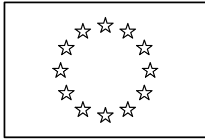

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COMMUNICATION FROM THE COMMISSION TO THE COUNCIL, THE EUROPEAN PARLIAMENT AND THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE

Co-ordinating Member States' direct tax systems in the Internal Market

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1. INTRODUCTION

Member States have to face new challenges. The main purpose of national tax systems is to provide an adequate level of revenue to finance public expenditure. Globalisation of business and private activities put the competitiveness of tax systems at pressure. As Community law currently stands, Member States remain largely free to design their direct tax systems so as to meet their domestic policy objectives and requirements. Dealing with the interaction of multiple tax systems poses a challenge for the internal market. Tax systems also represent basic democratic choices on how such funds should be equitably raised and how income should be distributed. However, national tax rules designed solely or primarily with the domestic situation in mind may give rise to inconsistent tax treatment when applied in a cross-border context.

An individual or corporate taxpayer who is in a cross-border situation may suffer discrimination or double taxation or face additional compliance costs[1]. This creates a disincentive for individuals who wish to work or invest in other Member States. It also constitutes a barrier to cross-border establishment, activity and investment by companies, deterring them from taking full advantage of the Internal Market[2]. These problems are only partly addressed through unilateral action by the Member States or through their existing bilateral tax treaties. Fiscal barriers to cross-border activity and investment remain and have been the subject of extensive litigation over the last few years as taxpayers have sought to challenge Member State rules on the basis of the Treaty freedoms[3].

The Commission believes that one systematic way to address the underlying tax obstacles which exist for corporate taxpayers operating in more than one Member State is to provide multinational groups with a common consolidated corporate tax base (CCCTB) for their EU-wide activities. The Commission has therefore announced its intention to present a comprehensive legislative proposal for a CCCTB in 2008. However, there also continues to be a need for more targeted measures to address the most urgent problems in the short to medium term. In addition, there are issues which will remain even if a CCCTB is introduced, for example because CCCTB would not cover individual taxpayers and would not necessarily apply to all corporate taxpayers and/or Member States and because there will be a need to address the interaction between the CCCTB and other aspects of direct tax systems.

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[1] The main company tax obstacles to cross-border economic activity in the Internal Market are described in the study Company taxation in the Internal Market (SEC(2001)1681, 23.10.2001, part III, pages 223-305.

[2] The Commission, in a detailed economic study (SEC [2001]1681, annexed to the Communication Towards an Internal Market without tax obstacles, COM [2001]582), identified several tax obstacles to cross-border trade in the Internal Market and some steps which could be taken to remove them. In the area of financial services, other tax obstacles have also been identified by the "FISCO" expert group (see the Communication Clearing and Settlement in the European Union – The way forward, COM [2004]312) which advises on the removal of fiscal compliance barriers to the clearing and settlement of cross-border securities transactions within the EU.

[3] The current limits of national tax policies in an integrated Internal Market have been shown in several decisions of the European Court of Justice (see, only in 2006, judgements of the Court in cases C-520/02 *Turpeinen*, C-196/04 *Cadbury Schweppes*, C-386/04 *Centro di Musicologia Stauffer*, C-290/04 *Scorpio*, C-346/04 *Conijn*, C-152/03 *Ritter-Coulais* , C-471/04 *Keller Holding* and C-365/04 *Bouanich*).

Therefore there remains a need to ensure that unharmonised national tax systems work together properly, both in order to overcome the abovementioned obstacles, but also to prevent an erosion of Member States' tax bases. It has become increasingly apparent that the lack of co-ordination between direct tax systems may also lead to unintended non-taxation or abuse and, hence, erosion of tax revenues, interfering with the ability of Member States to operate efficient and balanced tax systems. This may impact on the sustainable financing of Member States' social models[4].

Thus, this Communication is directed at co-ordinating and improving the performance of unharmonised direct tax systems. Whereas harmonisation results in the creation of a common body of Community legislation which supersedes national laws, co-ordination builds on domestic systems to render them compatible with the Treaty and with each other. The aim of co-ordination is not to replace existing national tax systems by a uniform Community system but to ensure that such national systems can be made to work seamlessly together.

As the Commission underlined in its contribution to the Hampton Court summit, there is a need to look closely at making current tax systems perform better across the EU. Improved co-operation between Member States and better co-ordination of their rules will significantly improve the performance of their tax systems. Member States will be better placed to attain their tax policy goals and protect their tax base while ensuring elimination of discrimination and double taxation for the benefit of individuals and business. Tax systems will thereby contribute more effectively to the success of the Internal Market, to improved growth and employment, and to enhanced competitiveness of EU business at the global level in line with the renewed Lisbon strategy[5].

2. KEY PRINCIPLES FOR CO-ORDINATED TAX SYSTEMS

2.1. Key principles

Coherent and co-ordinated tax treatment implies:

- Removing discrimination and double taxation,
- Preventing inadvertent non-taxation and abuse, and
- Reducing the compliance costs associated with being subject to more than one tax system.

Co-ordinating initiatives may take a variety of forms ranging from concerted unilateral action by Member States, at one end of the spectrum, to collective action in the form of a Community instrument at the other. In some cases it may be sufficient for Member States unilaterally to implement commonly agreed solutions, e.g. changes to domestic rules in order to remove discrimination. In other cases unilateral action may not be sufficient, and bilateral action through tax treaty provisions or collective action through a Community instrument may be needed. This is particularly so where instances of double taxation or unintended non-taxation arise from mismatches between Member State rules. There is also a need for better co-ordination of arrangements between Member States and third countries in certain areas,

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[4] COM(2005)525 final, 3.11.2005, European values in the globalised world: Contribution of the Commission to the October meeting of Heads of State and Government.

[5] COM(2005)532 final, 25.11.2005, The contribution of tax and customs policies to the Lisbon strategy

particularly in relation to anti-avoidance measures, in order to safeguard Member States' tax bases.

A major concern for Member States, particularly in the light of the sharp increase in litigation by taxpayers over the last few years, is to ensure that their tax rules comply with the requirements of Community law. By assisting Member States to eliminate discrimination, such initiatives should help to ensure compliance with their Treaty obligations and minimise the disruption which may result from litigation.

2.2. Removing discrimination and double taxation

Removing fiscal discrimination is a basic requirement of Community law. A Member State may treat cross-border situations differently from domestic situations only if this is justified by a difference in the taxpayer's circumstances. Over the years it has become apparent that there are numerous aspects of Member States' rules that conflict with the Treaty, including rules on taxation of gains (e.g. exit taxes), dividend taxation (e.g. withholding taxes), group taxation (e.g. lack of cross-border loss relief), taxation of branches and anti-avoidance rules. Yet, despite a substantial body of case law of the European Court of Justice (ECJ), it is not always easy to understand how the broadly expressed Treaty freedoms apply in the complex area of tax law. Much of the case law is recent, it continues to evolve and it generally concerns particular tax provisions of individual Member States. It is not always easy for taxpayers, tax administrations and national courts to understand the full implications of rulings or place them in a broader framework.

In the Commission's view there is a need for guidance on the principles flowing from the case law and how these apply to the main areas of direct taxation. Such guidance will promote greater legal certainty for the benefit of taxpayers, tax authorities and national courts.

However, that is only a starting point. It is necessary to find solutions which will ensure coherent cross-border tax treatment. Experience has shown that it is not always possible to implement the non-discrimination obligation coherently or in an optimal way by unilateral measures. Member States have in some cases responded unilaterally by removing domestic tax advantages or by extending requirements for cross-border situations to domestic situations in circumstances where this was not desirable in tax policy terms. This runs counter to the interests of the Internal Market and undermines the competitiveness of Member State economies.[6] The Commission proposes to present a number of initiatives to assist Member States in finding co-ordinated solutions which will allow them to achieve their tax policy goals while complying with the requirements of Community law.

The elimination of double taxation in the Internal Market is expressly contemplated by Article 293 of the EC Treaty. International double taxation is a major obstacle to cross-border activity and investment within the EU. Its elimination is therefore a basic objective and principle of any co-ordinated solution. International double taxation arises by definition because of a taxpayer being subject to more than one tax jurisdiction. It is a classic example of an obstacle

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6 See §68 in AG Geelhoed's Opinion of 29 June 2006, C-524/04 Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue: "Such an extension of legislation to situations falling wholly outwith its rationale, for purely formalistic ends and causing considerable extra administrative burden for domestic companies and tax authorities, is quite pointless and indeed counterproductive for economic efficiency. As such, it is anathema to the internal market".

to the Internal Market arising from a lack of co-ordination between national tax systems which can be solved only by co-operation between Member States.

2.3. Preventing non-taxation and abuse

Hiatuses between tax systems due to a lack of co-ordination may also lead to unintended non-taxation and provide scope for abuse. Non-taxation and abuse are equally detrimental to the interests of the Internal Market because they undermine the fairness and the balance of Member States' tax systems. This problem can also be addressed by better co-ordination of Member States' rules and improved co-operation with respect to enforcement. This will be an essential element of the Commission's initiatives, and the Commission proposes to examine this area together with Member States in a working group in the near future depending on the progress of relevant ECJ case law.

2.4. Reducing compliance costs and simplifying procedures

The existence of multiple tax systems means multiple sets of compliance requirements. The need to relieve multinational companies from having to comply with up to 25 Member State systems, together with the transfer pricing rules allocating the tax base between them, was a key factor in the Commission's decision to work towards a CCCTB for companies. At the same time the Commission has sought, through the work done by the Joint Transfer Pricing Forum, to explore the scope for easing transfer pricing compliance burdens. It is desirable to explore more generally the ways in which cross-border compliance costs can be reduced and procedures simplified for taxpayers, including SMEs and individuals, notably through improved administrative co-operation between Member States.

3. TOWARDS CO-ORDINATED SOLUTIONS

The Commission considers that the above objectives can often best – and sometimes only – be met by co-ordination between Member States. The Commission has today issued two Communications in specific areas where it considers there to be a need for concerted action.

The first Communication concerns the area of exit taxes. The area of exit taxes, which includes taxes on transfers of assets to another jurisdiction, illustrates the need for proper co-ordination Member States' tax rules reinforced by effective co-operation on enforcement. It follows from the principle of non-discrimination as interpreted in ECJ case law that cross-border situations may not be treated less favourably than comparable domestic situations. In the case of exit taxes, the ECJ has ruled out the possibility of immediate collection of such taxes on unrealised gains in cross-border situations if there is no such taxation in comparable domestic situations[7]. The ECJ also ruled that tax deferral may not be made subject to certain conditions, such as the requirement of a bank guarantee or the appointment of a fiscal representative. Without proper co-ordination and effective co-operation on enforcement there is, however, a risk that any gain realised on the disposal of assets will escape taxation or be subject to double taxation because of a mismatch in the taxing rights provided for under domestic and bilateral tax treaty provisions or because the necessary information or means of collection to properly enforce the tax claims is lacking. In the Communication on exit taxes the Commission has made a number of specific proposals as to how Member States can better

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[7] Case C-9/02 Hughes de Lasteyrie du Saillant v. Ministère de l'économie, des Finances et de l'Industrie, OJ C 94, 17.04.2004, p.5

co-ordinate their rules in this area so as to eliminate unlawful discrimination while avoiding double taxation or double non-taxation. It has also identified certain areas where more detailed work needs to be done. The Communication is of importance for both corporate and individual taxpayers.

The second Communication concerns cross-border loss relief for companies and groups. In the absence of such relief there is the risk that profits and losses of group companies or different establishments of a company become stranded in different jurisdictions, with the consequence that a group or a company pays tax on an amount which exceeds its total EU-wide results. This plainly creates a disincentive for cross-border business activity and undermines the competitiveness of EU companies and groups. The CCCTB, if adopted, would provide for comprehensive EU-wide consolidation of results for groups covered by the regime. The Communication is aimed at more immediate co-ordination of Member States' rules. It builds on recent case law of the ECJ, in particular the ECJ's judgment in the Marks & Spencer case, and promotes a minimum standard for cross-border loss relief involving relief for losses of subsidiaries at the level of the parent company.

Co-operation between Member States is plainly essential in areas such as the above, where mismatches between Member States' systems give rise to double taxation or double non-taxation. However, even in cases where it is possible for Member States to implement solutions by unilateral measures, it may be preferable to seek common solutions. The Commission considers that anti-avoidance rules, such as Controlled Foreign Companies (CFC) rules[8], are one such area. As recent case law has shown, this is a delicate area where there is a need to strike a proper balance between the interest in combating abuse effectively within the EU and the need to avoid disproportionate restrictions on cross-border activity which are contrary to Community law. There is also an urgent need for better co-ordination of the application of such rules in relation to third countries in order to protect Member States' tax bases.

The Commission plans to issue a further communication next year on anti-abuse rules. As explained above, there is an urgent need in this area to find balanced solutions which meet Member States' needs while complying with Community law requirements.

Mismatches may also arise, for example, in relation to the qualification by Member States of debt and equity. One Member State may consider a transaction to be a contribution of equity rather than a loan and therefore not treat the income from the capital as taxable, whereas another Member State may consider the loan to be debt and allow the interest paid as a deduction for the company paying the interest. This may result in a deduction in one Member State without corresponding taxation in another Member State. Another area concerns the use of hybrid entities, i.e. entities which are regarded as a corporate body (opaque) by one Member State and as non-corporate (transparent) by another Member State; this difference in qualification by Member States may lead to double exemptions or double deductions. The Commission is also actively considering the need for initiatives in other areas such as withholding taxes, taxation of branches and inheritance taxes. It is keen to explore with Member States, market operators and other interested parties, where appropriate, further areas in which there is a particular need for such initiatives.

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[8] The main purpose of CFC rules is to prevent resident companies from avoiding domestic tax by diverting income to subsidiaries in countries with a (significantly) lower level of taxation. Typically, CFC rules provide that the profits earned by a controlled foreign subsidiary may be attributed to its domestic parent company and taxed in the hands of the latter in the same way as its own profits.

The Commission considers that, in addition to such specific initiatives, better co-ordination of Member States tax systems involves the need to devise a more general solution for taxpayers who find themselves subject to double taxation because of conflicts in taxing rights. The Arbitration Convention, whose operation the Commission is committed to improving, is limited to disputes relating to transfer pricing. The Commission proposes to explore with Member States the scope for an efficient and generalised binding dispute resolution mechanism to deal more generally with problems of international double taxation within the EU. Such a mechanism would be of real benefit to taxpayers in cross-border situations, particularly individuals and SMEs.

4. CONCLUSION

Appropriate co-ordination and co-operation between Member States can enable them to attain their tax policy goals and protect their tax bases, while ensuring elimination of discrimination and double taxation and reducing compliance costs. Tax systems will thereby contribute better to the success of the Internal Market and help enhance the competitiveness of EU business at the global level in line with the renewed Lisbon strategy.

The Commission is willing to assist Member States in developing the principles for co-ordinated solutions set out in this Communication and in improving the practical arrangements for administrative co-operation. Specifically, it proposes to come forward with a series of initiatives covering key areas of direct taxation such as those described above, together with a more general initiative designed to ensure effective elimination of international double taxation within the EU.

The success of these initiatives will depend on Member States' willingness to co-operate and to invest in co-ordinated solutions. A failure to act could only further impair Member States' ability to protect their tax revenues and lead to further litigation concerning individual provisions. The Commission therefore calls on Member States to examine the proposals made in this Communication and in the two Communications on cross-border losses and exit taxation presented today, and to work together with it to deal quickly and effectively with the issues raised therein.

This initiative is designed to be of immediate benefit for all taxpayers in cross-border situations, helping to complete the Internal Market in parallel with the initiatives already launched, in particular the work on establishing a CCCTB. The Commission calls on Member States, market operators and EU institutions to embrace the prospects offered by this initiative.

The Commission invites the Council, the European Parliament and the Economic and Social Committee to give their opinion on this Communication.