



## Taxation

**The** member governments of the EU retain sole responsibility for most direct taxes – tax on company profits (i.e., corporate tax), personal incomes, as well as savings and capital gains tax – level, on the grounds that they do not sufficiently affect the free movement of goods, persons, services and capital (the four freedoms of the European single market) to merit the intervention of the European Union. As long as the member states respect the broad economic policy guidelines of the EU, they retain complete freedom in spending and raising direct taxes. Ensuring the preservation of state autonomy in these areas, a unanimous vote is required to modify any EU tax rules. However, it has been accepted that some national direct taxes do potentially impinge upon the four core freedoms.

EU tax policy focuses upon any national tax rules that might operate to limit effectively the right of EU citizens to work in any member state. The EU's policy also seeks to eliminate all national tax rules that block the free movement of capital in the Union, while also ensuring that this free movement does not permit the avoidance of tax. However, national systems of direct taxation have not been harmonized at the EU-level and the limited policy developments in this area concern specific situations such as double taxation on cross-border economic activities. There is considerable disagreement among the member states on the harmonization of other forms of direct taxation. EU tax policy concerns principally indirect taxes, and notably value-added tax and excise duties, on the grounds that the rates of these taxes have an impact upon the operation of the single market in goods and services. With the EU budget funded in part by VAT revenues from the member states, common rules were also designed to prevent excessive distortions in the contributions of EU member states.

### Corporate Tax

Because of the unanimity rule and significant national differences on desirable EU policy on corporate tax, very little legislation exists today. The EU has two stated goals in this area:

- To ensure the free movement of capital.
- And to prevent what is perceived to be harmful tax competition between member states.

On the former, there are EU rules or (non-legally binding) codes of conduct to ensure comparable tax treatment of cross-border payments of interest, royalties and dividends to sister and parent companies and of cross border intra-company sales of goods and services (so-called transfer prices). With regard to the free movement of capital, two

directives and a Convention were adopted by the Council in July 1990. One directive was designed to eliminate double taxation on dividends paid by subsidiaries to their parent companies located in another member state. The second (so-called merger) directive established a common system of taxation under which any capital gains arising from mergers, divisions, transfers of assets or exchanges of shares are not taxed at the time of the transaction, but only when those gains are actually realized. The 1990 Convention introduced an arbitration procedure designed to prevent double taxation that may occur as a result of differing interpretations by member states of the transfer prices used by associated enterprises for their joint operations. This procedure entered into force on January 1, 1995 for a period of five years.

Since 1990 there have been on-going discussions to achieve progress in this area but without any concrete result. However, these discussions did result in a package of measures agreed by the Council in December 1997 to tackle harmful tax competition among member states with the objective of providing impetus for further intra-EU tax coordination for both companies and individuals. This package included a code of conduct on company taxation (with the major aim of preventing the use of tax incentives to attract foreign investment), recommendations on the taxation of savings and an agreement in principle on the need to eliminate withholding taxes on cross-border interest and royalty payments between companies, which was seen as creating a significant obstacle for cross-border business. A Code of Conduct Group was officially established by the Council in March 1998 to assess the tax measures that might fall within the scope of the code of conduct and to oversee the provision of information on those measures. The agreement in principle on withholding taxes has since been transformed into a June 2003 directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different member states.

### **Ongoing Disagreements on Tax Harmonization**

Discussions on tax harmonization and preventing tax competition have become increasingly politically charged over the past two decades. Certain governments with higher corporate taxes (notably France) have pushed for the elimination of the national veto on taxation matters in order to increase the likelihood of harmonization in this area. Other member states, having made considerable use of tax incentives to attract inward American investment (notably Britain and Ireland) have consistently sought to ensure that unanimity rules continue to apply to all taxation matters in the EU. The development of EU policy on tax matters has become politically sensitive for various reasons. For the British and Irish it is a question of retaining pro-enterprise taxation policies whilst in France and for some other governments with high tax levels, there is the fear that companies will move production to those member states with lower tax rates (“fiscal dumping”). In the past, these different outlooks frequently engendered policy disputes. One example was a controversial Franco-German initiative that attempted to lower structural funding for EU member states with low corporate tax rates.

**European Corporate Tax Rates**

<b>Country</b>	<b>Corporate Tax Rate (Rank)</b>
Austria	25% (9)
Belgium	33.99% (16)
Bulgaria	10% (1)
Cyprus	10% (1)
Czech Republic	24% (8)
Denmark	28% (11)
Estonia	22% (6)
Finland	26% (10)
France	33.33% (15)
Germany	38.36% (18)
Greece	25% (9)
Hungary	16% (4)
Ireland	12.5% (2)
Italy	37.25%
Latvia	15% (3)
Lithuania	15% (3)
Luxembourg	29.63% (12)
Malta	35% (17)
Netherlands	25% (9)
Poland	19% (5)
Portugal	25% (9)
Romania	16% (4)
Slovak Republic	19% (5)
Slovenia	23% (7)
Spain	32.5% (14)
Sweden	28% (11)
United Kingdom	30% (13)

Source: KPMG's Corporate and Indirect Tax Rate Survey 2007

Despite these entrenched national differences on tax harmonization, the Commission continues to argue that the only systematic way of addressing the underlying tax issues European companies' face, when they operate in more than one member state, is through a consolidated corporate tax base. Debates on the issue gained a new momentum with the adoption in October 2001 of a Commission communication "Towards an internal market without tax obstacles – a strategy for providing companies with a consolidated corporate tax base for their EU-wide activities". A follow up communication in November 2003 renewed the push of the Commission for a consolidated tax base and led to the establishment of a Commission Working Group.

The Commission argues that a single tax base would:

- Significantly reduce the compliance costs for companies that result from the need to deal with 25 national tax systems within the Internal Market.
- Eliminate transfer pricing problems within the EU.

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- Allow for the offsetting and comprehensive consolidation of profits and losses on an EU basis.
- Simplify many international restructuring operations.
- Avoid many double taxation situations.
- Remove many discriminatory situations and restrictions.

Drawing on the work of the Commission Working Group, in May 2007, the Commission adopted a Communication on “Implementing the Community Programme for improved growth and employment and the enhanced competitiveness of EU business: Further Progress during 2006 and next steps towards a proposal on the Common Consolidated Tax Base (CCCTB)”. In this communication, the Commission draws attention to the remaining problems with the CCCTB and the available options. It envisages a CCCTB that enables companies to follow the same rules for calculating their tax base for all EU-wide activities, simplifying procedures and reducing costs. It is foreseen that the CCCTB will be distributed among member states in accordance with a fair sharing commitment that has not yet been put in place. The Commission envisages making a formal proposal on the CCCTB in 2008.

### **Indirect Tax Harmonization in the EU**

The main Community efforts at tax harmonization have concentrated on two major indirect taxes: valued added tax (VAT) and excise duties. VAT was introduced in the original European Economic Community by two 1970 directives with the intention of replacing the diverse national production and consumption taxes, which were seen as hampering trade. These 1970 directives established the principle of taxation in the member state of consumption (or taxation at origin) for goods and services intended for taxable persons, at the rates and under the conditions applicable in that member state. A 1977 harmonization directive (the Sixth VAT directive) introduced a common assessment for VAT and provided legal definitions for important concepts. Directives in 1991 and 1992 focused upon the abolition of tax frontiers, the adaptation of VAT to the requirements of the new single market with the creation of a system for taxing trade between the member states based on the principle of taxation in the member state of origin of the goods or services supplied and the elimination of VAT on imports from member states. In the 1992 directive, the member states also agreed to establish minimum rates on VAT (set at 15 per cent) on the grounds that changes in these taxes can result in the rapid distortion of competition with, notably, consumers crossing borders to profit from significantly different rates. Member states retain the option of applying one or two reduced rates (which must not be below 5%) to certain goods or services of a cultural or social nature. The temporary retention of existing zero rates and super-reduced rates (i.e. below 5%) were authorized, while higher VAT rates were abolished.

There remain three shortcomings of the current VAT system:

- The application of the parallel origin- and destination-based taxation regimes.

- The variable application of Community legislation.
- The fact that national rates remain excessively far apart.

The Commission has attempted to address some of these problems with a work program adopted in July 1996 to accelerate the move to an effectively operating common system. However, several member states showed little enthusiasm for Commission harmonization proposals. In 2000, the European Commission changed tack and decided to concentrate on the operation of the VAT system within the context of the single market with the long-term strategy of focusing on four principal objectives: simplification, modernization, a more uniform application of the existing regulations and a fresh approach to administrative cooperation. The strategy was reviewed and updated by another Communication in 2003. In 2006, the Council consolidated the existing legislation on VAT with an eye towards providing greater transparency. The Commission's most recent Communication on VAT rates, from July 2007, urges that a greater simplification and rationalization of VAT rates is needed. At the same time, the Commission argues that there is room to grant more autonomy to member states in setting reduced VAT rates. The Communication will be followed by a consultation process, with an eye on launching a new legislative proposal on VAT rates at the end of 2008 or beginning of 2009.

In the context of the establishment of the Internal Market, the EU also set minimum harmonized rates for excise taxes (to be reviewed every two years). The affected excise taxes are those on energy sources (mineral oils – notably petrol – natural gas, electricity and coal) alcohol and tobacco. Furthermore, the harmonization of minimum excise rates was seen as a way in which the EU could collectively act to encourage energy saving and cleaner fuels and thus cut greenhouse gas emissions. There has also been some EU legislation to provide for a minimum degree of harmonization of structures – scope of taxation, methods of collection, tax exemptions, and payment terms – as part of the effort to eliminate tax frontiers. Thus directives have harmonized the structure of excise duties applicable to alcoholic drinks, cigarettes and manufactured tobacco; seek to provide more precise definitions of the products subject to tax; and endeavor to determine allowable exemptions with the aim of providing a common basis of taxation.

### **Ongoing Exemptions to Indirect Tax Harmonization**

The EU currently allows member states to retain considerably different rates in indirect taxes – which often reflect cultural differences – and allows some countries to charge lower rates on the grounds that their public finances are in a healthy situation. With its absence of debt, Luxembourg maintains low VAT and excise duties, attracting motorists and shoppers from neighboring member states; the British flock to northern France to purchase beer, wine and tobacco given relatively high rates of tax on these products in the UK. Higher and lower standard rates are allowed within certain limits, as are exemptions on certain goods and services that, generally, are not in competition with those coming from another member state – e.g., restaurant meals – or those which are considered to be necessities of daily life – notably groceries and medicines. The European Commission has continued to push for as few exemptions as possible and further harmonization of

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indirect taxes on the grounds of “fair play”, decreasing opportunities for fraudsters who take advantage of the currently complex system. Further harmonization also improves the effective operation of the single market, where the diversity of indirect tax regimes and complexity increases business costs and acts as a barrier to cross-border activities.

Indirect taxation remains a hotly contested subject of debate in the context of the Commission’s efforts to narrow the band of acceptable VAT and excise rates. Governments recognize that with the lowering of VAT and excise rates it will likely be necessary to increase other taxes to compensate given the increased constraints on member state budgets. It is politically easier to maintain existing levels of indirect taxes rather than increase direct taxes. Moreover, the Swedish and Danish governments whose welfare states are financed to a large extent through indirect taxes rather than payroll taxes, oppose the lowering of the level of acceptable divergence (upper limits) from the harmonized rate. Any modifications to EU minimum excise taxes also tend to be fought determinately by certain member states and industries affected by it. Certain member states, such as the UK, maintain higher excise taxes to compensate for relatively low corporate tax rates. In 2007, the Commission proposed extending derogations for all member states until 2010, with a view of applying new common rules after 2010.

### **Green Taxation**

In early 2007, the Commission launched a Green Paper on “Green Tax Reform”. By launching the paper, the Commission intended to initiate a broad consultation on the use of market-based instruments to stimulate sustainable consumption and production. The paper debates a wide range of issue areas, where taxes and other market-based instruments can fulfill a greater role in promoting environmentally friendly practices, including: energy use, transport, water management, waste management, protecting biodiversity and air pollution. The Green Paper has been given added weight by a common initiative launched by France and the UK in October 2007 aimed at stimulating consumers to shop in a more environmentally friendly way. Their proposal advocates cutting value-added taxes on energy efficient products. A Franco-British policy proposal regarding the subject will be introduced in the later part of 2007. A separate contribution on the debate about “green taxation” has recently been made by France, which raised the idea of an EU levy on imports from non-Kyoto countries. Arguing that European companies faced “unfair competition” from firms not applying European standards on CO2 emissions, France regards EU levies as a possible solution. Being aimed primarily at the US and Australia, the French proposal is likely to stir controversy.

### **Summary**

Progress on harmonizing taxes at the EU-level has remained very limited to date, not only in the area of direct taxation but also in the area of indirect taxation, where minimum rates have been established on the grounds that excessive divergence of VAT and excise duties distorts the operation of the Single European Market. A comparison with the US federal government’s powers in the realm of taxation can be drawn. The

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federal government used the interstate commerce clause to assume responsibility for a wide array of tax instruments, in the context of eliminating trade distortions in the single American market. The EU treaties, in contrast, do not provide sufficient grounds for the EU to extend its remit in this area, thus considerable divergence in the national rates of both direct and indirect taxes remains. American firms have profited from the tax competition that exists in the EU – in the past through investment into Ireland, and in the future through investment into several of the new member states of Central and Eastern Europe which offer attractive tax incentives to foreign investors. While the rhetorical intensity of opponents to such practices – notably French and German governments – may cause concern, US firms can rest assured in the knowledge that the unanimity requirement on tax matters makes it unlikely that the EU member states will agree upon the establishment of harmonized EU-wide minimum corporate tax rates. In the field of indirect taxation, there is likely to be slow and staggered progress towards the harmonization of VAT and excise rates which, in turn, should help to simplify the operation of US firms in the Single European Market. However, should Europe become serious about using tax measures to promote environmentally friendly technologies this can be expected to hurt US products that are subject to far more lenient environmental standards.