Summary of the European Tax Conference

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At its EU Company Tax Conference in Brussels 29-30 April, the EU Commission -- with the general support of EU businesses, selected member states, and other interested parties -- committed to a consolidated tax base for EU companies' EU-wide activities, using formulary apportionment to distribute the common tax base to the member states. The conference rejected the harmonization of tax rates as an action that goes further than necessary to eliminate tax obstacles in the Internal Market.

Taking into consideration the comments of conference participants, the Commission now will work on a pilot project to implement its strategy, on a transitional basis, for use by small and medium-sized enterprises in a few member states. That short-term strategy will help the European Union understand the practicalities and redistributional implications for member-state tax bases.

Michel Vanden Abeele, director-general of Taxation and Customs Union at the EU Commission, said it expects to issue a new communication on its progress by the end of 2003. The Commission also hopes to continue the dialogue with member states and other interested parties.

Corporate Tax Reform

The highly anticipated conference, which the Commission announced in an October 2001 communication opened with a series of keynote speakers who addressed the need for company tax reform in the European Union. After having issued a communication and a 500-plus-page study establishing its arguments in favor of a consolidated corporate tax base for companies' EU-wide activities, there was little doubt that EU Tax Commissioner Frits Bolkestein would present a convincing case in favor of comprehensive company tax reform in the European Union. "Without determined action on the tax front, the EU will fail to achieve its self-imposed objective of becoming, in this decade, the most competitive and dynamic knowledge-based economy in the world," Bolkestein stated in his opening remarks. He noted that the presence of about 500 interested parties at the conference confirmed that the Commission's strategy is not "pie in the sky," but instead reflects an ambitious, yet necessary and realistic, approach to tackling tax obstacles in the Internal Market.

The Commission's strategy was endorsed by other keynote speakers, particularly Benedetto Della Vedova, a member of the European Parliament (EP) and rapporteur of the EP's Economic and Monetary Affairs Committee resolution on the Commission's Communication on Company Taxation; and Philippe De

Buck, secretary- general of the Union of Industrial and Employer's Confederations of Europe (UNICE). Della Vedova, for example, recalled that the EP's resolution on the Commission's communication supports the Commission's view that a common consolidated corporate tax base with formulary apportionment is the ultimate goal of EU company tax policy.

De Buck reminded the conference that the European Union must undertake company tax reform to reach its goal of becoming the most dynamic knowledge-based economy in the world by 2010. EU businesses say it is imperative to reduce their tax burden and to preserve tax competition. Yet, it is also important to reform corporate tax structures so that the taxation of EU companies will be consistent with the Single Market.

De Buck stressed that UNICE does not want a full harmonization of tax rates. Member states must retain policy flexibility in that area, he said. However, EU businesses regard the existence of 15 separate tax systems as entirely incompatible with the Single Market. Moreover, EU businesses bear the burden of that lack of consistency across the member states.

The View of Conference Participants

The first conference panel debated the choice of approach in company tax reform. Essentially, the debate settled on whether the Commission should pursue comprehensive reform involving the creation of a new, common EU tax base, as proposed under the Common Consolidated Base Taxation (CCBT) option, or whether it should pursue a more limited effort in adopting Home State Taxation (HST) for a subset of member states.

The panel concluded that the HST option, while attractive, would create significant complications related to its application across the member states and the definition of the group. HST also would lead to competition for tax bases among the member states and provide a false sense of simplification. As Herve Le Floc'h Louboutin, director of the French Ministry of Finance, noted, HST requires member states to give up sovereignty, not to the European Union, but to the other member states, whose tax bases would apply in that member state. Thus, CCBT was seen as a more desirable option.

Jan van der Bijl of Unilever, chair of the UNICE Fiscal Affairs Working Group, acknowledged that there is an "impressive" list of problems associated with HST. He stressed, however, that EU businesses would like to have a consolidated corporate tax base for their EU operations and that only HST and CCBT make sense for the European Union. Although CCBT would require a new set of company accounts for EU businesses, it was presented as the ultimate goal of EU businesses. Van der Bijl noted that even though the European Union has never been able to achieve that objective, EU businesses now may be ready to put forth the effort necessary to agree on a definition of a common tax base, as long as it is presented as optional.

To gauge the degree of support for each of the methods presented, the chair of the panel asked for a show of hands in support of each option. While the informal poll should not be viewed as definitive, it revealed relatively strong support for the CCBT option, pockets of support for HST, a sprinkling of hands for a European company income tax, and surprisingly high (although still low)

support for a compulsory harmonized tax base. However, a vast majority of hands remained in place, implying that even though the chair insisted that "doing nothing is not an option," many conference participants preferred "none of the above."

Tax Authorities' View

Not surprisingly, tax authorities pointed out many difficulties in implementing an optional company tax system using formulary apportionment. Le Floc'h noted his objections to making the chosen method optional. Those options create more problems than they resolve because they require tax authorities to retain expertise in the arm's-length system while developing new expertise in formulary apportionment methods. More generally, making a tax system optional creates budgetary problems for the states, he said. Le Floc'h wondered why the rules should be optional if member states are able to agree on common rules for calculating the tax base. Allowing companies the option of using a choice of tax systems would only create additional pressure among member states to compete against one another in offering favorable tax-base definitions, Le Floc'h said.

Michel Aujean, director of the Tax and Customs Union directorate, responded that the optional component of CCBT is the only difference between it and a compulsory harmonized tax base. That option is the only reason EU businesses accepted the idea of moving toward a common base, Aujean said. Member states had never accepted the notion of a compulsory harmonized tax base.

One conference participant, however, presented a more cynical view. He suggested that EU businesses favor an optional system because it would allow them to continue tax planning practices. Business representatives responded to that criticism by noting that any optional system would include antiabuse rules.

Unlike the business representatives, who strongly supported an optional common tax base, tax authorities were more inclined to accept a compulsory harmonized tax base. Le Floc'h, for example, does not particularly oppose the idea of replacing the European Union's national tax systems with a single EU company tax system. He emphasized that pursuing the HST option, for example, might result in a divergence of tax rules across the member states, which would not be in the interests of the European Union.

Some tax authorities had particularly strong views about the options under consideration. Gerhard Juchum, director-general of the German Ministry of Finance, adamantly opposed the proliferation of EU tax bases that would occur under HST. He said the idea that tax authorities would have to deal with so many tax bases under HST is "horrendous."

Gaston Reinesch, director-general of the Luxembourg Ministry of Finance, asked whether the Commission should be more pragmatic and, instead of pursuing comprehensive tax reform, should focus on incentives for member states to make their tax bases more similar. He opposed introducing a common tax base by the back door. In his view, the necessary first step would be making tax bases more similar through small steps, as the Commission has proposed for its near-term strategy.

Reinesch also supported the introduction of a minimum tax rate, making it clear that the minimum rate need not be an average of the tax rates in the European Union. He recalled that when minimum rates were proposed in the past, it was done as a means of providing a safety net. He encouraged member states to engage in a discussion about rate harmonization.

Doing What Is Possible

EU businesses have made it clear that they would like to operate within a single tax system and to consolidate their income earned throughout the European Union. Until now, however, the requirement that all direct tax matters be unanimously approved has prevented the European Union from making progress in that area.

One key conference development was the apparent agreement that the Commission could proceed with its program by implementing a common base in a few member states for a few companies. Vanden Abeele said the Commission would take its work in that area forward by examining possible distortions that might be introduced through consolidated base taxation, especially when applied on an optional basis, and the possible application of HST for SMEs.

Sven-Olof Lodin, one of the authors of HST, acknowledged that it is a second-best solution. He indicated that a common consolidated tax base would be the ultimate goal, but that, practically speaking, member states had shown that it was impossible to reach that goal as a first step. Thus, HST is a practical measure to make progress in the area of company tax reform, he said. HST would simply be a transitional step on the path to CCBT in the European Union.

Although HST is seen as a way to move toward eventual CCBT, many conference participants expressed reservations about that approach. Vito Tanzi of the Italian Ministry of Finance (but making his comments in a personal capacity), noted that HST would be very costly for tax administrators. He wondered whether tax administrators would be able to handle the burden of understanding the tax systems of the 15 member states, which could occur under HST. In contrast, Tanzi noted that companies of all sizes would benefit if the EU member states could agree on a single tax base, as envisaged under CCBT.

Formulary Apportionment: Going Forward or Backward?

Although it was not to be discussed until the end of the conference, formulary apportionment loomed over the discussions throughout the conference. Friedrich Rodler, chair of the second panel, identified important issues concerning the tax formula, including: the fact that the formula effectively creates a tax on the factors used to apportion income; that different industries might require different formulas; and that the whole notion of how to define the formula had not really been addressed.

Addressing some of the reasons the European Union might consider moving toward formulary apportionment, Tanzi discussed a few of the problems that arise in attempting to apply arm's-length pricing to highly integrated operations. In many cases, there are no markets for the goods, so the arm's-length pricing outcome may no longer bear any relation to the true amount of income earned.

In practice, the lack of arm's-length prices, coupled with the increasingly integrated nature of multinational businesses, has led many businesses to reach agreements with tax authorities concerning pricing methods.

Albert Raedler, a former member of the Ruding Committee, echoed those concerns. Only a system of arm's-length pricing can reflect economic reality, he said; what the European Union really needs is a formula that prevents tax planning.

Despite concerns about how to define the formula, others noted that an exact definition might not be as important as reaching agreement on a single formula. Such an agreement would require unanimous approval, an obstacle that many think might be difficult to overcome.

Other conference participants expressed concern about the move to formulary apportionment. Former Dutch Finance Minister Onno Ruding, for example, said the question of whether formulary apportionment is a way forward is too vague. "If one favors progress in the area of creating a common tax base, whether via HST or CCBT, then . . . you need to do something in the area of formulary apportionment," Ruding said. He wondered whether it would be possible to move forward in the area of EU company tax reform without formulary apportionment.

Le Floc'h also noted that if the European Union were to pursue a tax system similar to the ones used in the United States and Canada, it would be important to remember that those countries operate within a federal structure that does not exist in the European Union.

The controversial application of formulary apportionment on a worldwide basis was a taboo subject. Ruding referred to the subject just long enough to say that many taxpayers have "deep scars" over the use of worldwide unitary taxation by California years ago. Ruding said he did not want to go as far as endorsing the worldwide application of formulary apportionment; however, he does not want to reject formula apportionment out of hand. Ruding said his cautious support for formulary apportionment, in the context of comprehensive EU company tax reform, reflects practical realities rather than an "expression of love" for formulary apportionment. (Ruding was one of the guest speakers at the U.S. Treasury Department's conference on formulary apportionment in 1996. At that time, he noted that his experience in the European Union illustrated the difficulties involved in harmonizing EU tax systems and that any move to formulary apportionment probably would face the same challenge.)

Preserving Tax Competition

While conference participants seemed prepared to move toward greater coordination of company tax policies, most remained firmly opposed to tax rate harmonization and favored allowing tax competition to take place. Della Vedova warned that member states should not "fall into the trap" of believing that the creation of a Single Market requires a leveling out of EU tax policy. Della Vedova singled out Ireland as a good example of how flexibility in tax policy can assist countries with their economic development.

Della Vedova reiterated that the EP firmly emphasizes that "decisions on the levels of tax must remain within the exclusive competence of the member

states." There is no case for harmonizing company tax revenue or for introducing a minimum level of tax, he said.

However, the decision to maintain member state sovereignty in setting tax rates was not universally approved. Le Floc'h, for example, reminded the conference that the Commission's own study made it clear that tax-rate differences create the largest distortions in effective tax rates across the European Union. Le Floc'h argued that it does not make sense to allow member states to continue to set their own tax rates. Other conference participants believed that the harmonization of company tax bases would lead to the harmonization of company tax rates.

The View From the OECD and Beyond

Jeffrey Owens, head of the Centre for Tax Policy and Administration at the OECD, attended the conference and reminded participants that there is a world outside of the European Union. He cautioned against creating new obstacles between EU and non-EU countries when choosing among the various options. Many conference participants noted that the comprehensive solutions presented in the Commission's study do not adequately deal with issues relating to non-EU income. Van der Bijl particularly lamented the shortcomings in that area. Neither the HST nor the CCBT proposals, which van der Bijl views as the only sensible options, resolve how to incorporate non-EU income, such as dividends and royalties, into the EU consolidated tax base, van der Bijl said.

Edward Troup of Simmons and Simmons emphasized that the European Union must ensure that its policies fit in with policies pursued in the rest of the world. He cited potential difficulty meshing a formulary apportionment system with the separate accounts system used in the rest of the world. In particular, the system may not be consistent with the OECD, which in its 1995 transfer pricing report endorses the arm's-length principle and rejects global formulary apportionment methods.

Other participants worried that moving toward formulary apportionment might undermine the OECD's efforts to improve the arm's-length pricing approach.

Owens made the practical suggestion that the European Union and the OECD work to improve the current system by applying it more consistently across countries while also easing compliance burdens that have developed in certain countries' implementation of the arm's-length principle. While the current system can be improved, according to Owens, it might be desirable for the OECD to show some flexibility in its interpretation of acceptable transfer pricing approaches. Perhaps the OECD should return to its 1995 transfer pricing report and "stop treating profit methods as Cinderella, and put them on the same basis as other methods," Owens said.

Not Everyone Agrees

While few participants disputed the need for company tax reform, not everyone accepted the conclusion that the European Union needs to implement a comprehensive solution. For example, the Irish Business and Employers' Confederation (IBEC) opposes the Commission's proposal to develop CCBT, as well as UNICE's endorsement of that proposal. An IBEC representative

suggested that the Commission devote its efforts to the targeted measures presented in its communication. Moving toward a common EU company tax base inevitably would lead to higher tax rates and pressures for full harmonization, the IBEC spokesman said.

Van der Bilj rejected those views, saying that a common tax base would not necessarily lead to full harmonization of bases and rates.

Another business group, the European Business Initiative on Taxation (EBIT), also stressed the importance of pursuing practical, short-term measures. EBIT recommended that the Commission pursue its short-term objectives, which include improving the merger and parent- subsidiary directives, adopting a consistent approach to transfer pricing, and modernizing tax administrations, before moving to a common base. Progress will occur, according to EBIT, only by taking incremental steps, rather than by pursuing grand tax reforms.

Emilio Gabaglio, secretary-general of the European Trade Union, was the only participant to recognize employee concerns in the matter of company tax reform. He noted that the tax burden has been shifted from capital to labor, resulting in an antiemployment, socially unjust distribution of the tax burden within the European Union. Gabaglio said reaction to the Commission's proposals will depend on how companies take their responsibilities to a wider world in general.

Views Not Voiced

Finally, the voices that were not heard should be mentioned. In particular, the voice of the U.K. government was noticeably silent. Perhaps that was due to a desire not to be seen as a barrier to company tax reform in the European Union, at least for the moment. Regardless of the motive, the U.K. voice, which generally is not silent in matters of EU direct tax matters, was noticeable for its absence.

Although its views were not expressed at the conference, the United Kingdom's opposition to formulary apportionment is well known. That opposition extends back at least 25 years to the time when the United States and the United Kingdom negotiated an income tax treaty that would have prevented the U.S. states from using formulary apportionment when taxing U.K. companies doing business in those states. (The treaty was approved only after that provision was eliminated.)

In the intervening years, the United Kingdom: (1) implemented, but did not enact, retaliatory legislation against the use of the method; (2) litigated the Barclay's Bank case to the Supreme Court, which ruled that California could apply the unitary tax to foreign- based parents; and (3) stressed its unyielding support for the arm's- length principle for international taxation. More recently, Gabriel Makhlouf, director of the Inland Revenue's International Policy Division, stressed that the Commission's long-term goals for company tax reform are not in line with the United Kingdom's priorities.

Prospects for Company Tax Reform

Pessimists might conclude from the conference that the Commission has embarked on an overly ambitious agenda. That agenda may be subject to the

unanimity requirement, which may block any progress in tax reform. Moreover, as one participant noted, average EU tax reform takes a quarter-century. However, others noted that it is not productive to be too pessimistic about the ability of the member states to make progress, especially with new tools, such as enhanced cooperation, that allow member states to move forward without reaching unanimity. Moreover, EU businesses now see the creation of a single tax base as a chief priority of EU policymakers.

Recognizing that the individual member states still play a role in EU company tax reform, Ruding cautioned that the requirement of unanimity presents itself again -- this time in efforts to agree on a uniform formula. To overcome potential opposition in the member states, Ruding recommended that supporters of company tax reform direct their efforts toward the European capitals rather than to Brussels.

Achieving a common consolidated tax base, even if it requires using formulary apportionment, is the chief goal of most EU businesses. Thus, while the typical tax proposal may take 25 years to be implemented, it is remarkable that in less than six years, the Commission and many of the member states have moved away from the view that the arm's-length principle is "the only legitimate basis for taxing foreign companies" (in the U.S. state context), to an endorsement of a consolidated corporate tax base with formulary apportionment among the EU member states.

Many participants agreed that it is time for the Commission to examine ways to eliminate tax obstacles to EU businesses. That view was supported by Tanzi, Reinesch, and Vanden Abeele, all of whom recommended the creation of a tax policy group to examine ways to make progress in EU company tax reform.

Summary

Perhaps to the surprise of EU tax pessimists, the Commission made significant progress toward reforming EU company tax policy. While the Commission has not yet proposed moving to a consolidated tax base for EU-wide activities using formulary apportionment, its efforts in the near future will be directed toward examining some of the technical issues involved in making that move.

On balance, the Commission is to be congratulated for opening its internal debate to a wide audience. It took a big risk and should be commended for opening to the public a process that for too long has been closed to the parties that are most affected.

The Commission recognizes the importance of that move. As Vanden Abeele stressed, the only way to move forward in the area of company tax policy is by soliciting the views of parties that are directly affected. As noted at the opening of the conference, however, the debate is not the end of the story. As Bolkestein reminded participants at the start of the conference, they can continue to express their views on the proposed strategy through the electronic discussion forum set up by the Commission.

The conference concluded on a very positive note. There was nearly universal agreement that opening the debate to the public greatly assisted the Commission in its endeavors to implement EU company tax reform.

Furthermore, regardless of any second thoughts that may occur, one thing is certain. The Commission has taken a significant step toward opening the process of shaping EU company tax policy. Hopefully, that openness will be a feature of future tax policy discussions in the European Union.

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