, the approximation of legislation should be seen exclusively as a functional measure. It is not an end in itself.

(b) The economic policy arguments

7. A free and common capital market can be created only if the free movement of capital is guaranteed. However, non-harmonized systems of company taxation give rise to economically unsound movements of capital as a factor of production and impede its optimal utilization.

8. Moreover, the present situation in the Community prevents choices of location from being made exclusively on the basis of economic factors. Because of the different taxes on profits, fiscal considerations play an increasingly important part in decisions on where to invest.

9. In the field of indirect taxation, the Member States of the Community have reached agreement on VAT. No such agreement has yet been reached in the field of direct taxation. Thus, the different systems of company taxation are bound to lead to considerable distortions of competition and are therefore directly at variance with the objectives of the EEC Treaty.

10. The lack of uniformity in the taxation of shareholders is another argument in favour of harmonization. It is economically wrong for investors to be forced to go to certain Member States for tax reasons. It should be possible for decisions on investments to be based without exception on economic considerations.

(c) The political objective

11. The Council expressly called for company tax reform in its decision of 22 March 1971. This requirement must be met. In 1971 the principle of the reform was embodied in the Council decision on economic and monetary union. However, the postponement of the introduction of economic and monetary union cannot be allowed to override the Council's political determination to achieve harmonization in the field of direct taxation.

12. We can therefore conclude that harmonization is most definitely necessary.

III. Existing systems of company taxation

(a) The 'classical' system

13. Under the 'classical' system profits are subject to double taxation. They are first taxed at company level and are then subject to income tax after distribution to shareholders. If the shareholder is a limited company, the profits are once again subject to corporation tax. Thus, this system is quite different from the one used for taxing partnership profits. The latter are distributed between the partners and are subject to tax at that level but not at the level of the partnership itself.

(b) Full imputation

14. As the opinion of the Committee on Economic and Monetary Affairs rightly points out, the Commission proposal is based only on the choice between the 'classical' system and the partial imputation system. Hence the explicit reference here to the full imputation system. Under this system the profits of undertakings are also fully subject to corporation tax, but if they are distributed this tax is deductible in its entirety from the income tax liability of the shareholder. If the amount of deductible corporation tax is higher than the income tax liability, the excess is refunded. The basis of assessment for income tax consists of two components, namely the distributed basic dividends plus the amount payable in the form of refundable corporation tax; i.e. the amount payable in the form of refundable corporation tax is subject to income tax at the level of the shareholder.

(c) Partial imputation

15. Under the partial imputation system, however, corporation tax is only partly allowable against income tax. The double taxation of dividends is partially alleviated by means of a tax credit. Under this procedure, the basis of assessment is increased by the amount of the tax credit, i.e. the credit is taxed as an additional yield from the share, exactly as in the case of full imputation. The tax credit is granted in the form of fixed percentage of the dividends. Variable credits have scarcely ever been used because of the technical complications they give rise to.

(d) The split rate

16. Until recently the Federal Republic of Germany applied the split-rate system, whereby distributed profits were only partially subject to corporation tax, while non-distributed profits were fully taxed. This split-rate corporation tax has the disadvantage that any relief under this system automatically applies equally to all shareholders alike.

The subsidiary system of primary dividends is no longer of any importance and is not now used to provide tax relief in the European legal system.

IV. The disadvantages of the 'classical' system

(a) The equation of distributed and non-distributed profits

17. Under the 'classical' system, non-distributed and distributed profits are necessarily placed on an equal footing. Where corporation tax rates are relatively high, the double burden imposed on distributed profits gives rise, from the economic point of view, to over-taxation. This gives excessive encouragement to financing through borrowing. On the other hand, relatively low rates of corporation tax result in the undertaxation of non-distributed profits and give rise to undesirable levels of self-financing. Since they naturally have more to gain from such internal increases in capital, the 'classical' system on the whole favours major shareholders and represents an obstacle to a broader spread of share capital.

(b) Lack of neutrality with regard to the taxation of the various forms of undertaking

18. One of the important disadvantages of the 'classical' system is that taxation varies depending on the legal form of the undertaking. The fact that an economic inevitability such as taxation is based on the legal form of the undertaking, which is largely optional, represents a considerable obstacle to the desired aim of achieving neutrality in company law.

(c) Encouragement of tax avoidance

19. The 'classical' system provides only for the corporation tax - usually 25% - to be deducted on dividend payments at source. On the whole, this does not seem to be enough to safeguard against fiscal irregularities in subsequent taxation, which would have serious consequences for the exchequers concerned. Under the partial imputation system, on the other hand, the tax credit acts as a payment on account and therefore has a safeguarding effect.

V. The negative aspects of full imputation, the split-rate system and primary dividends

(a) Full imputation

20. An analysis of the systems of company taxation at present used in the Member States shows that the only alternative to the choice between the non-relief and full relief of double taxation is a compromise in the form of partial imputation.

21. The transition from the 'classical' system to full relief could not be achieved without losses of revenue for the exchequers of the Member States concerned. Moreover, it should be borne in mind that the need to base the rate of corporation tax on the maximum rates of income tax would cause very difficult problems in the Netherlands and the United Kingdom, which apply maximum income tax rates of 70 and 90% respectively.

22. Since all systems of relief call for fiscal compensation between the Member States, the full imputation system would serve to make the situation even worse. In the case of shareholders resident abroad, the source state would be left with absolutely no revenue from the corporation tax on distributed profits. In the case of parent corporations and subsidiaries the problem of fiscal compensation would become impossibly complicated.

(b) The split-rate system

23. The split-rate system previously used in the Federal Republic of Germany, i.e. the application of different rates of corporation tax to distributed and non-distributed profits, has manifestly been unsuccessful. It has the disadvantage that relief is automatically given to all shareholders alike. However, it is better for the exchequer if, within the framework of a flexible system which allows for exceptions, it grants tax privileges to shareholders only in individual cases where it considers they would be politically justifiable.

24. The Member States should not be deprived of this flexibility by a European proposal for harmonization since this could also be interpreted as unacceptable interference in the affairs of the national tax authorities.

(c) Primary dividends

25. The Committee on Economic and Monetary Affairs has rightly complained that the Commission proposal contains no opinion on the system of preferentially taxed primary dividends. Even if this method has no chance of success in the Common Market, the Commission should nevertheless have given the European Parliament its reasons for rejecting it so that the Community institutions could reach a balanced decision on this important proposal for harmonization.

VI. The advantages of the partial imputation system

26. The partial imputation system represents a compromise between the two most divergent systems, i.e. full imputation and unrelieved double taxation ('classical' system).

With this proposal for harmonization, the Community, which must take account of the different national forms of industrial financing, share markets and companies, will be working towards a politically acceptable 'common denominator'. No political value judgement by the various parties can fail to come down in favour of partial imputation, which best conforms to:

- the principle of taxation on the basis of productivity,
- the principle of the uniformity of taxation, and
- social policy requirements.

27. The partial imputation system makes it possible to harmonize systems without affecting in any way the budgetary revenue of the Member States. This increases the likelihood of successful implementation of the directive.

28. The partial imputation system is more neutral than the other systems with regard to the various forms of company. On the one hand it prevents the fiscal penalization of small limited companies (family businesses), which was a disadvantage of the classical system, and on the other it deals flexibly with the advantage of limited-liability capital accumulation, which the full imputation system could not do.

29. The proposed system encourages a socially desirable increase in the spread of production capital and would thus inject new vigour into the capital market by inducing small savers to buy shares.

30. In combination with the additional withholding tax, the tax credit, which amounts to a payment of tax on account, gives rise to a total deduction at source of about 50%, which can be considered a suitable safeguard against tax avoidance.

VII. The application of the imputation system by and between Member States

(a) Compensatory tax

31. Tax credits are intended to provide relief only in cases where economic double taxation actually exists. However, under the fiscal systems of all the Member States, there are a number of instances in which little if any corporation tax is levied. Variable tax credits cannot be used in such cases because the system would be impractical at income tax level. The Commission's proposal therefore makes provision for the introduction only of a fixed-rate tax credit. As a result, a compensatory tax is to be imposed on companies distributing profits with a view to neutralizing the uniform tax credit in cases where corporation tax has not been charged at the normal rate (Article 9). This is what France does by means of the 'précompte' (advance payment) system.

(b) Parent corporations and subsidiaries as a single economic unit

32. Article 10 of the Commission's proposal relates to the application of the imputation system to parent corporations and subsidiaries. In this connection the principle of non-discrimination requires that direct and indirect shareholders shall be treated in the same way. Thus, the tax credits on dividends received from subsidiaries within the previous five financial years and redistributed by the parent corporation are to be included in the basis of assessment for the compensatory tax (prepayment) to which the parent corporation is liable and then offset against the amount of that tax. In this way, parent corporations and subsidiaries are treated as a single economic unit and the imputation system is applied logically to this unit.

However, it would be far too complicated to repay compensatory tax by offsetting it against the income tax of dividend recipients. This represents a departure from the objective of maintaining the principle of non-discrimination.

(c) Fiscal compensation between Member States

33. Under Article 5 of the Commission's proposal tax credits are to be granted by the Member State to whose income tax or corporation tax the dividend recipients are subject.

The partial imputation system therefore gives rise to practical difficulties in cases where distributions are made between Member States, i.e. either from a corporation based in one Member State to a shareholder resident in another or by a parent corporation based in one Member State to a subsidiary based in another or vice versa.

34. Under the partial imputation system tax previously paid is deducted by means of a tax credit offset against the dividend recipient's income tax liability in the Member State in which he is resident. This necessitates fiscal compensation between the Member State in which the corporation has its seat and the state in which the state in which the shareholder is resident. In order to ensure that this particularly important procedure can in fact be carried out, further measures for the detailed implementation of Articles 4 to 9 (for example with a view to establishing a clearing office) must be adopted on the basis of Article 4(4).

35. Moreover, provisions for the standardization of the tax credit forms are essential for the purposes of efficient administration and hence for the liberalization of the movement of capital within the Community and the facilitation of the transfrontier activities of limited companies.

It is regrettable that the Commission's proposal does not give clear expression to these requirements. The broad outlines of possible implementing provisions should at least have been included in the explanatory memorandum.

VIII. Proposals for improvements to facilitate the application of the partial imputation system

36. In keeping with the European Parliament's resolution of 2 February 1970 on the proposal from the Commission of the European Communities to the Council for a directive on the common tax arrangements applying to parent companies and subsidiaries in different Member States[1], it is appropriate for Article 2 of this directive also to take the actual place of work of an undertaking as the criterion determining the seat of that undertaking. This principle, unlike the incorporation theory, holds that profits should be taxed in the place where they are actually made. It has therefore been necessary to amend the first indent of Article 2 accordingly.

37. Paragraphs 2 and 3 of Article 3 make provision for derogations which, in certain circumstances, could undermine the efforts to introduce a harmonized system. The possibility of exemption from corporation tax should not therefore be formulated in such general terms even at this early stage, i.e. the directive on approximation, since the Member States might be tempted to compete for the title of the country with the most liberal or most liberally operated tax system, using the derogation clause as a loophole. Careful wording of the derogation clause is accordingly just as important for fiscal neutrality as the principle laid down in Article 3(1). It has therefore been necessary to propose a new version of Article 3(2).

38. In its opinion on this subject, the Committee on Economic and Monetary Affairs went even further and called for the derogations provided for in Article 3(2) and (3) to be granted only the basis of a decision taken by the Community institutions. The Committee on Budgets welcomes

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[1] ROSSI report, Doc. 195/69 2.2.1970

this proposal but considers it to be unrealistic at the present time. Its ultimate effect would be to give one of the Community institutions the power to encroach on the fiscal jurisdiction of the Member States. Given the present state of Community integration, this could well jeopardize the implementation of the directive on harmonization.

39. The proposed amendment to Article 4(4) is intended to draw attention to the absolute necessity for provisions to ensure the efficient application of the administrative procedure. Such measures would include a standard form for tax credits. Experience in the field of customs law should be used as a model in this connection.

40. A completely new wording is proposed for Article 6. First and foremost it is not clear why the conclusion of double taxation agreements should only benefit individuals and not companies in third countries. For this reason the term 'persons' should be replaced by the more general expression 'recipients of dividends'.

41. Moreover, it would appear absolutely essential to encourage the conclusion of double taxation agreements with third countries as a means of preventing a protectionist isolation of the European capital market from the world market. Liberalization of the movement of capital within the Community should not in any way result in discrimination against direct investments from third countries. Since the Community is in any case in danger of having protectionist methods forced upon it in other fields, liberalization is also to be called for vis-à-vis third countries.

OPINION OF THE COMMITTEE ON ECONOMIC AND MONETARY AFFAIRS

Draftsman : Mr COUSTE

On 3 October 1975 the Committee on Economic and Monetary Affairs appointed Mr Cousté draftsman.

It considered the Commission's proposal and the draft opinion at its meetings of 21 October and 18 November 1975, 17 February, 13 April, 30 September, 22 November 1976 and 26 January 1977. At its meeting of 26 January 1977, it adopted the draft opinion by 10 votes to 3 with 3 abstentions.

Present: Mr Van der Hek, chairman; Mr Notenboom and Sir Brandon Rhys Williams, vice-chairmen; Mr Cousté, draftsman; Lord Ardwick, Mr Clerfayt, Mr Dykes, Mr Hougardy, Mr Lange, Mr Leonardi, Mr Martens (deputizing for Mr Ripamonti), Mr Van der Mei, Mr Normanton, Mr Prescott, Mr Starke and Mr Thornley.

PRESENT STATE OF TAX HARMONIZATION IN THE COMMUNITY

1. Little progress has so far been made, whether in the harmonization of indirect taxes, of VAT, or of various excise duties, and less still in the area of direct taxation; the delay is due essentially to the lack of political resolve on the part of the Council. In a most timely recent communication (Doc. COM(75) 391/fin) the Commission has drawn up a programme of measures to be taken in the fiscal area in the next three years.

Harmonization of company taxation and of withholding taxes is one of the measures which it is essential to introduce in 1975 and is the subject of the proposal for the directive under consideration here.

2. It is clear from the Commission's explanatory memorandum that considerable differences exist at present between the EEC Member States, both as regards the rates and the principles of taxing company profits.

Thus, the tax rate on distributed profits ranges from 30% in the Federal Republic of Germany to 52% in the United Kingdom. What is more, there are cases of double taxation of company profits, to the detriment of shareholders.

These tax disparities within the Community represent an obstacle to genuine integration of the Member States' economies. They lead to distortions of competition, to inequality of treatment of shareholders in different Member States, and they may have a serious effect on investments (when shareholders are subject to double taxation, investment tends to be financed almost solely from retained profits). These considerations show why the necessary harmonization of company taxation and withholding tax systems is of great importance, not only from the point of view of the reorganization of the Member States' tax procedures, but also for the tax payers - and thus not only falls within the competence of the Committee on Budgets, as the committee responsible but also has an economic aspect.

Improvement of the tax system is bound to have important repercussions on the economic behaviour of each Member State and it would clearly be impossible to try to achieve total harmonization at once.

MEASURES PROPOSED BY THE COMMISSION

3. The Commission's proposal takes account of these facts and is no more than a first step towards gradual harmonization.

It will be convenient to examine the proposed measures from the angle of their application to companies, to dividend-drawing shareholders, and to Member States respectively.

(a) Taxation of company profits

4. The differences between the rates of corporate profits taxation obtaining at present in various Member States are at the root of inequalities in the conditions of competition and of abnormal capital movements and they play an important part in the choice of the place of business. The Commission proposes the establishment of a 'normal' taxation rate, ranging between 45% and 55% to replace the rates applicable so far. This undoubtedly is a step in the right direction.

5. However, this progressive provision is immediately hedged with a number of derogations listed in Article 3 (2) and (3) which are so extensive that it may be justifiably asked whether in practice they do not reduce excessively the scope of the initial provision.

Article 3 (2) permits the application of a rate different from the normal rate, or complete exemption, in a Member State, <u>in particular cases and for well-defined reasons of economic, regional, or social policy.</u> And this derogation may be invoked on a permanent basis. A Member State wishing to avail itself of this option should first consult the Commission, but if the Commission opposes the measures proposed by the Member State, there is no provision for any Community procedure to approve or reject these measures and the Member State may put them into effect after 30 days - the period granted to the Commission to express its views - or after the Commission has made its views known. Article 3 (3) permits Member States to apply, <u>for the purpose of regulating the economy</u>, temporary increases or reductions of corporation tax. This derogation does not even require consultation with the Commission.

6. What is more, Article 2 (2) exempts from the provisions of the directive dividends received by the beneficiary through the intermediary of investment funds and leaves the regulation of such transactions to a future special technical directive. Pending harmonization in this area, Member States are free to settle for themselves the problems posed by dividends which are transmitted through financial intermediaries of the portfolio investment type. Lack of harmonization in this area, once harmonization of company taxation and withholding tax systems has been achieved, is likely not only

to perpetuate but to exacerbate the chances of distortion. Without this harmonization, persons preferring to have the investment of their savings managed by specialized intermediaries will probably, in some Member States, find themselves penalized fiscally, compared with those undertaking other investment activities. This will inevitably result in a disturbance of the market and a switching of funds to ordinary shares.

The Committee on Economic and Monetary Affairs therefore urges the Commission to submit as soon as possible a proposal concerning this area of taxation so that the appropriate directive may be adopted immediately after the general directive.

(b) Tax credits for shareholders

7. The Commission states that studies have shown that only two systems of company taxation merited consideration: the 'classical' system and the imputation system.

However, in its 1967 'Programme for the harmonization of direct taxes'[1], the Commission did consider the split-rate system as one that could be extended throughout the Community on the same basis as the imputation system. The Commission also claims that the system involving deduction of a primary dividend from corporate profits is also now out of the question. It may be that these systems do not merit consideration but the Commission could have at least given its reasons.

8. The Committee on Economic and Monetary Affairs agrees with the Commission that the imputation system has many advantages compared with the classical system. The common imputation system, or the 'tax credit' system, ensures greater neutrality of taxation as regards the source of investment, since double taxation encourages self-financing as against financing from outside sources. The Commission, however, is probably being somewhat over optimistic in stating that the imputation system 'tends to put loan and equity financing on a more equal footing.' In the 'Programme for the harmonization of direct taxes' the Commission states: "If the systems of tax credit and split rates do in fact reduce 'double economic taxation', they do not appear to appeal to shareholders to the extent expected, nor have they solved the problem of the excessive preference given by companies to loans for financing operations."[2] The question then arises as to whether, since those words were written, the preference for loan financing has diminished.

The tax-credit with its higher rate of corporation tax, also ensures greater neutrality with regard to the various legal forms of undertakings. The gap between corporate taxation rates and the rates levied directly on one-man businesses at the level, respectively, of the owner or of the partners in the enterprise, is smaller under the imputation system than under the 'classical'

[1] Supplement to Bulletin of the EEC No. 8 - 1967

[2] See Supplement to Bulletin of the EEC No. 8-1967 'Programme for the harmonization of direct taxes,' p.14

one.

In addition, the system ensures greater fairness of taxation. The 'classical' system has the effect of making shareholders whose rate of personal income tax is low subject to a tax burden which is relatively heavier than that of shareholders whose rate of personal income tax is high. The imputation system reduces this burden for small shareholders. What is more, the classical system promotes ploughing back rather than distribution of profits, to the disadvantage of small shareholders who are primarily interested in an income from their shares.

The rate of corporate taxation is higher under the imputation than under the 'classical' system and thus closer to the maximum rate of income tax, thereby discouraging tax avoidance.

Finally, as we have already observed, the imputation system seems more likely to attract to the investment market medium- or even small-scale savers, an important factor for the future development of the share market.

9. An argument against the imputation system is that, to a greater extent than the 'classical' system, it has an incidence on prices. It is generally admitted that proportionate taxes on profits can be more easily offset by raising prices than personal income-tax. On this reasoning it might be concluded that - in an imputation system in which corporate taxes are relatively higher than taxes on income - the tax burden is more likely to be shifted to prices than under the 'classical' systems, even though the shareholder is given a tax credit to allow for the tax paid by the company. Studies show that the burden of taxation is passed on in extremely complex ways. Account must also be taken of the effect of other factors, such as profit retention or distribution on the shifting of the tax burden. An analysis by Professor Dr. S. J. van den Tempel[1] suggests that there is no certainty that any one system more than another causes taxes to be passed on in prices.

10. In view of these considerations the Commission's choice of tax credits can be approved, but with the reservation that other systems should have been examined in the analysis on which the Commission bases its choice.

(c) Harmonization of systems of withholding tax at source : fiscal cooperation among Member States

11. A wide variety of rates apply to the withholding at source of taxes on dividends. The tax on the same amount of revenue may vary from 0 to 30 per cent. Moreover, the final tax burden to which a recipient of dividends

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[1] See 'Studies' No. 15-1970 'Corporation tax and individual income tax in the European Communities', p. 15

or interest on bonds is subject varies according to the EEC country in which these revenues arise; the disparities are due to the fact that, depending on the individual case, the tax withheld at source is not, is only partly, or is totally charged to personal tax liability, or is even refunded.

Added to these discrepancies there are differences in the methods and the efficiency of the control of the final tax charged on dividends paid to residents of the Member States.

It must therefore be realized that the method of withholding of tax at source as practised currently in the Member States, and in spite of alleviation by existing conventions to prevent double taxation, continues to result in double taxation or in over-taxing as well as in complications for the potential investor and is the cause of abnormal movements of capital.

12. To mitigate these disadvantages, the proposal for a directive envisages (in Article 14(1)) that, in respect of third countries, each Member State shall impose a withholding tax at a standard rate of 25% on dividends distributed by the corporations of that State, no matter who is the recipient of these dividends.

In the Commission's view this deduction at source is essential to prevent fiscal fraud. The rate of 25% proposed by the Commission for the withholding tax on distributed dividends would have the effect of raising the total amount levied, allowing for tax credit, to approximately 50%, or close to the rate of personal income tax, thus assuring fairness of taxation and discouraging fiscal fraud.

On the other hand, the proposal provides (Article 14(2)) that there shall be no deduction at source on a dividend distributed by a subsidiary to a parent corporation resident in any Member State.

Finally, Article 16 establishes a common system for setting off the withholding tax against the amount of the tax on income or profits to which the recipient of the dividends is liable.

Such a Community system of tax deduction at source would represent real progress: there would be no more double taxation; thanks to the common system of calculating and setting off the standard-rate deductions at source, there would be an end to abnormal movements of capital due to the present fiscal disparities.

(d) <u>Tax cooperation among Member States</u>

13. The implementation of the provisions of this proposal for a directive would imply fairly close fiscal cooperation among the Member States, both

in granting tax credits and in offsetting deductions at source.

Such cooperation would also be needed in the sharing out of the budgetary costs of tax credit (Article 13(3) and (5)), where dealings between subsidiary and parent companies domiciled in different Member States are concerned. In respect of third countries, Article 6 stipulates that Member States shall cooperate with a view to adopting a common position.

The Commission considers that its proposals go sufficiently far in reducing the technical difficulties involved.

CONCLUSIONS

The Committee on Economic and Monetary Affairs:

(a) is of the opinion that the objective of the proposal is to establish neutrality of taxation with regard to capital movements between Member States, an objective which the European Parliament has always supported;

(b) is of the opinion that the system of corporate taxation chosen should not discourage risk capital as a means of financing essential investments in the present conjunctural and structural economic crisis;

(c) feels that the Commission should not have restricted its choice of Community system to the alternative between the imputation system and the 'classical' system;

(d) is of the opinion that the derogations provided for in Article 3(2) and (3) should only be granted on the basis of a decision taken by the Community Institutions;

(e) urges the Commission to submit as soon as possible a proposal for a special directive dealing with investment funds so that this directive can be adopted immediately after the general directive;

(f) feels that the effort to eliminate distortions of competition involves not only harmonizing systems of company taxation and withholding taxes on dividends but also harmonizing the basis of assessment and the rate of company taxation;

(g) stresses - contrary to the piecemeal approach adopted by the Commission - the need for overall fiscal harmonization and therefore insists that the objective of harmonizing the basis of assessment and the rate of company taxation should be further pursued;

(h) notes that the absence of harmonization referred to in points (f) and (g) partly accounts for the current divergence in the economies of the Member States;

(i) considers that, in the interests of fiscal equity, it is of the highest importance to avoid creating a situation more favourable to capital-derived than to labour-derived income.