

INTERNATIONAL

Taxation Trends in Europe

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1. INTRODUCTION

After the emphasis put on various international aspects of corporate income tax, including harmful tax competition, transfer pricing and taxation of e-commerce by the keynote speakers at previous two annual tax conferences of the Asian Development Bank, I would like to discuss two trends in individual income tax in Europe, the introduction of so-called dual income taxes and the disappearance of imputation systems. Before an audience of tax policy makers of Asian countries it may be relevant to start with a particular European Community (EC) development which has affected the direct tax systems of Member States to a much greater extent than was expected a decade ago.

In this, I mean the rapid transfer of sovereignty in tax matters by Member States to the EC as a supra-national organization. Although such a development is not lurking around the immediate corner in Asia, there can be seen a beginning of cooperation in tax matters, particularly in the ASEAN. As EC Member States only anticipated a limited transfer of sovereignty, it may be useful to explain how this accelerated transfer could occur.

2. ACCELERATED TRANSFER OF TAX SOVEREIGNTY BY EC MEMBER STATES

There are five different but related areas that can be distinguished, as follows:

- (1) the statutory transfer of tax sovereignty, which was intended by the Member States as this transfer was initially based on provisions dealing with tax unification and tax harmonization in the 1957 Treaty of Rome which established the European (Economic) Community (EEC), as amended by the Treaties of Maastricht

of 1992 and Amsterdam of 1997, establishing the European Union (EU);¹

- (2) the increasing impact on domestic tax legislation of rulings of the European Court of Justice (ECJ), interpreting directly applicable general principles included in the EC Treaty, such as non-discrimination and the rights of business establishment and employment throughout the EU;
- (3) peer pressure amongst Member States resulting in the removal of harmful tax competition by Member States;
- (4) the increasingly active role of the Commission concerning the application of state aid rules; and
- (5) the potential claiming of competence to negotiate treaties for the avoidance of double taxation by the Commission.

2.1. Statutory transfer of tax sovereignty

Indirect taxes

In first instance, the right to levy customs duties was taken over by the EC in the early days of the EEC. Art. 23 of the EC Treaty provides for unification of customs duties through EC regulations. Regulations are EC legislation, which apply directly in all Member States, and domestic rules in these matters are not permissible as the regulations have a direct effect. Art. 25 of the EC Treaty prohibits import and export duties within the EC, while Art. 26 and Art. 27 provide for the levying of customs duties at the external borders of the EC. These duties constitute revenue of the EC itself.

The situation concerning turnover taxes is different. Turnover taxes are harmonized on the basis of Art. 93 of the EC Treaty via directives. Directives contain instructions for the Member States to achieve legislative goals in a prescribed manner. The EC system of value added taxation (VAT) is therefore levied on the basis of domestic taxation with common features prescribed by a great number of VAT directives.

The Sixth Directive, which has been effective from 1978, is still the most important of the VAT directives. It introduced a common VAT system with a uniform basis of assessment, prescribing taxable goods and services, taxable persons, taxable transactions, the place of supply, chargeable event, taxable amounts, deductions and special schemes (e.g. agriculture and small businesses). However, within the (E)EC border formalities were still necessary.

1. In the Treaty of Amsterdam the articles of the Treaty of Rome were renumbered. This text refers to the current numbering of the EC Treaty.

On exportation, a 0% rate was levied, while upon importation in the other Member State the domestic rate on the goods concerned applied.

In 1993, VAT border formalities within the EC were abolished. In the case of cross-border transactions within the EC with non-taxable persons, the VAT is now charged in the country of the purchase. In the case of transactions between taxable persons (entrepreneurs), the so-called "destination principle" is applied, i.e. the vendor applies the zero rate, while the purchaser charges the VAT rate of its country to domestic clients. This temporary system is still applicable today.

The VAT revenue accrues to the Member States, who then have to contribute 0.75% of such revenue to the EC Commission. This is also one of the reasons that the Commission scrutinizes the VAT legislation of Member States on compatibility with the directives. A great number of decisions of the ECJ illustrate the Commission scrutiny.

As a result of 30 odd directives and about 300 rulings on VAT of the ECJ, the Member States now have little freedom to use VAT as a means to influence their domestic economies.

Member States are still free to determine the VAT rates applicable within their jurisdiction provided the rates do not fall below the standard 15% rate and reduced 5% rate thresholds. However, non-entrepreneurs and exempt persons and entities, e.g. private persons and hospitals, are increasingly inclined to order goods in the Member State with the lowest tax rate. As indicated, in such cases the sale is subject to the tax rate of the country of the seller. Member States with high VAT rates are losing revenue as a result of the increasing awareness of the public of this possibility.

Excise duties and other indirect taxes such as capital (formation) tax have also been harmonized but to a lesser extent than VAT.

Direct taxes

In contrast to indirect taxes, the harmonization of direct taxes has seen little progress, at least not via the relevant articles of the EC Treaty. Art. 94 of the EC Treaty provides for the approximation of provisions in the legislation of Member States which directly affect the common market.

When the EEC was founded in 1957, the main goal was to realize a common market within 12 years (old Art. 8 EC Treaty). In 1987, the term "internal market" was introduced in Art. 8a of the EC Treaty, which meant the same as "common market" but conceals the fact that such a common market had still not been realized. An internal market, according to the ECJ, is a market without obstacles to intra-community trade in order to merge the national markets into a single market bringing about conditions as close as possible to those for a genuine internal market.²

Many measures that are necessary for a functioning internal market have been adopted since 1984, when the then EC Commissioner Lord Cockfield produced his White Paper. Direct taxes turned out to be a stumbling block, mainly because Member States were reluctant to surrender

sovereignty in this area. The unanimity requirement for decisions of the Council in tax matters (Art. 95, Para. 2 EC Treaty) has allowed reluctant Member States to forestall harmonization of direct taxes.

Although Art. 96 of the EC Treaty offers a way out from the unanimity rule, by providing that in the case of serious market distortions, a qualified majority is sufficient for the adoption by the Council of a pertinent directive, it has yet to be used.

Corporate tax

The first directives on corporate tax were proposed by the Commission over 20 years ago and were only adopted by the Council in 1990. These directives were the Parent-Subsidiary Directive (PSD) and the Merger Directive (MD). A third proposed directive, on the avoidance of double taxation in transfer pricing disputes, was adopted in the form of a convention between the Member States, and not as a directive.

The PSD avoids economic double taxation by providing that the Member State of a parent company which receives profits from a subsidiary company in another Member State, shall either exempt such profits or apply a credit in proportion to the corporate tax levied in the source state. Juridical double taxation is avoided by abolishing withholding taxes levied by Member States on intercompany dividends paid to another Member State.

The MD facilitates cross-border mergers, divisions and take-overs in the EC by postponing the levying of tax until a later taxable event, e.g. a capital gain on an asset is not realized at the moment of the merger but upon a later sale of the asset or shares, as the case may be.

The Arbitration Convention provides for a quasi-arbitration procedure if the competent authorities of Member States have not concluded a mutual agreement procedure concerning a transfer pricing adjustment within two years of the relevant case being submitted. After that time, the case must be referred to an "advisory commission" which has to deliver its opinion within six months. After having received this opinion the competent authorities may adopt this opinion, or come up with a different agreement, within six months. The convention entered into force on 1 January 1995 (the extension of the convention from the year 2000 is yet to be ratified by all Members). It is remarkable that there have been no cases brought to an "advisory commission", as this would mean that mutual agreement procedures within the EC do not last for more than two years. Prior to the entry into force of the Arbitration Convention in 1995, it was not uncommon to have cases that lasted as long as ten years.

From the perspective of transfer of sovereignty, two interesting aspects can be noted here. First, the Member States preferred a convention among themselves, based on a rather "obscure" and non-committal article of the Treaty, i.e. Art. 220, now Art. 293 of the EC Treaty. This article provides for negotiations between Member States on the abolition of double taxation. Member States assumed that

2. Gaston Schul I, Case 15/81 (1982) ECR, at 1409.

under a convention, organs of the EC, the Commission and the ECJ would not be able to acquire competence or jurisdiction in transfer pricing matters as they would have been able to if a directive had been adopted.

The second aspect equally illustrates the reluctance of Member States to surrender powers in the field of transfer pricing. Under the Arbitration Convention, Member States have shown remarkable ability to resolve cases within the two-year time frame, rather than risk having the case referred to an independent party, i.e. the advisory commission, should the two-year time frame not be met.

In 1992, the Ruding Committee advised the EC Commission and the Council on corporate tax harmonization. It concluded that harmonization of the corporate tax bases was necessary in the long term. The Ruding Committee also advised that in the short term, discrimination and distortions of national tax systems which impact cross-border investment and shareholding should be eliminated together with tax competition among Member States, and also that tax incentives should be made transparent. Moreover, proposed directives on loss offsetting and on inter-company interest and royalties should be adopted as soon as possible.

The reaction of the Council in 1992, was not overly enthusiastic and they attached many conditions to the adoption of the Ruding Committee proposals. This means that no progress could be expected in the Council for several years, due to the unanimity clause. Surprisingly, however, things moved rapidly forward because of developments beyond the control of Member States and the Council, as we will see hereafter in 2.2.

Disappointed by the lack of progress in the legislative area, the Commission became very active in monitoring the implementation of the two corporate tax directives adopted, the PSD and the MD. The International Bureau of Fiscal Documentation was invited to produce a report analysing as to whether the two directives were completely and correctly incorporated in the legislation of the Member States. The report presented interpretations of various clauses and pointed to a great number of deficiencies.³ With the report as a basis, the Commission summoned defaulting Member States to comply with the requirements of the two directives. In the event of non-compliance, Member States were brought before the ECJ under the so-called infringement procedure of Art. 226.

Currently, the Commission is trying to achieve a consensus on a common consolidated tax base in all Member States. This tax base would be optional for enterprises who are active in more than one Member State (the other option is of course to remain subject to the domestic corporate tax systems of the countries concerned). The countries concerned would apply their own tax rate to their share of the common consolidated tax base. It would require a formula to apportion a share of the tax base that is to be taxed by the Member States concerned. Advantages of such a consolidated system would be that transfer pricing disputes would no longer arise, losses in one country could be set off against profits in other countries, and, administrative requirements could be reduced considerably. Once the technical problems concerning the tax base itself and the

apportionment have been solved, Member States that are still reluctant may be coerced to accept the proposal via Art. 96 of the EC Treaty.

Individual income tax

There have been no directives adopted in the area of individual income tax. The only measure currently being considered is the proposed savings directive, which is intended to tackle the tax evasion of savings in the EC, primarily via an exchange of information between the Member States. Alternatively, the proposed savings directive suggests a withholding tax application.

There is opposition to the savings directive, in particular from Luxembourg and Austria, and for different reasons the United Kingdom. The savings directive is part of a tax package, consisting of acceptance of the code of conduct, and the interest-royalty directive for payments between related companies. The adoption of the savings directive has also been made dependent on cooperation, in particular, of Switzerland in respect of the exchange of information. The current negotiations between Switzerland and EC Commissioner Bolkestein do not seem to be successful.⁴

It may be concluded that the statutory transfer of tax sovereignty by the Member States to the EC itself has been successful and almost complete in the field of indirect taxes, but is still in an initial stage in respect of direct taxes.

2.2. Loss of sovereignty as a result of case law of the ECJ

As already indicated, the EC Treaty contains articles which aim at the adoption by the Council of proposals on regulations and directives, put forward by the Commission, and, in the case of directives, the adoption of relevant implementing domestic legislation.

Other provisions of the EC Treaty, however, have a direct effect on individuals and corporate entities within the Community, overriding incompatible domestic provisions. These include the prohibition of discrimination on grounds of nationality (Art. 12), the freedom of movement of workers within the Community (Art. 39), the freedom of establishment as a self-employed person or as an undertaking, including the setting up of agencies, branches or

3. *Survey of the Implementation of the EC Corporate Tax Directives*, IBFD, Amsterdam, 1995.

4. On 21 January 2003, the Council reached an agreement with regards to the Savings Directive. The Council agreed that the method to be used to tackle tax evasion on savings will, ultimately, be based on the exchange of information. Twelve member states will have to implement an automatic exchange of information from 1 January 2004, while Austria, Belgium and Luxembourg will implement a transitional withholding tax from 1 January 2004 and will implement an automatic exchange of information if the EC enters into an agreement with Switzerland, Liechtenstein, San Marino, Monaco, Andorra and the United States on the exchange of information upon request as defined in the OECD agreement. The Council had agreed that the EC should enter into a unanimous agreement with Switzerland based on a package which will involve the imposition of a withholding tax similar to that provided to Austria, Belgium and Luxembourg; revenue sharing; and voluntary disclosure of information. The Council also agreed that similar agreements should be entered into with Liechtenstein, San Marino, Monaco and Andorra.

subsidiaries (Art. 43), the freedom to provide services (Art. 49), and the prohibition of restrictions on the movement of capital (Art. 56), the latter also with third countries. In cases where the interpretation of the above provisions are concerned, national courts are required to refer the case to the ECJ for a preliminary ruling (Art. 234).

Since the *Avoir Fiscal* case in 1986⁵ and in rapid succession since 1990, the ECJ has given preliminary rulings on 30 cases dealing with non-discrimination and the four above-mentioned freedoms. In almost all cases, the ECJ concluded that there was an incompatibility of domestic tax law with the directly applicable provisions of the EC Treaty concerned, in particular the non-discrimination clause, the freedom of movement of workers and the freedom of establishment.

The approach of the ECJ in these cases can be summarized as the unacceptability under EC law, of a less favourable treatment, under the tax laws of a Member State, of a cross-border situation within the EC in comparison to that of a purely domestic situation. An exception is only justified if a legitimate public interest is served in a proportional manner. These days, the exception is being applied very restrictively by the ECJ.

The rulings of the ECJ have had an impact on, for instance, the following aspects of the tax laws of the Member States:

- the treatment of resident and non-resident individuals (different treatment is still generally allowed, but the same treatment is mandatory if the non-resident obtains a large part of his income in the source country concerned);
- the treatment of permanent establishments (PE) (higher tax rates and non-deductibility of costs are not allowed, and the availability of “resident” tax facilities is mandatory);
- group treatment (availability to resident group members only is not allowed);
- measures for the avoidance of double taxation (imputation credit must also be extended to a PE of a non-resident EC company; pro rata attribution to domestic and foreign income of tax deductions is not allowed; a ruling is also expected in respect of the limitation of the deduction of costs to domestic situations under the participation exemption);
- exemptions (exemption of capital tax and net wealth tax not only in domestic situations);
- exit taxes;
- tax incentives;
- withholding taxes;
- thin capitalization (automatic classification of loans as equity in case of non-residents not allowed);
- non-deductibility of payments to foreign entities; and
- procedural rules (tax refund more burdensome for foreigners not allowed).

The above case law of the ECJ results in two substantial problems for the Member States:

Firstly, the Member State affected by the ECJ ruling has to incorporate the ruling in its legislation. Moreover, all other Member States with similar provisions must check and, if necessary, adapt their legislation. The ECJ has, thus, pro-

voked a harmonization process in the area of direct taxation over the last 12 years, which has not been anticipated by the Member States. This is even more striking now as the Member States are still reluctant to accept harmonization proposals on direct taxes put forward by the Commission. The Commission recently announced that it will provide guidance to the Member States on how to incorporate ECJ case law into their domestic tax laws.

The second problem is the budgetary effect of rulings of the ECJ. The revenue impact of, for instance, making available group treatment also in cross-border situations and allowing costs deductions under the participation exemption in cross-border situations is difficult to measure but is probably quite high. The options available to set off such revenue impact are not attractive, as it would involve either increasing the corporate tax rate, or abolishing the facility concerned completely.

2.3. Peer pressure and harmful tax competition

Traditionally, certain EC member countries, such as France and the Netherlands, have had features in their tax legislation and administrative practice which facilitate the complicated tax position of multinational enterprises. The Netherlands as the “birth place” of several large multinationals has been an attractive location for holdings because of its large tax treaty network which provide for low withholding tax rates for intercompany payments, the absence of withholding taxes on interest and royalties, a participation exemption, and, in particular, since over 50 years, the availability of private rulings, particularly concerning taxable profits to be allocated to the Netherlands.

Over the last two decades, other European countries have successfully introduced special tax facilities with the aim of attracting foreign investment, for instance the coordination centres in Belgium, the Dublin Dock and Shannon facilities in Ireland, the new participation exemption in Denmark and the tax-free zones in several other countries. At the same time, a country like Germany suffered from the fact that its corporate tax infrastructure was not competitive when compared with other EC countries. The introduction of the group finance facility in the Netherlands in 1997, reducing the effective tax rate for group finance centres to 7%, was difficult for Germany to accept and a campaign against tax competition was started.

This campaign against tax competition resulted in the adoption of a Code of Conduct on Business Taxation by the EC Council of Ministers and the setting up of the so-called Code of Conduct group in December 1997. Not being EC legislation or a convention, the Code is not legally binding. Its aim is to tackle harmful tax competition which causes distortions in the functioning of the internal market and reduces the tax revenue of Member States. Member States voluntarily agreed not to introduce new potentially harmful tax facilities and to roll back existing measures.

5. Case 270/83, included in “Materials on International and EC Tax Law”, Kees van Raad (ed.), ITC, Leiden 2002.

In 1999, the Code of Conduct group produced a list of 66 potentially harmful tax measures. The list covers tax facilities for intra-group financial services, insurance, other services, holding companies, offshore companies and tax-free zones.

As previously indicated, the Code of Conduct is part of a "tax package", consisting of the proposed savings directive and interest-royalty directive. The implementation of the Code as per 1 January 2003 may be blocked by an absence of agreement on the other proposals among the Member States.

The Code of Conduct action has, however, produced results. Belgium has amended the regime for coordination centres and revised its Controlled Foreign Corporation (CFC) rules. Denmark has restricted the exemption from withholding tax on dividend payments to certain non-residents, while Ireland has announced the repeal of specific incentives and the introduction of a general corporate tax rate of 12.5%. The Netherlands has revised its ruling regime and announced that requests for the application of the group finance regime will not be accepted for the time being. On the other hand, several countries such as Germany, Sweden and the United Kingdom have reduced their general corporate tax rates, like Ireland, and this being a competitive measure which is not covered by the Code of Conduct.

The Code of Conduct is an interesting example of loss of tax sovereignty because of political pressure among Member States of the EU.

2.4. Increasingly active role of the EC Commission concerning state aid

The EC Treaty gives far-reaching powers to the EC Commission to tackle schemes of Member States which distort competition.

Art. 87 of the EC Treaty forbids state aid which favours certain undertakings or the production of certain goods, unless it serves certain purposes, e.g. of a social character. Other purposes such as the development of areas with serious underemployment may be acceptable.

Art. 88 gives the EC Commission the power to decide that a certain form of state aid is not allowed under Art. 87 and that the Member State concerned must abolish or alter the aid within a certain period of time. If the country concerned does not comply with this, the matter may be referred to the ECJ for an immediate review. Member States must also inform the Commission on plans to grant aid, and pending a decision of the Commission, the aid scheme may not be introduced.

In connection with the Code of Conduct resolution of December 1997, the Commission has produced guidelines on the application of the state aid provisions of the EC Treaty in the field of taxation. In its Notice of 11 November 1998, the Commission states that it will contribute to the tackling of harmful tax competition via its powers in the field of state aid. The Notice defines state aid via tax measures as a reduction in the tax base (special deductions, depreciation, reserves), a reduction in the amount of

tax (exemption or credit), or deferment, cancellation or restructuring of tax debt. The advantage must be granted by the State or through State resources, including regional or local bodies, and the practices of tax authorities is also covered. The state aid measure must affect competition and trade between Member States. General tax measures affecting all "economic agents" operating within a Member State are acceptable, but specific or selective measures, favouring certain undertakings or the production of certain goods are not.

EC Commissioner Monti, who is responsible for competition, started investigations on state aid in the form of tax schemes and practices in July 2001. The following tax provisions are being tackled:

- the Belgian, German, Luxembourg and Spanish (Bask) Coordination Center regimes;
- the French Headquarters and Logistics Center regime and the French Group Finance facility;
- the Irish Foreign Income exemption;
- the Netherlands Group Finance facility;
- the Finnish Åland Island Captive Insurance scheme;
- the United Kingdom Gibraltar Offshore Companies regime;
- the Greek Foreign Companies Offices regime;
- the Trieste (Italy) Financial Services and Insurance Center incentive; and
- the Swedish Foreign Insurance Companies regime.

It is expected that this initial action of the Commission will lead to the abolition of the above schemes.⁶ Moreover, now that the Member States realize that the conditions of Arts. 87 and 88 of the EC Treaty are strictly applied by the Commission, in particular the requirement of notifying the Commission of domestic tax measures with a potential state aid effect, new specific tax incentives will not be easily adopted within the EC.

As indicated, Member States will be inclined to adopt competitive measures of a general character, such as lowering corporate tax rates.

2.5. Competence to negotiate tax treaties with non-member countries (external powers of the EC)

The EC Treaty confers external powers on the EC as a supranational legal body in certain specific cases, e.g. in Arts. 133, 300 to 304 and 310. According to the ECJ, however, external powers are not limited to the cases specifically mentioned in the Treaty.

In 1971, the ECJ decided that the EC Commission (the Community) and not the Council (the Member States) was competent to negotiate a European Road Transport Agreement. The Court held that also in cases not explicitly mentioned in the E(E)C Treaty, the Community may have an external authority. Every time the Community, in order to implement a common policy envisaged by the Treaty, adopts provisions establishing common rules of whatever form, the Member States no longer have the individual or collective right to undertake obligations with third coun-

6. At the time of publishing this speech, the above Bask, Finnish, UK-Gibraltar and Trieste incentives were held incompatible with state aid rules.

tries which affect these common rules.⁷ As to whether such a power is exclusive, the ECJ held in its Opinion 1/75,⁸ that exercising concurrent powers by the Member States and the Community would amount to recognizing that, in relation with third countries, Member States may adopt positions which differ from those which the Community intends to adopt, and would thereby distort the international framework and prevent the Community from fulfilling its task in the defence of the common interest. In later cases, the Court confirmed and widened its opinion on the external competence of the Community.

The only measures adopted in the field of direct taxation are the two 1990 corporate tax directives, the PSD and the MD. The preambles to these directives refer to the necessity for the internal market of these measures and that the formation of groups should not be hampered by restrictions and distortions arising from the tax provisions of Member States; therefore, it is necessary to introduce common tax rules which are neutral from the point of view of competition. The PSD has resulted in an almost identical tax treatment of profits paid by subsidiaries to parent companies in different Member States. Withholding taxes were abolished and in the receiving country either a credit or an exemption is applied.

However, the PSD only applies to intra-EC situations. Parent companies in different Member States remain in different positions with regard to profits (dividends) received from third countries. In Italy, for example, only a partial exemption applies to dividends received from non-EC subsidiaries. Dividend tax withheld in non-EC countries is not always fully creditable, which is a problem because most Italian treaties allow a withholding tax of 10% or 15% on intercompany dividends. On the other hand, in the Netherlands, a participation exemption applies and in almost all cases the treaty rate of the withholding tax on intercorporate dividends is either 0% or 5%.

Another difference is the scope of the limitation on benefits clause of tax treaties between the United States and EC Member Countries. As a result of this, certain countries have a competitive advantage over other countries.

The removal of tax distortions affecting the functioning of the internal market in the EC can therefore only be achieved if the internal EC measures concerned are complemented with a common tax treaty policy towards third countries. The EC Commission has not yet claimed the right to negotiate tax treaties with third countries or to have an EC tax treaty with third countries covering the important issues mentioned.

I assume that this is for tactical reasons and as soon (or late) as a common consolidated tax base and a savings directive have been adopted, the above issue will be on the agenda.⁹ It goes without saying that the successful claiming of competence in this area will have an impact on Asian countries as well.

3. DUAL INCOME TAXATION; A RETURN TO SCHEDULAR TAXATION?

3.1. Introduction

In 1989, Portugal was the last OECD country to give up schedular individual income taxation and to introduce a global income tax system. Global tax systems aggregate income from all sources at the individual or family unit level. The total income is then taxed at the same rate, being part of a progressive rates system. Schedular tax systems divide income into different categories, each category being subject to its own computation rules and tax rates. Global tax systems typically go with progressive tax rates, representing the ability to pay principle.

Increasing tax planning and tax evasion in the area of capital income, subjected to high progressive rates under global systems have induced several countries to partly abandon the global system and to (re)introduce separate tax treatment of capital income.

In 1984, Belgium was the first European country to introduce different treatment of dividends and interest, applying withholding taxes which are final or, if the taxpayer opts to include dividend or interest in the taxable income, creditable against the tax on the total income.

At the beginning of the nineties, Scandinavian countries introduced the so-called dual income tax systems to replace global systems with very high progressive tax rates. Basically this means that labour income and capital income are treated separately, with progressive tax rates for labour income and a flat rate for capital income. Labour income consists of wages, salaries, fringe benefits, pensions and social security benefits. Business and professional income is calculated separately (in the same way as for companies), but – together with labour income – taxed as “earned income” under the progressive rate system. Capital income covers any income from capital investment, including dividends, interest, capital gains and rents. Norway applies a variation in that both the labour and capital income are first taxed at a flat rate of 28%, and after which the labour income is subject to an additional progressive tax. In addition, Norway applies a full imputation credit to dividends. The combination of a relatively low flat rate on capital income and full imputation is unique. In Finland and Norway, the rate of corporate tax is equal to the rates on capital income, i.e. 29% and 28% respectively.

7. ERTA Case 22/70 (1971) ECR, at 264.

8. (1975) ECR, at 1355.

9. On 5 November 2002, after the date of this speech, the ECJ gave its decisions in the so-called open skies cases (Cases C466/98, C467/98, C468/98, etc.), which confirm the above reasoning. The EC Commission took several Member States to Court claiming that the negotiation of “open skies” agreements by these Member States with the United States violated Art. 43 of the EC Treaty and EC Regulations on access to air routes, fares and computerized reservation systems, and that the Member States concerned have infringed the external competence of the Community. The Court decided in favour of the Commission.

3.2. The Netherlands

Since 2001, the so-called three boxes system has been in force in the Netherlands. It replaced a global system covering various sources of income.

The main reasons for the introduction of the new schedular system were base broadening, the different treatment of various forms of private investment and savings, and the high level of tax avoidance and evasion in the field of capital income taxation under the former global system. The top rate of 52% stimulated the opening of bank deposits in, for instance, Luxembourg and Switzerland by Dutch residents.

Moreover, tax planning flourished under the former system. Various forms of savings and private investment were taxed differently, interest and dividends were taxable, capital gains normally not, premiums for life insurance annuities were deductible, etc. Rather than introducing a capital gains tax, the Dutch government proposed an original new system in 1999, which came into effect in 2001 and can be summarized as follows.

Box 1 of the new system covers income from employment and former employment, self-employment, business, and also fictitious income from self-occupied dwellings. Other than costs related to commuting (including the typical Dutch "bicycle deduction"), real costs of employment are no longer deductible. However, a fixed credit for costs is provided, and interest costs on mortgages used to finance the purchase of dwellings are fully deductible. A four-bracket tax rate is then applied. The rate for the first bracket is relatively high (2002: 32.35% on Box 1 income up to EUR 15,331), but it covers also social security contributions. The top rate of 52% starts at a taxable Box 1 income of EUR 47,745. The former basic tax-free amount was replaced by a general tax credit in Box 1. A negative result of Box 1 may only be set off against positive Box 1 income of three past years and of future years.

Box 2 includes income in the form of dividends and capital gains from a substantial shareholding (a direct or indirect holding of 5% or more, together with a partner). The costs are deductible but capital losses cannot be set off. A negative result in Box 2 may arise if costs in a given year are higher than income, and this may be carried back to a maximum of three years, or carried forward indefinitely. A rate of 25% applies to taxable income of Box 2.

Box 3 covers presumed income from savings and private investment. It replaces a net wealth tax of 0.7% and a global income tax with progressive rates covering also income from capital. The taxable base consists of a presumed 4% return on the average value at the beginning and the end of the tax year in respect of movable and real property. Related debts are deductible, but not expenses incurred. A fixed amount of EUR 17,600, or, in the case of a "fiscal couple", EUR 35,200, may be deducted from the average value. A flat rate of 30% is applicable. The levy of Box 3 has more characteristics of a wealth tax than of an income tax by ignoring the real income and applying in fact a rate of 1.2% to the value of the taxpayer's capital.

Other countries such as the United States seem to accept the opinion of the Netherlands Ministry of Finance that the

Box 3 levy is an income tax. Otherwise the foreign tax credit regulations of those countries could not be applied.

3.3. Policy considerations

Dual income taxes introducing progressive rates for earned income and a lower flat rate for capital income may conflict with certain tax principles.

Firstly, the principle of "horizontal equity".¹⁰ Is it justified to tax a person having labour income higher than a person having a similar amount of capital income?

The arguments in favour, which are put forward by governments, include:

- a lower tax on capital income takes inflation into account: labour income usually is better protected against inflation; and
- capital investment is riskier than employment (at least in North-West Europe).

A practical argument, usually not openly put forward by governments, is that earned income is less mobile than capital income and therefore easier to tax with relatively high rates.

Lower taxes do indeed reduce tax avoidance and evasion of capital income, particularly when combined with a tax amnesty and the introduction of high penalties.

A relatively low flat rate for capital income also affects the "vertical equity" among taxpayers which is typically achieved through progressive tax rates. However, one should realize that in the North-west European countries, taxpayers with earned income usually are savers and private investors as well. In such cases, when savings are made out of taxed earned income, one could even look upon a tax on proceeds from savings as double taxation.

The above equity arguments seem, however, subordinate to the practical advantages of a relatively simple and low flat tax on capital income. These arguments also play a role with regard to the following issue.

4. THE DISAPPEARANCE OF IMPUTATION SYSTEMS

The first policy question concerning the taxation of dividends, is whether (economic) double taxation arising from the fact that the underlying profits have first been taxed in the hands of the company concerned via corporate taxation, and, after distribution to shareholders, with an individual income tax, should be avoided or mitigated or not.

Under the classical system, the corporate tax sphere and the individual tax sphere are strictly separated, and thus, dividends are fully taxed in the hands of the shareholder. The United States has always used the classical system, while in Europe, the Netherlands has been a long-time defender of the classical system.¹¹

10. See for definitions of terms used: *International Tax Glossary*, IBFD, Amsterdam, 2001.

11. On 7 January 2003, the United States Administration proposed a tax package which included a proposal to abolish tax on dividends received by shareholders.

Countries which give priority to the problem of economic double taxation, arising in this situation, have various options, with strongly different implications and effects:

- on the corporate tax level: applying a split rate, which means a reduced rate, or even 0%, for distributed profits, or allowing a deduction for dividend paid similar to interest, or, an allowance for corporate equity (the so-called ACE solution);¹²
- on the individual income tax level: an imputation credit or an exemption or partial exemption can be given. Full exemptions for individual taxpayers are very rare.

Imputation systems have been common in Europe until recently. The basic features of imputation systems include a full or partial credit against individual income tax for the portion of corporate tax levied on the dividend received and a compensatory tax levied from the company concerned if and as far as dividends are paid out of profits not taxed under corporate tax.

The current trend in Europe is the introduction of a mitigated classical system, applying a rate of 50% of the normal rate, or only taxing 50% of the dividend received, or in the form of a dual income tax with a relatively low flat rate for all capital income.

The advantages and disadvantages of imputation systems and other forms of mitigating economic taxation have been discussed in great detail in a study for the EEC in 1970 by Prof. Van den Tempel,¹³ and in 1996 by Peter Harris in his impressive award-winning book on *Corporate/Shareholder Income Taxation*.¹⁴

Van den Tempel concludes that double taxation is a problem indeed, but the classical system causes less serious distortions internationally and is much simpler to apply than imputation systems. A major distortion under the classical system is of course the different treatment of dividend and interest for corporate tax purposes.

Contrary to the conclusions of the Van den Tempel report, the EEC Commission proposed a directive introducing an EEC wide imputation system in 1975. Not being able to achieve unanimity on this, in particular the Netherlands and Luxembourg remained opposed, the proposal was withdrawn in 1990.

The reason the Netherlands opposed the imputation system has always been because of the traditional presence in this small country of the holdings of large multinationals quoted on stock exchanges worldwide. Providing an imputation credit only to domestic shareholders would cause a huge distortion, while providing a credit to shareholders worldwide would be impossible from a budgetary point of view. Moreover, one anticipated advantage of the imputation system, i.e. to make investment by the public in shares more attractive, did not meet the expectations of countries with imputation systems. The potential capital gain, which is not taxed or taxed at a lower rate in several European countries, seems a stronger motive to invest in shares than the expected dividend.

The distortive effect of imputation systems in international situations can be reduced by agreeing on mutual credits under tax treaties, but such clauses are still exceptional.

The complexity of imputation systems can be further illustrated with the United Kingdom and Irish Advance Corporation Tax, a compensatory tax, which was abolished in 1999.

The above considerations explain why European countries moved away from an imputation system in recent years. One reason not mentioned yet, is that there was a general concern among “imputation countries” that at some point the ECJ would decide that not granting an imputation credit to shareholders, resident in other Member States, would infringe the provisions discussed in 2.2. In 1992, all EC Member States except Belgium, Greece, Luxembourg and the Netherlands applied imputation systems. Chart 1 gives the present situation.

CHART 1

Austria	: mitigated classical; only half the rate of income tax or final WHT of 25%
Belgium	: mitigated classical: final withholding tax of 25%; optional credit
Denmark	: mitigated classical; tax rate for share income < DKK 39,700: 28%
Finland	: mitigated classical; flat rate of 29%
France	: imputation; 50% of the dividend distribution; change expected
Germany	: mitigated classical; 50% of dividends is taxable
Greece	: exemption for domestic dividends
Ireland	: classical system
Italy	: imputation (partial) in case of substantial participation (> 5%); other dividends: final WHT of 12.5%
Luxembourg	: mitigated classical; 50% of the dividend is taxable
Netherlands	: mitigated classical; presumed return of 4% of average net wealth; flat rate of 30%
Portugal	: mitigated classical; 50% of dividends received is taxable
Spain	: imputation (partial)
Sweden	: mitigated classical; flat rate of 30%; exemption for dividends from qualifying SMS companies
United Kingdom	: imputation (1/9 tax credit)

Currently almost all countries apply either a dual income tax with a lower flat rate for capital income including dividends, or a reduced rate for dividends only, or a partial exemption of dividends received.

Based on the above, it may be concluded that there has been a more or less spontaneous harmonization of the tax treatment of dividends in the European Community.

12. Institute for Fiscal Studies (UK) 1991.

13. A.J. van den Tempel, *Corporation Tax and Individual Income Tax in the European Communities*, EEC, Brussels, 1970.

14. Peter A. Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights between Countries*, IBFD, Amsterdam, 1996.

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