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THE EU SINGLE MARKET AND THE CORPORATE INCOME TAX HARMONISATION ISSUE

Abstract

Tax harmonisation is an important aspect of the drive to a Single Market within the EU. Within the area of corporate income tax in the EU no formal process of harmonisation has been agreed upon yet. However, a certain degree of convergence is evident in the reduction of statutory tax rates. This reflects a spontaneous (market-driven) harmonisation in response to competitive pressures.

As it concerns formal (concerted) harmonisation, the European Commission has adopted recently a package on various taxation measures with a plan to harmonise the corporate taxes base to create a level playing field across the EU. The proposed measures do not include limiting tax competition in setting tax rates.

This approach, unless rejected by the national vetoes, may bring substantial benefits in increasing international competitiveness of the EU companies. Only when tax bases are more similar, will differing rates of taxation really start to affect competitiveness – companies will place greater emphasis on tax rates when deciding where to invest. The convergence in business operating conditions will allow companies to become more mobile. As a result, in the long term there could well be a natural market pressure to have similar (lower) rates of business taxation. This market-driven tax rate harmonisation will increase the external competitiveness of the EU within the global economy, leading to higher prosperity and lower unemployment for EU countries.

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JEL-Classification: H25, H87

Introduction

Globalisation processes manifesting themselves in increased international relationships in the real sphere and a growing mass of globally mobile capital (thus also the tax base mobility) pose a challenge to a state's economic policy indicated by a phenomenon of tax competition. In the case of the European Union an additional aspect of this competition was enlargement of the common market by the economies of new member states which, as a rule, are characterized by a lower degree of budget redistribution and more favourable taxation of capital – the most mobile production factor. The EU enlargement was accompanied with the fears of the „old" EU members that this process would lead to capital flowing out of their economies which will entail higher unemployment, tax base erosion and lower possibility of implementing the "welfare state" concept; tax competition and "fiscal dumping" have become areas of particular interest among politicians and EU institutions.[1] It resulted in numerous initiatives to increase – in comparison to the Stability and Growth Pact's provisions and the existing degree of indirect tax harmonisation – the areas of fiscal policy coordination mainly via the idea of formal harmonisation of corporate income tax systems. These initiatives were triggered off by the necessity to improve conditions of the common market functioning where the differences among national tax systems, while segmenting this market, raise the costs of compliance to tax regimes of other countries and distort competition conditions. Countries of relatively low taxes were against any proposals of harmonisation perceiving tax competition as a „democratic right" of poorer societies to improve their standards of living by attracting foreign capital and harmonisation as a synonym of „tax cartelization", where governments act as oligopolists protecting their tax revenues enabling maintenance of a large (frequently inefficient) public sector. Since, in accordance with the principle of subsidiarity, decisions concerning taxes require consensus of the member countries, the hitherto initiatives of increasing the harmonisation degree ended up in a fiasco.

1. Theoretical premises of tax harmonisation

The concept of tax harmonisation is most frequently understood as formal agreements between particular countries which are followed by legal actions adjusting

[1] It seems worthwhile to recall reaction of many „old" EU countries to income tax reduction accomplished by Estonia, Lithuania and Slovakia in 2005. Joschka Fischer, the then German foreign minister argued that „it is intolerable for Germany struggling for the rising budget deficit and unemployment of over 10% to finance EU subsidies to countries that are luring investment and jobs out of Germany by slashing taxes". See: *Flat is beautiful,* „The Economist" 2005, March 3.

(converging) their tax structures (which does not necessarily mean their complete uniformity). The view that such concerted harmonisation is a necessary condition to create the common market and make it function effectively is questioned by advocates of maintaining national sovereignty in the sphere of fiscal policy. This sovereignty is manifested by a possibility to use fiscal instruments (including the tax ones) for the implementation of specific objectives of individual economies, such as stabilizing economic growth rate or stimulating development of selected sectors or regions.[2]

It must be mentioned, however, that such a perception of the role of tax policy indicates a basically different philosophy of the common market creation and functioning. Retaining different tax structures in fact means allowing segmentation of this market. Distortions of trade directions and production factor flows resulting from diverse tax systems, according to advocates of tax sovereignty, can be eliminated by an efficiently functioning tax coordination in the form of a coherent network of multilateral agreements aiming at remedying tax differences among countries. However, if borders and capital flow control disappear, such coordination will be impossible. Besides, it will significantly limit market transparency required for the correct allocation of resources.

An alternative for concerted harmonisation can be spontaneous, market-driven harmonisation occurring without formal agreements but as a result of competitive pressures. In order to attract production and capital, particular countries compete with one another using tax measures and adjusting them to the different conditions of a local market. Tax preferences can be justified here by a need to compensate a higher risk of investment or a relatively weaker infrastructure. As a result of tax competition one can expect that effective taxation rates (taking into account the indicated differences in attractiveness of the investment place) will converge the lowest ones in a given integration area.

[2] Resistance to concerted tax harmonisation is much stronger in the situation of the Economic and Monetary Union implementation. Due to the fact that the instruments of monetary and currency exchange policy cannot be used, fiscal sovereignty is perceived as the last attribute of economic sovereignty. Retaining it, in the situation of relatively diversified economic structures of individual countries is considered appropriate from the point of view of absorption of the asymmetric economic shocks. On the other hand it is noteworthy that acceptance of the common currency necessitates tax harmonisation. It results from the fact that more transparent prices, elimination of the currency exchange risk and reduction of transaction costs (removal of subsequent, non-fiscal barriers within the common market) highlight differences among tax structures which disturb competition in the common market.

In this aspect tax competition seems to be beneficial for both tax-payers and economy's effectiveness – lower tax revenues will exert pressure on a state to reduce expenditures, thus they will act as a brake on the public sector growth and force the state to be more effective in rendering public services. An additional argument in favour of tax competition can be the „democratic right" of poorer societies to raise their standards of living by using relatively low taxes to attract foreign capital. From this point of view, after the benefits resulting from tax competition have been accepted, the formal (concerted) harmonisation is synonymous with "tax cartelization", where governments act as oligopolists protecting their tax revenues enabling them maintenance of the large (and inefficient) public sector.[3]

The question about economic and social consequences of tax competition concerns not only the area of the single market of the EU member countries. In the last few years, when globalization processes alongside Internet expansion increased tax base mobility at the same time threatening it with erosion, the problem of "harmful" tax competition has been regarded as a global problem discussed by the heads of the G-7 group governments (last time, in April 2009, by the G-20 group), OECD and the European Union. It must be emphasized here, however, that among activities aimed against "harmful" competition there is no self-contained proposal of concerted harmonisation of national tax systems.

Several facets of the negative aspect of tax competition are presented. Firstly, tax differences cause that the countries revealing relatively high tax rates (after having considered the standard and quality of the public services rendered) indicate lower tax revenues. It is a result of either the erosion of tax base which turns to areas of a better fiscal climate, or from the competition coerced reduction of the tax rates. From the „social" point of view, lower budget revenues, may be too low[4] in relation to the society's demand for services provided by the public sector.[5]

Secondly, reduction of tax revenues at relatively rigid public expenditures may entail pressure on increasing budget deficit or make its reduction difficult. This argument, like the one concerning necessity of financing the public sector services, is

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[3] G. Kopits (ed.), Tax Harmonisation in the European Community. Policy Issues and Analysis, International Monetary Fund Occasional Paper, No 94, July 1992, p. 4.
[4] *Not so harmonious,* The Economist 2001, March 31.
[5] Although a desired, market coerced, growth of effectively rendered public services may follow, at the same time a threat appears of a limited degree of budget redistribution, and consequently reduction in the level of social safeguards will enhance protests against globalization processes. It may become a source of significant social and political tensions threatening stability of world economy.

obviously questionable because it touches on the issue of the optimal state share in economy. In the opinion of the liberal concept advocates, in most countries the public sector reached the size threatening a long-term potential for economic growth and at the same time making an efficient control over it difficult. With reference to the European model of the social market economy a relative weight of the concepts of "social" and "market" can be taken into account. If one assumes that "self-limitation" of the excessively large state is unlikely, then the pressure of the reduced tax revenues can enforce such a process.

Thirdly, the tax base is not homogenous with respect to its mobility. Tax competition is most visible against the background of goods, services and production factors which are most mobile. As a result of it one can expect a shift in tax burden from capital to a less mobile labour factor.[6] It means socially and economically unfavourable rigidity of the labour market, higher unemployment and reduced potential for economic growth.

The latter negative aspect of tax competition seems particularly important in the context of the European Union. Is it then an argument for concerted harmonisation of tax structures? It is noteworthy that such harmonisation would eliminate the phenomenon of tax competition in two cases only:

- if it referred to the entire world's economy, or
- if the area of the European Union was cut off from the rest of the world.

As neither of these conditions complies with the realities of contemporary economy, concerted harmonisation of taxes does not provide a barrier protecting the EU member countries against the consequences of harmful tax competition.

2. Tax harmonisation areas in the EU

According to the official stand of the EU bodies, there is no need of full harmonisation of the member state tax systems.[7] Different social preferences of national states, a different range and structure of public expenditure can be implemented owing to the diverse tax structures. At the same time these structures should not create obstacles for the free movement of goods, services and production factors within the

[6]It refers in particular to the unqualified labour force; specialists are characterised by higher mobility and higher awareness of tax competition. The sector of economic entities is not homogenous, either, as far as the possibility of taking advantage of differences in tax structures is concerned – small firms, so important in the process of creating jobs, are here in a worse position in comparison to bigger companies.

[7] European Commission, *Tax Policy in the European Union – Priorities for the Years Ahead*, COM(2001) 260 final.

single market or distort competition. This means, first of all, the need to harmonise indirect taxes. With reference to direct taxes originally such a need was not articulated, however, as the out-of-fiscal barriers within the single market had been removed, the phenomenon of tax competition, especially on the grounds of financial transaction taxation and income tax from legal persons was becoming more and more evident. Even though progress in the sphere of indirect tax harmonisation is quite significant, the remaining areas of the tax structure remain considerably diversified. It results from difficulties in reaching a consensus by the member countries, needed to make a decision in the matter of taxes in the EU Council forum.

Article 90 of the European Community Treaty forbids all tax discrimination causing (directly or indirectly) an advantage of domestic products over the products coming from other member states. According to Article 93 of the EC Treaty, VAT, excise duties and other indirect taxes are subject to harmonisation on the level of community law, in the scope which is indispensable to ensure a free movement of goods and services among the EU member countries.

VAT harmonisation (introduced to the European Economic Commonwealth in 1970) is presently based on the Directive 2006/112/EC concerning a common VAT system,[8] which replaced (commencing on 1st January 2007) the Council's Sixth Directive of 1977. The new directive is of a codifying character and organizes the hitherto established VAT-related law. Generally, the VAT system harmonisation is synonymous with a uniform tax base and adoption of minimum rates (allowing exceptions to the rule, however), and not with tax uniformity.

Excise duty harmonisation was accomplished in 1992 simultaneously with the VAT system harmonisation. It indicates goods which are taxed by the excise duty (alcohol and alcoholic beverages, tobacco products, mineral oils) and establishes minimum rates of the excise duty. In practice significantly diversified rates applied by particular countries create significant barriers to trade and also cause abuse of the system.

With reference to direct taxes, it is generally assumed that diversification in the tax structures of the member states has a smaller impact on the common market functioning that differences in indirect taxes. The area of personal income taxes, like the

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[8] Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, OJ L 347.

system of social insurance contributions, remains outside the process of the EU tax harmonisation or coordination.

The issue of income tax from legal persons is perceived slightly differently. The EU enlargement and globalization processes intensified the discussion about the imperfections of a single market, competition of enterprises from particular countries and eventually tax competition among these countries. A special place in this discussion is given to capital taxation. The discussion resulted in proposals to harmonise national systems of corporate income taxes.

3. Concepts of common corporate income tax base in the European Union

To enhance efficiency of the EU single market it seems necessary to increase transparency and comparability of the corporate income tax systems occurring in the member states. Cross-border business activity is significantly hindered by tax obstacles – which mainly include costs of compliance with the tax regimes of other countries and the lack of possibility to consolidate profits and losses arising in these countries. However, in conformity with the principle of subsidiarity the issues of fiscal policy are decided by particular countries, whereas progress towards harmonisation requires a consensus of the Council which is particularly difficult to reach about tax-related issues.

The Community's only regulations concerning corporate income tax are three directives and one convention. Directive 90/434/EEC *(Merger Directive)* concerns the common taxation system applicable to mergers, divisions, transfer of assets and exchanges of shares concerning companies of different member states and aims at elimination of tax problems in the processes of enterprise restructuring and reorganizing. Directive 90/435/EEC *(Parent-Subsidiary Directive)* concerns the common taxation system applicable to parent companies and their subsidiaries located in different member states and aims at elimination of double taxation on profits distributed between the associated companies. On the other hand, Directive 03/49/EC *(„I+R" Directive)* deals with the common taxation system of cross-border inter-company payment of interest and royalties. Finally, the Arbitration Convention 90/436/EEC specifies procedures to settle disputes arising from application of transfer prices and adjustment of transfers of profits between associated companies.

In view of failure of previous initiatives,[9] since the mid-1990s in the discussions on the issue of different corporate income tax systems the emphasis has been shifted from formal harmonisation of tax structures to stronger coordination of the member state activities, and, in turn, the activities have been re-orientated to elimination of harmful tax competition among member states and the phenomena of tax evasion and fraud. On 1st December 1997, the Council adopted the Code of Conduct for Business Taxation which is a collection of guidelines and hence it is not legally binding. On the other hand, since 2001 discussions have been held on a possibility of introducing a common tax base for companies operating in more than one member states.[10] Also in its recent initiatives[11] the European Commission, while emphasising the lack of intention to replace national tax systems with a common system, proposes introduction of common principles to establish a tax base for companies which operate in the area of more than one member state, without intervening in tax rate levels which would remain an exclusive decision of the member states.

The hitherto discussions concerning the method of determining the corporate income tax base have led to the following two concepts:

- the Common Corporate Consolidated Tax Base (CCCTB). The tax base would be agreed upon in a uniform manner at the Union level, however, companies operating in more than one member country would have a possibility to choose between the new and the hitherto system. A more specific concept in the form of a legislative proposal was expected before the end of 2008;
- the Home State Taxation (HST). This solution would be based on mutual recognition of respective national regulations by the EU states without a necessity of converging them. Thus, it is obviously (politically and technically) easier and possible to be accepted by these countries. HST may also be a transitional solution preceding a possible adoption of the CCCTB principle. The HST concept was put forward as a pilot project applicable to small and medium-sized enterprises (SME)

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[9] On the issue of initiatives related to harmonisation of coordination of corporate income tax systems in the EU countries, see: G. Nicodème: *Corporate tax competition and coordination in the European Union: What do we know? Where do we stand?* Economic Paper 2006, No 250, European Commission.

[10] See: European Commission: *Tax Policy in the European Union – Priorities for the Years Ahead*, COM(01) 260 final and: European Commission: *Company Taxation in the Internal Market,* COM(01) 582 final.

[11] European Commission: *Taxation and Customs: Commission sets out actions to boost European competitiveness*, IP/05/1352, Brussels, 26 October 2005 and: European Commission: *Direct Taxation: The European Commission proposes an EU co-ordinated approach of national direct tax systems,* IP/06/1827, Brussels, 19 December 2006.

operating in more than one member state. The project implementation was a sort of test verifying purposefulness of its broader application and, at the same time, it was to improve conditions of the SME's functioning within the EU internal market.

4. Corporate income tax in the EU

Corporate income tax systems in the EU member states are considerably different, starting with the differences in tax rates (see Table 1).

Table 1. Adjusted top statutory tax rates on corporate income [a)] and corporate income tax in relation to GDP in the EU member states, %.

	Top statutory tax rates on corporate income							Corporate income tax to GDP ratio		
	1995	2000	2005	2006	2008	Difference 2008 -1995	Difference 2006 -1995	1995	2006	Difference 2006 -1995
Austria	34.0	34.0	25.0	25.0	25.0	-9.0	-9.0	1.6	2.4	+0.7
Belgium	40.2	40.2	34.0	34.0	34.0	-6.2	-6.2	2.3	3.7	+1.4
Cyprus	25.0	29.0	10.0	10.0	10.0	-15.0	-15.0	4.0	5.5	+1.5
Finland	25.0	29.0	26.0	26.0	26.0	+1.0	+1.0	2.3	3.4	+1.1
France	36.7	37.8	35.0	34.4	34.4	-2.2	-2.2	1.8	2.9	+1.1
Germany	56.8	51.6	38.7	38.7	29.8	-27.0	-18.1	0.9	1.4	+0.5
Greece	40.0	40.0	32.0	29.0	25.0	-15.0	-11.0	2.3	2.7	+0.3
Ireland	40.0	24.0	12.5	12.5	12.5	-27.5	-27.5	2.7	3.8	+1.1
Italy	52.2	41.3	37.3	37.3	31.4	-20.8	-14.9	3.3	3.0	-0.4
Luxembourg	40.9	37.5	30.4	29.6	29.6	-11.3	-11.3	6.6	5.0	-1.6
Malta	35.0	35.0	35.0	35.0	35.0	0.0	0.0	2.6	4.5	+1.9
Netherlands	35.0	35.0	31.5	29.6	25.5	-9.5	-5.4	3.3	3.7	+0.4
Portugal	39.6	35.2	27.5	27.5	26.5	-13.1	-12.1	2.4	3.0	+0.6
Slovenia	25.0	25.0	25.0	25.0	22.0	-3.0	0.0	0.5	3.0	+2.5
Spain	35.0	35.0	35.0	35.0	30.0	-5.0	0.0	1.9	4.2	+2.3
Eurosystem-15*	37.4	35.3	29.0	28.6	26.5	-10.9	-8.8	2.6	3.6	+1.0
Denmark	34.0	32.0	28.0	28.0	25.0	-9.0	-6.0	2.3	4.3	+2.0
Great Britain	33.0	30.0	30.0	30.0	30.0	-3.0	-3.0	2.7	3.9	+1.2
Sweden	28.0	28.0	28.0	28.0	28.0	0.0	0.0	2.6	3.6	+1.0
Bulgaria	40.0	32.5	15.0	15.0	10.0	-30.0	-25.0	...	3.6	...
Czech Republic	41.0	31.0	26.0	24.0	21.0	-20.0	-17.0	4.6	4.5	-0.1
Estonia	26.0	26.0	24.0	23.0	21.0	-5.0	-3.0	2.4	1.5	-0.9
Hungary	19.6	19.6	17.5	17.5	21.3	+1.6	-2.1	1.9	2.3	0.4
Latvia	25.0	25.0	15.0	15.0	15.0	-10.0	-10.0	1.8	2.3	+0.4
Lithuania	29.0	24.0	15.0	19.0	15.0	-14.0	-10.0	2.1	2.8	+0.7
Poland	40.0	30.0	19.0	19.0	19.0	-21.0	-21.0	2.7	2.4	-0.3
Romania	38.0	25.0	16.0	16.0	16.0	-22.0	-22.0	...	2.8	...
Slovakia	40.0	29.0	19.0	19.0	19.0	-21.0	-21.0	6.0	2.8	-3.2
UE-27**	35.3	31.9	25.5	25.3	23.6	-11.7	-10.0	2.0	3.0	+0.9

[a)] Existing surcharges and averages of local taxes are included.
*Eurosystem countries up to 2008; Slovakia has been a full member of the EMU since 1st January 2009. The ratio of corporate income tax revenues to GDP is calculated as the arithmetic average.
**The ratio of corporate income tax revenues to GDP is calculated as the weighted average.

Source: Author's own development on the basis of: European Commission: *Taxation Trends in the European Union*, Luxembourg 2008, p. 88 and 250.

The data included in the Table reveal a relatively insignificant role of corporate income taxes as a source of government budget revenues; in 2006 they accounted for 3% of GDP in the Union countries. It is noteworthy that reduced rates were accompanied by general increase in tax revenues in relation to GDP which resulted from broadening of the tax base, among others, by limiting the scope of tax reliefs and tax exemptions.[12]

With the existing tax base diversification, a tendency towards the tax base reduction is clearly visible, especially in the new member countries (except Malta). Seven of these countries (including Estonia where since 2000 the tax rate refers only to distributed profits, retained earnings are tax-free) impose tax rates below 20%. The process of rate reduction, particularly well-visible after 2000, has been an indication of tax competition, leading to their market-driven spontaneous harmonisation.

The rates included in Table 1 are basic rates, and consequently they do not take into account preferential rates used by many countries and applicable to selected sectors or economic subjects. Hence they cannot be the only basis for evaluation of the real (effective) tax burden. What is more, this real tax burden depends on the way the tax base is determined. Differences occurring in this respect among the member states concern, among others, the principles of fixed asset depreciation, intangible and legal asset depreciation, methods of inventory valuation, treatment of provisions and losses. Last but not least, the integration degree of corporate income taxation and taxation of dividends paid from this taxable income is different. The differences among the member states with respect to these issues are so significant that a simple comparison of tax rates does not allow us to assess attractiveness of a given country for a potential investor. It increases costs of compliance to the tax regimes of other countries and distorts competition conditions in the common market.

5. A project of taxing the income of small and medium-sized enterprises according to the principle of the Home State Taxation – premises and prospects of implementation

5.1. Situation of small and medium-sized enterprises in the single market

[12] In compliance with the spirit of the Code of Conduct for Business Taxation adopted by the EU Council on 1st December 1997 orientated to elimination of harmful tax competition.

Although obstacles resulting from different tax structures in the EU countries refer to all enterprises, they create a particular barrier to participation in the common market to companies from the SME sector. These firms constitute 99.8% of the total number of enterprises in the EU and provide 66% of jobs in the private sector. At the same time they operate mainly in domestic markets and do not take advantage of opportunities created by the internal market. It refers to all forms of internationalisation, but to the greatest extent, to capital investments – the establishment of a subsidiary, branch or joint venture abroad is only undertaken by 3% of EU-based SMEs. Costs of compliance to the tax systems of other countries are quoted as a cause of a particularly strong effect of tax barriers on the SME's cross-border expansion. In the case of SMEs compliance costs are disproportionately higher than in big enterprises, which results from a smaller scale of their operations. The second most important obstacle is related to the issue of consolidation of profits and losses made in different member countries. While big enterprises owing to tax planning and transfer pricing strategies are able to cover losses which are frequently unavoidable in the initial period of activity in a foreign country, the SMEs, as a rule, do not have such possibilities at their disposal. Taking into account their meagre capital resources, their access to the common market must be limited. Additionally, no possibility of cross-border settlement of losses worsens the position of the SME sector companies as subjects seeking external capital, where a barrier is an increased credit risk, naturally avoided by banks and other financial institutions.

Removal of tax obstacles for the SME intra-community expansion, would enhance effectiveness of their activities, and contribute to creation of new jobs and faster economic growth in the whole area of the Union. A way to achieve this goal could be the application of the Home State Taxation (HST) principle.

5.2. The essence of the HST concept

The concept of the Home State Taxation was developed by Malcolm Gammie and Sven-Olof Lodin[13] and then discussed in the forum of the European Commission within the framework of its work. Following public consultations conducted in 2003, the Commission put forward a proposal to test this concept in practice in the form of

[13] See: M. Gammie and S.-O. Lodin: *The taxation of the European Company,* European Taxation, 1999; M. Gammie: *Taxation issues for the European Company,* EC Tax Review, 1998, and M. Gammie and S.-O. Lodin: *Home State Taxation,* IBFD Publications, Amsterdam 2001.

a pilot project with the participation of the SME sector's companies.[14] Following further discussions in December 2005, the Commission accepted a communication concerning removal of tax obstacles for the SME sector activities in the internal market indicating HST as a recommended project.[15]

HST is based on the idea that the taxable profits of a group of companies (the parent company and its qualifying subsidiaries and permanent establishments in other participating countries) would be computed according to the tax rules of the parent company's home state. Thus determined tax base would then be allocated to the member states concerned according to the adopted apportionment formula and participating member states would then tax at its own corporate tax rate its share of the profits. In the current legal situation subsidiaries or a permanent establishments in another member state pay taxes as separate legal entities according to the tax regulations of the country in which they are located. This means, for instance, that if a subsidiary located in Poland indicates a loss in a given tax year, it can be deducted from its income in 5 subsequent years. If, however, the same subsidiary were in a group calculating its tax according to the HST principle, its loss would be consolidated with the profits made in the same tax year by other entities within the group.

As a result of the applied HST concept, transactions among the members of a group of companies located in different member countries, the hitherto stimuli "to shift profits" by means of the transfer prices would be weakened as the taxable income would be determined jointly for the whole group (according to the rules of the home state) and only then divided among members constituting the group.

In the proposed HST concept, the home state means the country of tax residence of the direct or indirect parent company, or of the company to which the permanent establishment belongs (head office), as appropriate. The host state means the country of tax residence of a subsidiary or a country in which the permanent establishment is situated. The Home State Group is a group of companies, or the company with permanent establishments, whereas the lead company in the Home State Group is a parent company or head office.

[14] European Commission: *Outline of a possible experimental application of Home State Taxation to small and medium-sized enterprises,* Brussels, 24 June 2004.
[15] European Commission: *Tackling the Corporation Tax Obstacles of Small and Medium-sized Enterprises in the Internal Market – Outline of a Possible Home State Taxation Pilot Scheme,* COM(05) 702 final; also: *Impact Assessment,* SEC(05) 1785.

Let us assume that the Home State Group consists of the parent company, located in state A (PA), subsidiaries located in states B (DB) and C (DC) and a sub-subsidiary in state C (DDC). Member state A is the Home State, member state B is Host State for DB, and member state C is Host State for DC and DDC. Company PA is the lead company.

Following multilateral agreements among states A, B and C concerning cooperation within the HST Project, the mechanism of its application could look as presented below.

PA calculates the joint taxable income of the group according to the tax regulations of the member state A. The tax base so established is then divided among the member states according to the adopted apportionment formula.[16] PA submits the tax return for the whole group in the member state A and pays the tax on its income share, DB self-assesses and pays tax in the member state B, whereas DC and DDC in the member state C.

According to above proposal, tax return would be submitted for the whole Home State Group by the lead company, in the Home State exclusively. Competent tax administrations of other countries to which the tax refers would receive only tax return copies together with relevant documents (such as a balance sheet, profit and loss account – as required by law and practice of the Home State). The information provided would have to be sufficient to determine other than income tax from legal persons profit-related taxes and surcharges (e.g. local taxes) which member states could still impose.

Joining the scheme would be voluntary for companies and would be based on bilateral or multilateral agreements between the member states. It could be done by temporary supplementing of existing double-taxation treaties or multilateral conventions, or by concluding a new multilateral convention.

Small and medium-sized enterprises might participate in the scheme. According to the EU's official definition of the SMEs, they are the companies with fewer than 250 staff, a turnover of 50 mln euros or less, and/or a balance sheet total of 43 mln euros or less. In order to avoid technical problems, the European Commission recommends that only the companies having a legal personality status should be embraced in the scheme.

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[16]European Commission recommends adoption of a „simple distribution key", for instance payroll share and/or turnover in particular jurisdictions. These quantities are easy to identify in accountancy and tax declarations; what is more, the combination of an input-related factor (payroll) with an output-related factor (sales) could diminish a possible formula arbitrariness.

What is more, it is recommended to exclude company groups which are subject to tax regulations specific for certain sectors of economy (for example, shipping, financial services, oil and gas trade and exploitation, agricultural activity).

Establishing whether a given company is in the Home State Group would be based on the regulations of the Home State concerning group taxation and the conditions defined in them (majority ownership requirement, financial control, etc.). As the company (parent or subsidiary) on no condition could be part of two different Home State Groups, member states should specify a generally applicable majority ownership requirement with a possible additional threshold, which would supplement or replace existing domestic thresholds, if these are lower.

The HST pilot scheme would run for 5 years and afterwards the final assessment of its functioning should follow. The decision to participate in the pilot scheme made by a company basically should be binding until the day of the project's completion.

5.3. Prospects of the HST scheme implementation

The aim of the project is remedying the tax obstacles for the SMEs cross-border activities. However the hitherto consultations of the European Commission services reveal clear and common skepticism of the member states concerning its shape and implementation possibilities.[17] Moreover, there is little or no knowledge about the opinion of those most concerned – namely the SME sector. Although the Commission in the formerly mentioned communication of 2005 notices „high interest [of the SMEs] for taking part in a possible pilot scheme", its conviction is based, among others, on the results of an anonymous survey conducted in 2004 which provided only 194 replies (including 168 from German companies).[18] 55 replies considered that the different existing business tax laws and arrangements within the internal market discourage businesses from expanding to another member state while 136 replies were not of this opinion. 99 respondents were interested in participating in a possible pilot scheme whereas 91 respondents were not.[19]

This skeptical (reluctant) attitude of member states towards the HST concept has several sources.

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[17] A manifestation of this is, for example, the fact that there is no information whatsoever on the official website of the Polish Ministry of Finance.

[18] As it is stated further in the Commission's communication, due to the negligible response to the questionnaire, results cannot be treated as statistically correct.

[19] See more European Commission*: Summary report on the replies received in response to the questionnaire on corporate tax as barrier to EU expansion of small and medium-sized enterprises*, Brussels, 18 January 2005.

Firstly, the issues of tax discrimination and unfair competition are raised. Companies subjected to different tax regimes would function in the same domestic market – depending on whether they qualify for the project, whether they decide to participate in it and on their home state.

Secondly, the HST concept does not eliminate entire compliance costs – the SME's decision about participation in the project would have to be preceded by an analysis of benefits resulting from such a decision, thus it would require a comparison of different characteristics of tax systems of the appropriate member states. Foreign sources of income (dividends, interests, etc.) from the third country or the one not participating in the project would be taxed according to the hitherto regulations which would require submitting of the tax return in the host country. Furthermore, existence of other than corporate income tax fiscal charges related to the domestic profit necessitate further adjustments. Last but not least, significant problems would appear in the case of mergers and acquisitions, resulting in a change of the home state or embracing entities located in the member states but not participating in the project.

The benefits of the HST application resulting from a possibility of profit and loss consolidation within a group depend on domestic regulations in this respect. The possibility is diversified, however, in the case of Belgium, Czech Republic, Estonia, Greece, Hungary, Lithuania and Slovakia, it does not exist. It means that the Home State Groups with a lead company in these countries would not enjoy such benefits.

It is very difficult to find an economically justified formula apportionment which member states could accept. Every accepted solution would exert an influence on tax revenues of the countries participating in the project and at the same time it would open new possibilities of tax planning in companies.

Without a doubt, it would entail increased costs of tax administration which, in the opinion of most member states, would exceed possible benefits of the project implementation.

6. Concept of the Common Corporate Consolidated Tax Base (CCCTB)

6.1. Maturing of the CCCTB concept

The CCCTB concept, after having been outlined first in 2001[20] and confirmed in 2003[21], was presented by the Commission in a non-paper of July 2004 at the meeting

[20] European Commission, *Company Taxation in the Internal Market,* COM(01) 582 final.

of the Ecofin Council in September 2004. Preparation of the document[22] was preceded by a letter which in May 2004 was sent to the Commission by the French and German Ministers of Finance. They requested the Commission to submit a proposal concerning common corporate consolidated tax base as soon as possible. What is more, German Minister of Finance pointed at the need to determine the minimum tax rate, whereas French Minister – N. Sarkozy – opted for relating the payments from the structural funds to the beneficiaries' tax policy. The Netherlands joined the advocates of the tax rate harmonisation (opting for the minimum rate of 20%). Swedish Prime Minister, G. Persson, gave his support as well. However, strong objections to such harmonisation were raised by Ireland, Great Britain, Poland, Slovakia, Latvia, Lithuania and Estonia.

In view of these objections the prepared non-paper emphasised the necessity to harmonise the tax base without interfering in the levels of rates applied by the member states. At the same time, predicting possible problems in achieving unanimity concerning the CCCTB, the document pointed at possibilities of using the so called enhanced co-operation mechanism, resulting from articles 43-45 of the EU Treaty. It enables undertaking a given integration project without the necessity of all member state participation in it (still, at least 8 countries have to participate). Consequently, the discussion during the Ecofin Council's meeting dealt with tax base harmonisation only. However, it did not bring about any decisions apart from the one about creating the work group for the CCCTB Project.

Further work and consultations resulted in the publication of reports (in April 2006 and May 2007) on the progress in the CCCTB principles formulation[23] and in July 2007 its preliminary outline was presented.[24] Laszlo Kovacs, EU Commissioner for Taxation, announced that in September 2008, during the French presidency, the Commission would present a project of the CCCTB directive to the Ecofin Council.

6.2. The essence of the CCCTB concept

CCCTB is based on the principle that the tax base for the subjects participating in the project (a company or a group of companies) will be calculated on the same basis

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[21] European Commission, *An Internal Market without company tax obstacles. Achievements, ongoing initiatives and remaining challenges,* COM(03) 726 final.
[22] European Commission, *Commission Non-Paper to informal Ecofin Council, 10 and 11 September 2004, A Common Consolidated EU Corporate Tax Base*, 7 July 2004.
[23] European Commission, *Implementing the Community Lisbon Programme: Progress to date and next steps towards a CCCTB*, COM(06) 157 final and European Commission, *Implementing the Community Programme for Improved growth and employment and the enhanced competitiveness of EU business: Further Progress during 2006 and next steps towards a proposal on the CCCTB*, COM (07) 223 final.
[24] European Commission, *CCCTB: possible elements of a technical outline,* CCCTB/WP057.

in every member country, which will enable consolidation of profits and losses made in different member states. Once the (consolidated) tax base is calculated (as a sum of tax bases in individual countries), then the aggregated tax base is divided between member countries according to the adopted formula apportionment. Next, the member states will apply national CIT rates to the their partial rates in this base. Adoption of the new taxation rules would be optional for eligible entities as an alternative to the hitherto rules of separate calculation of the tax base in individual countries.

This concept seems attractive as it reconciles the need for increased transparency of the tax system and lower costs of business activity (one tax base, regardless of the number countries in which a company or a group of companies operate, full consolidation of profits and losses, no problem of transfer pricing) at the same retaining autonomy of the member states in setting tax rates. However, attempts to draft detailed rules for the sake of implementation of this concept are immensely difficult not only from the technical and administrative points of view, but, what is more important, reveal new aspects of unfair competition and new factors potentially disturbing investment-related decisions of companies. They are indicated below after the current proposals of the Commission concerning CCCTB functioning have been discussed.

The project was addressed to the companies of the EU member states which are CIT payers.[25] A list of such companies and taxes would be an appendix to the prepared directive. The project could be also applied to companies from the third countries who pay such taxes in the EU.

Eligible EU companies may opt for the CCCTB; companies from the third countries may opt in on behalf of their permanent establishments[26] in the EU. Unless eligible companies are joining an existing consolidated group of companies, they may only opt with effect from the beginning of the tax year. The choice of CCCTB would be valid for 5 years with a possibility of renewing it for another 3 years unless notice to the contrary was given by the company. All companies within a group where each company is linked by at least more than 50% common ownership must either all opt for the CCCTB, or all remain outside the common base. In the situation in which the CCCTB group was joined by new companies, they must also opt for the remainder of the

[25] However, the project would not embrace financial institutions, whose specificity would have to be considered in the project.
[26]This would require a precise definition of the concept of „permanent location".

relevant period.[27] In the case the CCCTB company or group is taken over by another group which has not opted for the CCCTB, the CCCTB company or group option would remain in operation until the end of the validity period (after which the whole enlarged group must either all opt in or all opt out) with a possibility of choosing the CCCTB option by the subject taking over.

Taxation of incomes of the Union CCCTB taxpayers would apply to the whole income regardless of the place where it was earned (taking into consideration agreements eliminating double-taxation); in the case of taxpayers from the third countries, they would be subject to income tax on business income attributable to their permanent establishments in the Union.

It is assumed that within the consolidated CCCTB group there would be no withholding taxes or other source taxation. Yet, a doubt remains how to treat transactions between separate CCCTB taxpayers – maintaining such taxes would require introducing common rules on their structure, preventing double taxation and finally a division between individual countries. With reference to payments effected between the CCCTB payers and the taxpayers paying taxes in the traditional way (both EU residents and non-residents) the source taxation would still be governed by domestic law and international agreements.

As far as the tax base is concerned the project treats individual companies and groups of companies differently. A company may be a member of a group authorized to choose CCCTB on provision it has exceeded a 50% ownership threshold. This, however, would not be sufficient to be eligible for consolidation – in the consolidated CCCTB group, the ownership (direct or indirect) in subsidiaries would have to exceed 75%. A consolidated group would consist of a lead company headquartered in a member state (also if it was controlled by a lead company based in the third country), eligible subsidiaries and branches in other member countries. The group could also consist of subsidiaries in the EU member states controlled by a lead company from outside the EU, branches of the company from the third country in more than one member state, or a branch and a subsidiary of such a company in the member state. Thus for the sake of defining a group, it would be of no significance whether in the chain of ownership shares there are companies from outside the EU or not. For the

[27] Here it is necessary to regulate the situation when re-organisation of a group results in a different ownership structure – reduction of mutual capital shares to the level of ≤50%. Commission is of the opinion that resignation from the declared adoption of the CCCTB rule due to re-organisation should be excluded.

purpose of calculating the parent company's indirect ownership, individual stakes must be multiplied and the direct holding exceeding 75% would count as 100% (this would ensure that all controlled subsidiaries in the consolidated group – directly or indirectly – would be included in at least 75%). Conversely, a direct holding of 50% or less would count as 0 (this, in turn, would prevent including in a group of ineffectively controlled entities). The project includes also a proposal to solve the problems arising from a change in ownership shares in the course of the tax year which results in a change in the composition of the consolidated CCCTB group.[28] However, the said proposals reveal some technical complications and additionally make the already unclear shape of the proposal even more obscure.

The tax base would be calculated after adoption of a broad concept of income and would specify the rules of calculating tax deductible expenses, applicable tax exemptions and reliefs and fixed asset depreciation. Income and expenses during the tax year would be recognised on an accrual basis, with the adoption of separate (still unspecified) rules concerning long-term agreements. Other rules than the ones applied to consolidated companies are proposed for individual companies in the case of transactions with related companies (share capital above 20%), maintaining the arm's-length principle. A full consolidated tax base would be applicable within the consolidated group[29], which means that intra-group transactions would be tax neutral. The tax effect would be brought about only by transactions between the group and third parties. The group losses would be kept at the group level to be settled in future periods and not to be divided between group members; this, however, would have to occur together with the group's dissolution.

As far as the income earned abroad is concerned, a distinction was made in the project between the income earned within the EU and in the third countries. With reference to the income earned within the Union, it would be subject to consolidation (licence and patent-related dues, interests, dividends from portfolio investments and on account of the majority ownership exceeding 75%) or they would be tax exempt (dividends on account of majority ownership in the 10-75% bracket). The income earned in the third countries would be tax exempt (from permanent establishments or on

[28] An example here is the issue of the moment in which consolidation of the joining subject with the group and „deconsolidation" of the leaving subject with the group would occur, which would also influence the division of the tax base between individual states.
[29] If shares in a subsidiary amount, for example, to 80%, then consolidation covers 100% of the tax base. No compensation is planned for minority shareholders as companies of the entire group share its profits and losses.

account of majority ownership exceeding 75%); however if the corporate income tax rate in these countries was too low (below 40% of the average rate in the EU states), then tax reliefs would be applied. The reliefs would be applicable to dividends on portfolio investments as well as licence and patent-related payments and interests. It is noteworthy that the proposed solutions can be contradictory in relation to thevalid agreements on eliminating double-taxation, which makes implementation of the project more complicated.

As far a taxes and local charges are concerned, it is suggested that some of them (it has not been specified which ones) lowered the tax base after it had been divided between the member states.

The key aspect of the CCCTB concept is the method of determining the tax base formula apportionment with reference to member states. Despite the importance of this problem a discussion on this topic was started relatively recently. The Commission proposes taking into account production (supply) and demand factors of income generation in particular jurisdictions.[30] They would include a sales share, payroll share (and possibly employment share) and a share of assets. No weight of particular factors was proposed. The reason was that it is not a technical issue and it must be solved on the political decision level after having analysed different variance scenarios. In the meantime finding an economically justified formula apportionment which could be accepted by the member states is very difficult. Each accepted solution would affect the level of tax revenues of the states participating in the project,[31] and at the same time it would open new opportunities of tax planning in enterprises.

The issues concerning tax administration and the way of tackling disputes are hardly outlined,[32] thus it is difficult to decide if the idea of implementing one tax return submitted by a group in one country *(one-stop-shop approach)* is feasible .

Summary

According to the European Commission the HST concept is a realistic and efficient measure which could solve the tax problems of the SMEs in the single market, in particular, the problem of high compliance costs. However, in the hitherto discussions about the project, the member states were not very supportive of its

[30] See: European Commission, *CCCTB: possible elements of the sharing mechanism,* CCCTB/WP060.
[31]For example, adoption of the wage sharing factor reduces the tax base which would be calculated for the less affluent countries of lower wages, including Poland.
[32] European Commission, *CCCTB: possible elements of the administrative framework,* CCCTB/WP061.

implementation but pointed out a number of obstacles of legal, technical and administrative character and questioned economic benefits of its application from the point of view of both the SME sector companies and the countries being its potential participants.

Minimised obstacles would be possible only if project implementation was agreed between the countries of a similar tax base. However, in such a situation there would be no basis for a broader assessment of the HST usefulness as a method of increasing efficiency of the EU single market performance.

As the hitherto consultations of the European Commission services revealed a clear and common skepticism of the member states with reference to the HST concept implementation, as a result the CCCTB project has become a priority.

Although the Commission sustained the intention of presenting the CCCTB directive by the end of 2008, the date was not kept. The hitherto discussions in this area concerned general issues, whereas some detailed solutions – also the key ones like for example the formula apportionment, have not been formulated yet. Due to that, in the recent documents related to the CCCTB, the Commission indicated a possibility of using the comitology procedure,[33] enabling the Commission, after the directive has been accepted, to lay down the rules for the implementation concerning detailed solutions or their modification. Yet, most of the member countries protested against such a solution on the grounds that the directive should comprise all most essential elements of the CCCTB project.

Even if the date given had been kept, the consensus (concerning the CCCTB) would not have been reached. The fervent supporters of the concept are France, Germany, Spain, Italy, Austria and Benelux countries, yet seven countries are hostile to the idea. This means that CCCTB could function only within the framework of the so-called „enhanced co-operation" of at least eight countries.

Doubts and resistance in connection with the project have significant origins. Firstly, it infringes the rule of subsidiarity and autonomy in the sphere of the member state fiscal policy. Despite the declaration of the Commission not to interfere in the national tax rate levels, the countries of relatively low rates treat the tax base

[33] Council Decision of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission (1999/468/EC, OJ 2006 C255/4).

harmonisation proposal as a prelude to tax rate harmonisation by establishing a minimum rate, which would be higher than the one applied in these countries today.[34]

In practice, the project does not guarantee benefits associated with the tax base harmonisation – namely, increased tax system transparency, reduced business activity costs, and consequently, enhanced competitiveness of economy. The optional CCCTB would be the 28th tax system of corporate income taxation in the EU. In the "single market" one would encounter economic subjects following different tax regimes, depending on whether they qualify for the project and whether they decide to participate in it. Thus, new aspects of tax discrimination and unfair competition would appear. The decision about joining the CCCTB project – by definition irrevocable for 5 years - would have to be preceded by an analysis of costs and benefits of such a decision; it means it would require a comparison of the "national" and "Union" tax systems. Large companies possess sufficient human capital resources to make such comparisons, even by the trial and error method.

An important problem is the issue of how to calculate financial results from the perspective of the balance sheet and tax law in view of the existing diversity in member countries. The project does not assume the common use of the International Financial Reporting Standards (IFRS); the tax base would be calculated according to the national Generally Acceptable Accounting Principles. This means that even in the CCCTB project, the tax base harmonisation is not complete and significant differences between the member states would be maintained.

Any tax base formula apportionment between member states would open new possibilities of tax planning, no longer on the basis of transfer pricing but in the sphere of decisions concerning location of the manufacturing factors. No doubt, they would favour large companies at the expense of the small ones.

Lastly, apart from the obvious increase in the tax administration costs, project implementation would result in permanent disputes between the member countries in connection with their shares in the tax base.

Irrespective of the imperfections in the proposed harmonisation rules of the corporate income tax base in the EU, it is obvious that in order to ensure efficiency of the internal market, increased transparency and comparability of the tax systems used in

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[34] The Lithuanian Free Market Institute, in its petition against CCCTB argues that the Project is the first step toward a uniform tax policy in the EU, eliminating tax competition and reducing competitiveness of a group in global economy.

the member states is necessary. Tax base harmonisation would highlight differences in the tax bases contributing to better capital allocation, convergence (reduction) of tax rates, and eventually improved international competitiveness of EU companies and economies.

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