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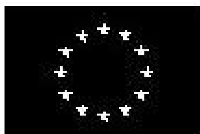

Directorate-General for Research

WORKING PAPER

Taxation in Europe: recent developments

Economic Affairs Series

ECON 131 EN

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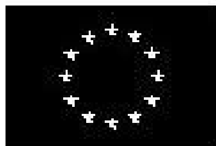

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Taxation in Europe: recent developments

ALICIA MARTINEZ-SERRANO AND BEN PATTERSON

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Preface

This Study updates three earlier papers in the Economic Affairs Series:

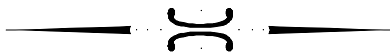
- Tax Competition in the European Union *(ECON 105, October 1998*);
- Tax Co-ordination in the European Union *(ECON 125, January 2001)*; and
- Tax Co-ordination in the EU: the latest position *(ECON 128, March 2002),*

All of these have been published by the European Parliament in English, French and German.

This text does not generally repeat material already covered in the previous publications, but analyses recent developments in a number of the fields covered: corporate taxation; the taxation of energy; the continuing negotiations on the taxation of interest; the taxation of motor vehicles; possible new proposals on the taxation of wine; and the OECD action against tax havens.

In addition, two new sections provide:

a) a detailed survey of how the main taxes are levied in the thirteen candidate countries and an examination of the possible effects of enlargement on taxation in the EU itself; and
b) an outline of recent tax reforms in the United States, and EU/US disputes in the field of taxation.



Summary and Conclusions

Introduction

The European Parliament gave its opinion on future taxation policy in the EU in a resolution adopted in March 2002. The report welcomed a degree of tax competition, which was *"not at odds with the completion of the internal market"*, and which had not led to any noticeable "race to the bottom". In addition, Parliament accepted that tax rates should generally remain the exclusive competence of Member States.

The report also, however, drew attention to a number of areas in which action at EU level was necessary:

- the removal of tax obstacles to the cross-border activities of European firms;
- rules preventing "improper conduct" in the context of tax competition;
- progress to the promised "definitive" VAT system, based on the origin principle;
- an agreed system for taxing energy on the "polluter pays" principle; and
- action to align the large number of bilateral tax agreements.

Corporate taxation

The report also commented on the recent Communication on Corporate Taxation, in which the Commission proposed several approaches for providing companies with a consolidated tax base for their EU-wide activities:

- Home State Taxation (HST).
- An optional Common Consolidated Tax Base (CCTB).
- A European Company Tax.
- A compulsory, fully Harmonised Tax Base.

In order to discuss these proposals, the Commission organised a conference in Brussels on 29 April 2002, which agreed that companies operating in more than one country should be taxed on the basis of a consolidated tax base. For smaller companies (SMEs), the preference was for HST; for larger, CCTB. The Commission announced that it was working on a pilot project covering SMEs and companies using the European Company Statute (*Societas Europeae)*. The project could initially be implemented in a restricted number of Member States which were favourable to the proposals.

One awkward finding of the Commission study was that if overall nominal tax rates were kept constant, a common tax base would tend to *increase* rather than reduce the dispersion in effective tax rates. Nominal rates were the most relevant tax driver affecting competitiveness, incentives to locate and financing decisions. Yet there was little support at the conference for the harmonisation of rates, or even a minimum rate.

The Commission study, however, was based on data from 1999. Since then most Member States have carried out significant tax reforms. Most have reduced statutory corporate tax rates, simultaneously broadening the corporate tax base, mainly through less generous depreciation allowances. As a result, corporate tax rates have converged over the last few years. The EU average corporate tax rate has fallen from 32.42% in 1999 to 29.32% in 2002, and dispersion has decreased by over 10%.

Two qualifying observations are nevertheless necessary.

- The way in which corporate tax systems develop in the future may depend to a considerable extent upon international developments. The ability of multi-national companies, in particular, to shift profits between jurisdictions argues for some general agreement on apportionment.
- The direction of recent tax reforms – a reduction of nominal rates combined with a broadening of the tax base – is not necessarily economically optimum. There are strong arguments for a system which exempts new capital formation from taxation.

Taxation in the candidate countries

In the last few years, most of the candidate countries have carried out significant tax reforms in order to comply with the main criteria for joining the EU. Nevertheless, on a number of specific technical issues they are not yet completely aligned with the *acquis*. The majority of countries have requested transitional measures.

There are currently wide differences between EU Member States and the candidate countries in every specific element of their tax systems, particularly in the cases of Personal Income Tax and Corporate Tax.

Personal Income Tax is applied at central government level in most candidate countries. In some cases these taxes are supplemented with one or several local taxes, though in the majority of countries personal income taxes at subordinate levels of government are either non-existent or relatively unimportant in terms of yield. Although Personal Income Tax rates at Central Government level are progressive in most candidate countries, Estonia, Latvia and Lithuania apply a flat rate. The maximum number of brackets is 6 and the average is approximately 3 brackets. The first positive rate is at its highest level in Lithuania (33%), and the lowest in the Slovak Republic (10%). The average minimum rate is 19.5%. Top marginal rates of Personal Income Tax levied by central government range from 25% in Latvia to 50% in Slovenia. The average maximum rate is 36.7%. Most candidate countries apply tax allowances; tax credits are applied only in Hungary and Turkey. Poland applies both kinds of tax relief. The most generalised method of giving relief is allowances for actual costs of certain work-related expenses and a standard non-taxable amount.

The many differences in Personal Income Tax between candidate countries and EU Member States are unlikely, however, to cause any distortions of competition in the labour market, nor in choice of workplace, except in the case of frontier workers.

In the field of ***corporate taxation***, the rates in candidate countries are lower than those applied by EU Member States. The average EU corporate tax rate is 29.3%, while the average corporate tax rate of the thirteen candidate countries, at 25.5%, is almost four percentage points lower. After a pending tax reform in Cyprus, which will come into force in January 2003 and when the rate will be reduced from 25% to 10%, the overall average will be even lower, at 24.4%.

There are also wide differences between EU Member States and candidate countries in every specific element of the corporate tax base.

One of the most important elements of the tax base is *allowance for depreciation*. While most EU countries apply the straight line method for buildings, and the option of straight line method or declining balance for machinery, most candidate countries only allow straight line for both: machinery and buildings, and only in some cases (e.g. Poland, Latvia, Malta) apply declining balance. Rates of depreciation also vary widely.

Some EU Member States allow a company to carry the amount of *trading losses* forward for a limited period (from 5 to 10 years); but for most countries the period is unlimited. Some countries allow the carrying back of trading losses (although most of them with certain limitations). Candidate countries allow the carrying forward for a period of no more of 5 years in most cases, with only Malta allowing an unlimited period. No candidate country allows the carrying back of trading losses.

In the *treatment of inventories*, there are also some differences, although an important number of candidate countries do not have specific rules, and usually apply generally accepted accounting principles. The main difference with EU Member States is that, while in EU countries the LIFO method (last input, first output) is allowed in most cases, in candidate countries only Slovenia applies this method.

These significant differences between Member States and candidate countries in the field of corporate taxation could add new problems to the process of tax co-ordination. In particular:

- The Commission's new strategy on the corporate tax base will probably be more difficult to implement.
- There will be a renewed downward pressure on tax rates.

As far as ***Value Added Tax*** is concerned, the majority of candidate countries have a regime similar to that of the EU – the average standard VAT rate in the thirteen candidate countries, at 19.1%, is only 0.2 points below the EU average. The standard rate of VAT in all but one candidate country is also above the EU statutory minimum rate of 15%. The exception is Cyprus; but here the standard rate will rise to 15% in 2003. The highest standard rate is 25% (Hungary). Most countries also apply one or two reduced rates, which range from the 12% applied in Hungary to the 1% applied on some products in Turkey, or the 3% applied in Poland. One country, Turkey, applies a higher rate for luxury goods.

In the field of ***excise duties***, the main problems will arise in the case of tobacco duties, where rates are generally lower than currently in the EU. Recent experience within the EU itself, moreover, shows that there is strong resistance to the harmonisation of rates, but also a serious problem of smuggling from low to high tax jurisdictions.

One general consequence of enlargement will be ***the increased difficulty of legislating on taxation***, since unanimity is generally required in Council. Therefore either:

- the Treaty should be changed to allow the use of weighted majority voting in certain areas of taxation, as suggested by the European Parliament (for example, on mutual assistance between tax authorities); or
- greater use should be made of "enhanced co-operation", which allows a subgroup of Member States to proceed with a policy opposed by a blocking minority.

The Taxation of Savings Income

Following the inter-governmental agreement at Santa Maria de Feira in June 2000, a revised Commission proposal on the taxation of savings income was published in the following year, based on the exchange of information system. Its final adoption, however, was conditional upon "equivalent measures" being introduced by a number of non-EU countries, notably Switzerland and the United States. Switzerland, although willing to introduce a withholding tax and to provide information on request in the case of tax fraud, would not agree to the automatic exchange of information, considering its bank secrecy laws "non-negotiable". Austria, Belgium and Luxembourg did not consider the Swiss proposals "equivalent".

Although the end-2002 deadline for adopting the Monti package – of which the taxation of savings measure formed a key element – was missed, ECOFIN reached a political agreement

on 21 January 2003. Subject to the conclusion of formal agreements with Switzerland, Liechtenstein, Monaco, Andorra and San Marino, these counties together with Austria, Belgium and Luxembourg would introduce withholding taxes on interest paid to non-residents from the beginning of 2004. The initial rate would be 15%, rising to 20% from the beginning of 2007 and 35% from the beginning of 2010. Other EU Member States would implement an automatic exchange of information system. This system would only come into effect throughout the EU if third countries, including Switzerland and the US, agreed to implement information exchange on request, as defined in the OECD agreement on the exchange of information on tax matters.

Any move to a full information exchange system would, however, require a unanimous vote in Council. Until then, the agreement in effect implies a return to the originally-proposed "coexistence model".

The Taxation of Energy

In 1997 the Commission proposed extending the existing system for excise duties on mineral oils by applying it to all energy products. Despite intensive discussions, however, no agreement on the proposal has so far been found.

The Commission has now made a new proposal on the taxation of diesel fuel, which would immediately raise the minimum rate of duty, and phase in a harmonised rate – estimated at €410 per 1000 litres – by 2010. The measures would end the distortion of the transport market caused by the existing large disparity in rates; and also produce an environmental gain as a result of reduced fuel consumption and an end to tax-induced journeys.

The UK would be required to reduce its rate of duty; other Member States would need to increase it.

The Taxation of Motor Vehicles

Motor vehicles are currently taxed in a number of ways:

- taxes on the purchase and/or registration of the vehicle;
- taxes on the possession or ownership of the vehicle (e.g. the *vignette*);
- taxes on the use of the vehicle (e.g. fuel duties, tolls, road-use charges, etc.)

The diversity of national systems means that there is no true single market for motor vehicles, either new or second hand.

In September 2002 the Commission therefore published a comprehensive strategy for the taxation of passenger cars. This would involve:

- the gradual abolition of registration taxes;
- meanwhile, a registration tax refund system for cars moved permanently between Member States;
- a switch to taxes on the use of vehicles, based on CO_2 emissions.

The Taxation of Alcoholic Drinks

Article 93 of the Treaty requires measures to harmonise excise duties where this is *necessary to ensure the establishment and functioning of the Internal Market.* Despite a number of attempts by the Commission, however, no agreement has been reached on the taxation of alcoholic beverages since the "Luxembourg agreement" of 1992 on minimum rates. The rate for wine was then fixed at 0%.

Disparities between Member States' rates, however, have given rise to substantial movements of products across certain borders, both legal (for own use) and illegal (for resale). The levels of tax on different products also vary. Two issues have therefore arisen:

- whether rates of duty on alcoholic drinks as a whole in the different Member States should be brought closer together; and
- whether the rates on the different products should be brought closer together, on the grounds that all alcoholic drinks are to some extent competing products.

A report on competition between alcoholic drinks was published by the Commission in February 2001. This found that competition between products was in fact weak; but that the minimum rates fixed in 1992 now required updating. So far, however, the Commission has not been able to agree on a new proposal, the introduction of a positive minimum rate on wine being the main bone of contention.

The OECD and Tax Havens

In 2000, the OECD's Forum on Harmful Tax Practices identified 47 possible tax havens outside the OECD Member States themselves. These were given a deadline of 28 February 2002 to commit themselves to co-operation with the OECD.

In April 2002 the resulting updated black list of "Uncooperative Tax Havens" was published. It contained only seven jurisdictions: Andorra, Liechtenstein, Liberia, Monaco, the Marshall Islands, Nauru and Vanuatu. Two OECD Member States, Luxembourg and Switzerland, have also consistently abstained on the OECD actions.

The non-OECD territories now have until the end of 2005 to abolish the practices identified as harmful. A model tax agreement has been drawn up, providing for bilateral or multilateral instruments. It has also been made clear that the blacklist is "dynamic": i.e. that jurisdictions which fail to live up their commitments will be placed back on the list, and that sanctions may be taken against them.

Meanwhile, major tax reforms have also been taking place in territories associated with, or dependent on, EU Member States: notably the Dutch Antilles, the Isle of Man and Gibraltar.

Taxation in the United States

In 2001 the US government initiated a process of major tax reforms. The "Economic Growth and Tax Relief Reconciliation Act of 2001", provided significant tax cuts, the largest since 1981. After the terrorist attacks of September 11th, the US government also proposed new measures to provide tax incentives for economic recovery. In December 2001, the House of Representatives passed the "Economic Security and Worker Assistance Act of 2001", which included most of these provisions. At the beginning of 2003 President Bush announced a new tax package, bringing forward tax reductions already announced, and abolishing completely the double taxation of stock dividends.

A number of high-profile American companies have recently renounced their corporate citizenship in favour of relocating off-shore – for example, in Bermuda – to avoid US taxes. This has prompted a series of proposals designed to prevent US-generated income being transferred off-shore. In July 2002 the US Committee on Ways and Means also developed a comprehensive package of tax reforms designed to improve the international competitiveness of the United States and its companies.

The US corporate tax system has, however, brought it into conflict with the EU. In August 2001 the World Trade Organisation found that that both the Foreign Sales Corporation and Extraterritorial Income tax structures constituted illegal export subsidies. This is only the

latest round in a dispute going back to the US Domestic International Sales Corporation (DISC) scheme, which was declared illegal by GATT in 1981.

The "American Competitiveness and Corporate Accountability Act" of 2002 is aimed at complying with the WTO decisions; encouraging companies to remain in the United States; and increasing the competitiveness of US companies in general.

Introduction: Parliament's View

The European Parliament's most recent resolution on general tax policy within the EU was adopted in March 2002[1]. As the *rapporteur* for Parliament's Economic and Monetary Affairs Committee, Benedetto Della Vedova, observed when introducing the debate, the Committee's report was, in particular, reacting to two Commission communications of 2001:

- on future priorities in general tax policy[2]; and
- on providing companies with a consolidated corporate tax base for their EU-wide activities[3].

It also commented on the earlier Commission "strategy to improve the operation of the VAT system"[4].

All three of these Commission documents are summarised in the previous study in this series, *Tax Co-ordination in the EU: the latest position* (ECON 128, March 2002).

The Della Vedova report, however, also dealt with the more general issue of **tax competition *versus* tax harmonisation or co-ordination** Though there had been competition between tax systems, observed the *rapporteur*, "*there is no sign of any 'race to the bottom'*". Tax receipts within the EU had risen steadily over the last 30 years, from 34.4% of GDP in 1970 to 45.5% in 2000. Nor had there been evidence of a trade-off between tax pressure on labour and that on capital[5]. There had, however, been a correlation between "*excessively high taxes and lack of economic growth*".

The resolution therefore stressed that "*tax competition is not at odds with the completion of the internal market*". It might "*in itself be an effective instrument for reducing a high level of taxation*"; and could help in attaining such objectives as a reduction in administrative burdens, increased competitiveness and modernisation of the European social model.

The report also dealt with the related issue of **how far action concerning taxation should be decided at EU level.** In principle, it stressed that "*the subsidiarity principle should guide EU taxation policy*" and that "*decisions on levels of tax must remain within the exclusive competence of the Member States*". Where action at EU level was undertaken, "*the principle of unanimity should be retained whenever tax bases or rates of taxation are at issue...*"

Nevertheless, the report also drew attention to a number of **a**

reas in which action at EU level was necessary. In particular:

- Increased efforts were needed "*to remove discrimination, double taxation and administrative barriers*". There was "*an urgent need for the Commission to tackle the main tax obstacles to cross-border activity by European firms*", which meant action on the fiscal treatment of intra-group transfer pricing, cross-border loss relief and cross-border flows of income between associated companies.

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[1] http://www3.europarl.ep.ec/omk/omnsapir.so/calendar?APP=PDF&TYPE=PV2&FILE=P5_TA(20020314) 0125en.pdf &LANGUE=EN.

[2] *Tax policy in the European Union - Priorities for the years ahead*, COM(2001)260, May 2001.

[3] *Towards an Internal Market without tax obstacles: a strategy for providing companies with a consolidated corporate tax base for their EU-wide activities*, COM(2001)582, October 2001.

[4] *Strategy to Improve the Operation of the VAT System within the Context of the Internal Market*, COM(2000)348, June 2000.

[5] See later in this study under "The Taxation of Savings Income. *Distortions of tax systems*".

- Tax competition had to take place "*in the context of rules preventing improper conduct"*. This implied support for a number of Commission initiatives. The tax package proposed by former tax Commissioner Mario Monti should be implemented as quickly as possible, and "*especially the removal of those rules which discriminate between residents and non-residents or leave loopholes for fraud and are thus incompatible with a single market".* Likewise, there should be support for the initiatives taken within the OECD to restrict "*the distortions produced by tax havens".*
- Progress towards a "*definitive VAT system which will apply, in full, the country-of-origin principle"* should be a priority, since there was a danger that *"the current system, which was originally a transitional one, is increasingly becoming definitive".* Measures to improve the current system were nevertheless welcome.
- The Council should adopt the framework directive on the taxation of energy products "*without delay".* The "polluter pays" principle should be applied more widely.
- *"A multilateral tax agreement for the EU"*, based on the OECD model tax agreement, should be framed to *"overcome the problems faced by companies and tax administrations in the light of the existence of over 100 very different bilateral tax agreements..."*

The report also supported a limited extension of qualified majority voting in Council *for decisions concerning mutual assistance and co-operation between tax authorities".* In any case, "*Parliament should be given co-decision powers in the taxation area".*

Company Taxation

The subject of a consolidated tax base for companies operating within the European Union is covered fully in Section I of this study. In particular, the Section analyses the results of the European Conference on Company Taxation, held in Brussels on 29-30 April 2002, at which representatives from business, governments and academia were able to comment on the new Commission strategy. The views of the Parliament, based on the Della Vedova report, were outlined at the conference by the *rapporteur* himself. They broadly supported the Commission's objectives.

> *"..[W]ith a view to reducing the legal costs of complying with 15 different tax systems and reconciling their existence with the internal market, it ought to be possible for EU companies with Community-wide operations – including those which in future are constituted as European Companies – to have a consolidated corporate tax base, or one calculated on the basis of a single set of rules, as well as a mechanism for distributing the consolidated tax base across the various Member States."*

Of the alternatives under consideration, Parliament was

> *"interested in the idea of Home State Taxation, perhaps as an intermediate stage in moving towards a common tax base",* understood as "*new harmonised EU rules, existing in parallel to national rules, available to European companies as an optional scheme."*

Parliament's report clearly implied that the desirability of such extensive reforms did not make any less urgent those measures to remove the particular obstacles to cross-border activity already noted. There is nevertheless some danger of "the best being the enemy of the good": i.e. that efforts to agree on an overall solution in terms of a consolidated corporate tax base will weaken efforts to arrive at more piecemeal solutions. This problem is added to the most politically contentious issue: whether it is desirable or possible to align Member States' *corporate tax base* without some alignment of *corporate tax rates.*

Some current EU taxation issues

Two other priorities of Parliament's report are also covered more extensively in Sections III and IV of this study: the long debate over the **taxation of interest**; and the Commission's proposals on **energy taxation**, including the most recent concerning excise duties on petrol and diesel fuel[6]. Section IV also covers two issues not directly raised in the Della Vedova Report:

- The **taxation of passenger cars** on which the Commission has recently published a Communication[7]. This outlines a number of *options for action at national and Community levels*, based on a study published in 1997[8].
- The level of **excise duties on alcoholic beverages**, on which the Commission has promised – but has so far not published – a new draft Directive. A key issue is whether the minimum rate of excise of wine should be increased from the current level of zero.

On this second matter, Parliament has over the years taken varying positions. In 1992 it called for all alcoholic beverages to be taxed at rates *proportional to the alcoholic strength*; but in 1997 advocated only that there should be no distortion of competition between different alcoholic beverages. In 2002, Della Vedova reported that Parliament

> *"does not agree with the Commission's policy with regard to duties on tobacco and alcoholic products, particularly with regard to upwards harmonisation through the constant raising of minimum taxation levels."*

Parliament, however, has only consultative powers in this field. In 2002 the Council was able to overrule the parliamentary rejection[9] of the Commission's proposal on tobacco excises.

The Candidate Countries and the International Dimension

Finally, this study looks at two subjects which go beyond the EU's internal tax policies. Section II examines the tax systems of the thirteen countries of Eastern and Central Europe and of the Mediterranean which are current candidates to become Member States of the European Union. Enlargement to include a number of these will probably take place in 2004; and is likely to have an important impact, particularly in the field of indirect taxation.

The last two Sections, nos. V and VI, cover recent developments at the international level. They update the survey, contained in *Tax Co-ordination in the EU: the latest position,* of measures within the context of the OECD to end "harmful tax competition" from both European and world-wide tax havens. Finally, recent developments in the corporate tax system of the United States are described, together with the implications of these for the European Union, and current EU/US disputes.

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6 *Proposal for a Council Directive [...]to introduce special tax arrangements for diesel fuel used for commercial purposes and to align the excise duties on petrol and diesel fuel*, COM(2002)410 of 24.7.2002.

7 *Taxation of Passenger Cars in the European Union*, COM(2002)431 of 06.09.2002.

8 *Vehicle Taxation in the European Union*, XXI/306/98 of 8 September 1997.

9 See reports for the Committee on Economic and Monetary Affairs – Rapporteur: Giorgos Katiforis – on the *proposal for a Council directive amending Directive 92/79/EEC, Directive 92/80/EEC and Directive 95/59/EC as regards the structure and rates of excise duty applied on manufactured tobacco products* (COM(2001), A5-0352/2001 of 16.10.2001; and A5-0016/2002 of 23.01.2002.

I. Corporate Taxation in the European Union

Introduction

Detailed proposals for the harmonisation of corporate taxation have existed from the earliest years of the European Community itself. The **Neumark Report**[10] of 1962 recommended that corporation tax systems should be harmonised along the lines of a split-rate system, with a lower rate of tax on distributed (i.e. dividends) than on retained profits. In 1970 the **Van den Tempel Report**[11] advocated a classical corporation tax system throughout the Community; and in 1975 the **Commission** itself tabled a proposal for a common partial imputation system, with rates within a band of 45-55%[12]. Finally, in 1992, the **Ruding Report**[13] recommended both substantial harmonisation of the corporate tax base and the harmonisation of tax rates within a 30-40% band. None of these ambitious proposals were acted upon.

However, at the end of 1998, the Commission was once again asked by Member State governments to prepare "*an analytical study of company taxation in the European Community"*. Two panels of experts were established, one academic and one from business and the trade unions. The resulting study – some 700 pages long, including Annexes – was released on 23 October 2001, with a Commission Communication "supplementing and building" on its findings. The documents were published in a single volume in early 2002[14], and were the subject of the Brussels Conference on Company Taxation in April.

The study: some comments

This latest, and very extensive, study covers a number of areas. It analyses differences in effective levels of corporate tax in Member States; examines whether the current application of company taxation in the Internal Market creates inefficiencies; and identifies a number of obstacles to cross-border economic activities in the Internal Market. On the basis of the quantitative analysis, it formulates a number of general conclusions:

- Effective corporate tax rate differentials are high inside the EU.
- The overall national nominal tax rate is the most relevant tax driver affecting competitiveness, incentives to locate and financing decisions.
- Introducing a common statutory tax rate in the EU would have a significant impact by decreasing the dispersion.
- If overall nominal tax rates were kept constant, a common tax base would tend to *increase* the dispersion in effective tax rates.

These conclusions – in particular the last two – are undoubtedly controversial, though confirmed by other studies in the past[15].

Nevertheless, in its comments, the Commission noted that:

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[10] *Rapport du Comité Fiscal et Financier*, EEC, 1962.

[11] *Impôt sur les sociétés et impôt sur le revenu dans les Communautés européennes*, Luxembourg, 1970.

[12] This was withdrawn in April 1990.

[13] *Report of the Committee of Independent Experts on Company Taxation, Commission of the European Communities*, Official Publications of the EC, ISBN 92-826-4277-1, March 1992.

[14] *Company Taxation in the internal market*, Office for Official Publications of the European Communities, Luxembourg, €31, 2002.

[15] See Baker and McKenzie (1999 and 2001), *Survey of the effective tax burden in the EU*, Amsterdam.

"these conclusions are the result of a static analysis, and it is possible that, in a dynamic context, the transparency associated with the harmonisation of the taxable base would induce a convergence of the statutory tax rates, thus implying a reduction in the dispersion of effective tax rates"; adding that

"there is no convincing evidence for the Commission to recommend specific actions on the approximation of the national corporate tax rates or the fixing of a minimum corporate tax rate….The level of taxation is a matter for Member States to decide, in accordance with the principle of subsidiarity."

At this point, and given that the Commission study is a static analysis using 1999 data, and does not assess the dynamic effects, it is necessary to take into consideration the most recent developments in the field of corporate taxation in the EU Member States.

Through recent tax reforms, most European countries have reduced statutory corporate tax rates, accompanying these measures with a simultaneous broadening of the corporate tax base – mainly through less generous depreciation allowances. Because of these recent changes, the dispersion in corporate tax rates between countries has been significantly reduced. In the last three years, Member States with corporate tax rates above the average (Germany, Belgium, Portugal, Netherlands, Italy, Greece) have reduced the rates, decreasing, therefore, their deviation from the European average (see Table 1). In most European countries, corporate tax rates are converging.

There is one exception, however, which requires special mention: Ireland. This country reduced the standard corporate tax rate from 24% in 2000 (which was already below the European average) to 20% in 2001. Effective from 1 January of 2002, the standard corporate tax rate has now been reduced from 20% to 16%, and from January 2003 this rate will be 12.5%[16]. If we calculate the dispersion through the standard deviation for all EU Member States, but *excluding* Ireland, we find that this indicator has decreased. If we *include* this data for Ireland, the standard deviation is higher.

[16] Although the current standard rate of corporation tax on trading income in Ireland is 16%, the rate of 125% is already applied to the trading income of small companies, which are companies with trading income not exceeding €254,000 euros (£I 200,000). A 25% rate applies to certain nontrading income, such as Irish rental and investment income. A reduction in the tax rate is available on income from the sale of goods manufactured in Ireland and from some service activities, giving an effective rate of 10%. In some cases, the rate of 10% also applies until December 2005 or December 2010. For more details concerning Irish Corporate Tax reform, see: Haccius, C. (2000), "The Irish corporation tax revolution", *Bulletin for International Fiscal Documentation*, vol. 54, no.3, pp. 122-132.

Corporation Tax in Ireland

Year	"Standard" rate %	"Cases III, IV and V" %	"ten per cent scheme"
2000	24	25	10
2001	20 and 12.5*	25	10
2002	16 and 12.5*	25	10
2003	12.5	25	0 (with exceptions at 10 until 2010)

* Under €254 000 trading income. Tapered relief above.

Table 1: STATUTORY CORPORATE TAX RATES IN EU MEMBER STATES

(1999-2002) Percentages (1)

	1999	2002	Variation (%)
AUSTRIA	34	34	0.00
BELGIUM	39	30 (a)	-23.08
DENMARK	32	30	-6.25
FINLAND	29	29	0.00
FRANCE	33.3	33.3	0.00
GERMANY	40	25	-37.50
GREECE	40	35	-12.50
IRELAND	10(b)	10(b)	0.00
ITALY	37	34(c)	-8.11
LUXEMBOURG	30	22	-26.67
NETHERLANDS	35	34.5	-1.43
PORTUGAL	34	30	-11.76
SPAIN	35	35	0.00
SWEDEN	28	28	0.00
UNITED KINGDOM	30	30	0.00
European average	32.42	29.32	-9.56
Standard deviation	7.29	6.55	-10.18

(1) Surcharges or local taxes are not included

a) *Taking into account the Corporate Tax reform announced by the Belgian government in September 2001. The standard corporate tax rate will be reduced from 39% to 33% and eventually to 30%..*

b) *In the case of Ireland,10% is taken as the effective tax rate for most companies.*

c) *The Italian government has recently approved the reduction of corporate tax to 34% for the next year.*

But, although the standard corporate tax rate in Ireland is 16%, most companies – those that receive income from the sale of manufactured goods and from some service activities – are taxed at an effective rate of 10%. This rate applied during the period 1999-2002. On the assumption of an Irish corporate tax rate of 10%, the dispersion of corporate tax rates in the European Union over the last four years has decreased by more than 10%.

In short, as a result of the last corporate tax reforms in Member States, the EU average of corporate tax rate has been reduced from 32.42% in 1999 to a 29.32% in 2002. Over the same period, the dispersion of corporate tax rates in the EU has decreased by over 10%. Moreover, taking into account ongoing tax reforms, statutory corporate tax rates will be reduced even further in the near future.

It can perhaps be argued that these trends constitute, in some measure, a "race to the bottom" (see next section). On the other hand, it is also true that – whether as a result of tax competition or deliberate co-ordination – the differences among countries in the case of the most relevant tax driver affecting competitiveness, incentives to locate and financing decisions, are steadily diminishing. Already by 2002, the main obstacle to cross-border economic activities in the Internal Market, identified by the Commission study on the basis of 1999 data study, has been significantly reduced.

The international context

A further important issue, however, concerns the direction taken by the national tax reforms. These indicate the existence of a discrepancy with policy recommendations. A reform of corporation taxation towards some form of neutral business taxation that leaves the return to

marginal investment untaxed (i.e. the switch to a cash-flow income tax, which leaves new capital formation untaxed) has long been advocated[17]. Most reforms, however, have been in the opposite direction.

According to Haufler and Schjelderup (2000)[18], one possible reason for the discrepancy between policy recommendations and actual corporate tax reforms may lie in the increasing internationalisation of national economies, in particular through the growing importance of multinational corporations[19]. In conditions of growing volumes of foreign direct investment (FDI), competition for "paper profits" causes Member States to distort their corporation tax structures in the direction of lower statutory tax rates, compensated for by a broadening of the tax base.

This creates a case for a *minimum* EU corporate tax rate, which could help to combat profit-shifting strategies by multinational firms. The Ruding Committee proposed this measure in its report in 1992. According to Haufler (1999)[20], the growing importance of transfer pricing in internationally integrated firms leads to highly elastic responses of paper profits to nominal tax rate differentials. A minimum EU corporation tax rate would prevent competition for profit tax revenues (Deveraux 1992)[21].

Nevertheless, multinational firms can avoid high EU corporate tax rates through profit shifting to other, low tax jurisdictions in which the firm operates. Multinational firms may react to tax harmonisation measures in Europe either by relocating production to non-member states (if they derive low firm-specific rents from locating in Europe) or by shifting profits to low-tax countries outside the Union. So it is possible for multinational firms to locate in

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[17] See Meade Committee (1978), *The structure and reform of direct taxation*, Institute for Fiscal Studies, London, and Sinn, H. W. (1987), *Capital income taxation and resource allocation*, North-Holland, Amsterdam. The switch to a cash-flow tax has also recommended as an alternative to the EU-wide harmonisation of corporate income taxes (Cnossen and Bovenberg (1997), "Company tax co-ordination in the European Union: Some further thoughts on the Ruding Committee Report", M.I. Bleijer and T. Ter-Minassian (eds), pp.164-178).

[18] Haufler, A. and Schjelderup, G (2000), "Corporate tax systems and cross country profit shifting", *Oxford Economic Papers* no 52, pp. 306-325. The paper analyses optimal taxation of corporate profits when governments can choose both the rate and the base of the corporation tax, constrained to collect a given amount of corporate tax revenue. This paper examines the effects of cross-border profit shifting on corporate tax systems and the tax rate cut *cum* base broadening reforms observed over the past decade. These may be motivated as an optimal policy adjustment to the rise in foreign direct investment. The authors conclude: when foreign direct investment is permitted and firms can shift profits between countries trough transfer pricing, it will be optimal for each government to distort investment decisions in order to reduce tax rates and limit the incentive for profit shifting.

[19] Multinationals corporations respond primarily to differences in statutory tax rates between countries (see: Deveraux, M.P. (1992), "The Ruding Committee Report: an economic assessment", *Fiscal Studies*, vol. 13, no 2, pp. 96-107, and Keen, M. (1993), "The welfare economics of tax co-ordination in the European Community: a survey", *Fiscal Studies*, vol. 14, no 2, pp. 15-36)).

[20] Haufler, A (1999), "Prospects for Co-ordination of Corporate Taxation and the Taxation of Interest Income in the European Union", *Fiscal Studies*, vol. 20. no 2, pp. 133-153. The paper evaluates the recent proposals for a co-ordinated capital tax policy in the European Union, focusing on an EU wide minimum withholding tax on interest income and alternative ways to increase the effective tax rate on corporate profits. The paper concludes that some aggregate efficiency gains can be expected from EU co-ordination proposals, but additional tax collections will be limited largely to the group of small savers while highly mobile large-scale investors are likely to avoid the EU tax.

[21] Deveraux, M.P. (1992), "The Ruding Committee Report: an economic assessment", *Fiscal Studies*, vol. 13, no2, pp. 96-107.

Europe and benefit from access to the Single Market as well as national infrastructures, but to avoid high EU corporate tax rates.

The problem is therefore wider. In the presence of world-wide mobility of tax bases, tax policy co-ordination at the EU level is not enough; it needs to be at an international level.

As some authors propose, a possible alternative, following the US example, could be to supplement the traditional arm's-length–pricing rule with the "comparable profits method". This regulation gives US tax authorities the right to correct corporation taxes on the basis of the profitability of comparable firms in the same branch over a longer time period. A more systematic solution would be an EU-wide application of formula apportionment (or unitary taxation), as currently employed by the US for firms operating in several States.

Proceedings of the Conference on Company Taxation

The Conference held in Brussels on 29-30 April 2002, to which the Commission invited several hundred representatives from business, government and academia, was intended to initiate a broad debate on the Commission's new strategy on European company taxation. The debate focused particularly on four general approaches towards providing companies with a consolidated tax base:

- home state taxation;
- a common consolidated base;
- a European company income tax; and
- a fully harmonised tax base.

These proposals are compared in Table 2.

The EU Tax Commissioner Fritz Bolkestein, when opening the conference, specifically related the issues at stake to the "Lisbon process".

> *"Without determined action on the tax front, the EU will fail to achieve its self-imposed objective of becoming, in this decade, the most competitive and dynamic knowledge-based economy in the world."*

Most of conference participants indeed agreed that there had to be some reform of Europe's corporate tax system. Company representatives in particular complained that European tax regimes had not kept up with the development of the Internal Market.

Benedetto Della Vedova, *rapporteur* for the European Parliament 's Economic and Monetary Affairs Committee on the Commission's Communication, sounded some notes of caution (see Introduction). But he also pointed out that the European Parliament resolution on this subject shared the opinion of the Commission in supporting the rapid removal of tax obstacles to the cross-border activities of European companies.

There was not complete agreement, however, on the best approach. A substantial body of opinion – basing itself on the work of the Stockholm Group[22] – supported the **Home State Taxation (HST)** option. This would be of particular benefit to SMEs, which would need to conform only to the domestic tax code with which they were already familiar. It obviated the need to devise a new, harmonised code; and accorded with the principle of subsidiarity. HST,

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[22] A group of individuals from both Europe and North America, which has met regularly since 1993 to discuss corporate tax issues. Its original proposal for a system of Home State Taxation, made in 1999, has been further elaborated since (see *Home State Taxation* by Lodin, S.O. and Gammie, M., IBDF Research Department, Amsterdam 2001).

moreover, did not need to be adopted by all Member States together. Groups of countries with similar tax codes might agree to adopt the scheme amongst themselves, applying existing practice to others.

Opposition to HST came from a number of participants. It was argued, in particular, that different firms competing in the same market would be applying different tax rules; and that it would lead to the relocation of firms in the most accommodating Member State, and to competition for tax bases.

The preferred solution for this body of opinion – almost certainly the majority – was the **Common Consolidated Tax Base (CCTB),** existing as an option for firms operating in more than one Member State. The tax base for all such firms would be identical; but the rates applied to the base would vary according to the proportion of turnover in each relevant Member State. The main advantages were:

- The compliance cost resulting from the need to deal with 15 tax systems within the Internal Market would be significantly reduced.
- Transfer pricing problems within a group of companies would end, at least within the EU.
- Profits and losses would, in principle, be automatically consolidated on an EU basis.
- Many international restructuring operations would be fiscally simpler and less costly.

The most frequently-raised objections to this option were that it involved the creation of a sixteenth tax base, in addition to the existing fifteen national codes; and that it allowed firms too much choice of code. A minority argued for a move, as soon as practicable, to a compulsory, fully harmonised tax base.

As the discussion developed, however, it became clear that these divisions of opinion were not as sharp as had at first appeared, and depended in part on the envisaged time-scale. Sven-Olof Lodin, one of the authors of HST, indicated that it could be the first step on the path to CCTB. Others believed that CCTB might begin as an option for firms operating in more than one Member State, becoming compulsory once experience had been gained in its application. There was also support for the parallel introduction of HST and CCTB: the former for SMEs for which operations in another Member State was only occasional or marginal; the latter for larger companies operating regularly in more than one Member State.

On a number of issues, however, the conclusions of the conference were less clear.

- Few of those attending were prepared to advocate the harmonisation of **corporate tax rates**, or even the application of **a minimum rate**. It appeared generally accepted that rates of tax were the sovereign responsibility of national governments and parliaments. This was despite the findings of the study, already referred to, that aligning the corporate tax base without aligning tax rates risked *increasing* divergence between Member States.
- For much the same reasons, few accepted the option of a **European Company Tax**, the revenue from which might help fund the EU Budget.
- Not much attention was devoted to the **revenue effects** of the different proposals for Member States. Experience from the past, however, indicates that such effects, however small, weigh heavily with national finance ministries.

There was some discussion, however, of the **"fifth option"**: that is to proceed on the basis of piecemeal reform. Here, one measure was singled out as being of crucial significance: enabling firms operating in more than one Member State to be able to consolidate profits and losses of their different subsidiaries.

Table 2: COMPARISON OF PROPOSALS ON COMPANY TAXATION

	HOME STATE TAXATION	COMMON CONSOLIDATED BASE	EUROPEAN COMPANY TAX	HARMONISED TAX BASE
Application	Optional	Optional	Compulsory or optional	Compulsory
No. of systems	Existing 15	Existing 15 plus new one	Existing 15 plus 1	Only one
Participation	All or some companies	All or some companies	All or some companies	All companies
Main Features	The tax base would be computed in accordance with the tax code of the company's home state (i.e. where the headquarter is based)	New harmonised EU rules for the determination of a single tax base on European level.	Originally conceived as a compulsory European Corporate Income Tax for large multinationals, could be an option.	To harmonise national rules on company taxation by devising a single EU company system as a replacement for existing national systems.
Advantages	Quick, simple and pragmatic rules	This could be the first step to achieve an harmonised tax base in the long term	The tax could be levied at the European level and could be a source of revenue for the EU	The most complete solution and the best option for improving the functioning of the Internal Market and the competitiveness of the European enterprises
	Politically feasible	Politically feasible		Higher transparency, efficiency and effectiveness
	Not require harmonisation of existing rules	Not require harmonisation of existing taxation rules		
Disadvantages	Competition for tax bases among the Member States	Specific and technical problems for achieving common taxation rules: a new tax code would have to be devised	Possible political problems for its approval	Higher political problems for achieving an agreement
	Complications related to its application across the member States	More complexity: multinationals would need to know the 15 existing rules plus a new one to choose the best option	Complexity: 15 existing rules plus a new one	

The Commission has not yet published its own conclusions from the Conference. It will publish details of its progress on EU company taxation in a new communication by the end of 2003. At the end of the Conference, however, Michel Vanden Abeele, Director General of Taxation and Customs Union, summarised the Commission's short- term plans to address tax barriers to the Internal Market; and its medium-and- long term plans for tax base consolidation (see Table 3).

Table 3: ACTION PLAN ON COMPANY TAXATION IN THE EUROPEAN UNION

SHORT TERM	Improve implementation of current Directives: the Merger Directive and the Parent-Subsidiary Directive
	Develop guidance on important European Court of Justice rulings on Member States' company tax and double taxation treaties and to co-ordinate, via appropriate Communications from the Commission, the implementation of these
	Present a proposal for a Directive to renew and improve the Arbitration Convention
	Prepare for a Communication on the issue of double taxation conventions of Member States with a view to the eventual conclusion of either a multilateral convention or an agreed EU model
	Explore the particular potential of a comprehensive company tax regime and of a consolidated corporate tax base for the EU-wide activities, determining the best way forward with the project
	Make sure that the current body of EU company tax law will be fully applicable to companies formed under the European Company Statute as from 2004.
MEDIUM TERM	Implement the strategy to provide companies with a consolidated corporate tax base
LONG TERM	It would be desirable to fully harmonise the tax base.

The Commission was working on a pilot project, on a transitional basis, for use by a limited number of companies: small and medium-sized enterprises (essentially HST); or the companies adopting the form of *Societas Europeae*[23] (essentially CCTB). This strategy might first be implemented in only a few Member States.

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[23] This company structure will allow corporate bodies to establish a European Company. It is a new legal instrument based on European Community law that gives companies the option of forming a European Company known formally by its Latin name of *Societas Europeae* (SE). An SE will be able to operate on a Europe-wide basis and be governed by Community law directly applicable in all Member States. The European Company Statute is established by two pieces of legislation: a Regulation establishing the company law rules (OJ L294, 10.11.2001, pp. 1-21) and a Directive on worker involvement (OJ L294 10.11.2001, pp. 22-32). The Regulation and Directive enter into force three years after their formal adoption.

Recent developments in the Member States[24]

AUSTRIA

The main tax measures recently enacted by Austrian government are:

- An additional deduction of 10% for research and development expenditures is introduced. This additional deduction is available for expenditures on operations that meet specified conditions. Companies generating tax losses may now apply for an award equal to 3% of research expenditures, which is credited to the tax account. The rules applicable to the additional tax deduction also apply to the award.
- *Advance Depreciation Deduction*: Construction expenditures that are incurred in 2002 and are capitalised in the cost of a building may be written off in advance at a rate of 7%.
- *Additional Tax Deduction for Training Expenditure*: The additional tax deduction for training expenditure is increased from 9% to 20%. Companies generating tax losses may now apply for an award equal to 6% of training expenditure, which is credited to the tax account.

All these measures are effective from January 2002.

On 17 December 2001, the Ministry of Finance released a new tax code simplifying the system for refunding Austrian withholding taxes under double tax treaties. The withholding taxes covered include those imposed on dividends, interest, royalties, capital gains and payments to certain taxpayers, including athletes, lecturers and artists. The code provides new tax forms that may be used by residents of treaty countries to obtain refunds of withholding tax imposed on income earned on or after 1 January 2002.

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[24] Tax developments described in this section are only in the field of Company Taxation in EU Member States in the last two or three years, and only the most significant measures have been included. Detailed description of how Corporate Taxes are levied in European countries can be found in earlier *European Parliament Working Papers* (See *ECON 105* and *ECON 125*). Several sources provide information in this section: the periodical publications: *World Tax Advisor* (Delloitte and Touche); *Tax News International* (Ernst and Young) and the following web pages:

- Bundesministerium für Finanzen (Austria): http://www.bmf.gv.at
- Ministère des Finances (Belgium): http://www.minfin.fgov.be
- Finansministeriet (Denmark): http://www.fm.dk
- Valtiovarainministeriö (Finland): http://www.vn.fi
- Ministère de l'Économie (France): http://www.finances.gouv.fr
- Bundesministerium der Finanzen (Germany): http://www.bundesfinanzministerium.de
- General accounting Office (Greece): http://www.mof-glk.gr
- Department of Finance (Ireland): http://www. irlgov.ie and Irish Revenue: http://www. revenue.ie
- Ministero delle Finanze (Italy): http://www. finanze.it
- Ministère des Finances (Luxembourg): http://www.etat.lu/FI
- Ministerie van Financien (Netherlands): http://www.minfin.nl and http://www.belastingdientst.nl
- Ministério das Finanças (Portugal): http://www.min-finanzas.pt and http://www.dgci.min-finanzas.pt
- Ministerio de Hacienda (Spain): http://www.minhac.es
- Finansdepartementet (Sweden): http://www.finans.geringen.se
- H. M. Treasury (United Kingdom): http://www.hm-treasury.gov.uk and Inland Revenue: http://www.inlandrevenue.gov.uk.

BELGIUM

In September 2002 the Belgian government announced a reform of corporate taxation which includes a significant reduction of tax rates. Corporate rates will be reduced in two phases. First, the standard corporate income tax rate will be reduced from 39% to 33%, (increased by the complementary crisis contribution, resulting in a global rate of 33.99%); then the rate will be cut to 30% (the complementary crisis contribution will then be done away with). The rates for small and medium-sized enterprises (SMEs) will be reduced from 28.84% to 24.25%.

To make the reforms budget-neutral, tax reductions will be accompanied by other measures:

- A reinforcement of the provisions regarding thin-capitalisation.
- A withholding tax of 10% on capital gains on shares if the company liquidates or if it buys its own shares.
- A modification of depreciation rules.

In December 2001 the government also announced the following measures:

- Amortisation of an asset in the year of its purchase *pro rata temporis.* As a result, amortisation of an asset for the year of purchase will be allowed only for the period in which the asset is actually used.
- Tax exemption for profits that are reinvested in fixed assets by small and medium-sized companies. The maximum amount of profits qualifying for the exemption will be €37,500 or 50% of taxable profits, whichever is less.
- The possibility to obtain a ruling for any transaction.
- Non-deductibility for tax purposes of certain regional taxes, including the environmental tax.

The reforms will probably enter into force in 2003.

DENMARK

On 7 February 2002 the Danish government presented draft legislation (Bill No. L 99) that was passed by the Danish Parliament on 17 May 2002.

One of the main changes is the reduction of the ownership requirement to receive tax-free dividends. Under existing law, Danish companies are exempt from tax on dividends received from their Danish and foreign subsidiaries.

Foreign parent companies are also exempt from Danish withholding tax on dividends received from their Danish subsidiaries if

- the recipient owns at least 25% of the share capital of the payer of the dividends; and
- the shares have been owned for a period of at least 12 months that includes the dividend distribution.

The 25% participation will be reduced to 20% and will apply to inbound dividends received by a Danish company from its subsidiaries as well as to outbound dividends paid by a Danish company to its (Danish or foreign) parent company. The new rules generally apply from 1 January 2002. The 20% threshold will apply to dividends declared from 1 January 2002.

The five-year limit for the carrying forward of losses has been abolished so that tax losses may now be carried forward for an unlimited time. This will apply to losses incurred in fiscal year 2002 and onwards.

Danish corporate tax rates have been reduced significantly over the last decade. Before 1991 the rate was 40%; in 1991 and 1992 it was 38%; in 1992 there was a further reduction to a 34%; then, after 1998, to 34%; and shortly afterwards to 32%. The current rate is 30%.

FINLAND

Effective from 1 January 2000, the corporate tax rate was increased from 28% to 29%. The withholding tax rate for dividends paid to non-residents was also increased from 28% to 29%. Tax treaties may reduce the domestic withholding tax rate. The tax rate is also increased from 28% to 29% for the following income received by individuals:

- dividends paid by listed companies;
- dividends paid by unlisted companies that are considered capital income; and
- interest income.

However, interest paid to non-residents is generally exempt from tax. The new tax rate affects distributions of 1999 profits under the Finnish imputation credit system. The distributing company is taxed at 28% tax rate and the tax credit available is calculated by using this rate (7/18 of the dividend); but for dividends received in 2000, the recipient is taxed at a rate of 29%. As a result, Finnish resident recipients of dividends paid out of 1999 profits pay tax at a rate of 1.4% on the amount of dividend received. Dividend income is normally exempt from tax as a result of the tax credit received. Effective for 2000 profits, the amount of tax credit is 29/71 of the dividend distributed, which corresponds to the tax rate of 29%.

FRANCE

The 2001 Finance Bill, enacted on 30 December 2000, introduced significant corporate income tax changes, including changes to the additional corporate surtax, the parent-subsidiary regime for dividends and the *avoir* fiscal (tax credit attached to dividends distributed by French companies). Under the bill, the additional corporate income tax surtax was reduced from 10% to 6% for fiscal years ending in 2001. This resulted in an overall corporate income tax rate of 35.33%, not including the 3.3% social surtax. For fiscal years ending in 2002, the surtax was reduced to 3%, for an overall corporate income tax rate of 34.33%, not including the 3.3% social surtax.

The bill also provided for a modification of the parent-subsidiary regime. Under previous legislation, 95% of dividends received by a French company were exempt if the value of the company's interest in the payer was at least FF 150 million or if the company's interest in the payer represented at least 10% of the share capital of the payer. The Finance Bill modified the conditions for benefiting from the 95% exemption. The FF 150 million criterion was eliminated and the percentage of shareholding required to qualify for the regime reduced to 5%. In the absence of any specific measure providing otherwise, these changes applied to fiscal years ending on or after 31 December 2000.

Under the bill, the *avoir* fiscal was reduced for companies that do not meet the conditions for the parent-subsidiary regime. Under previous legislation, the *avoir* fiscal for these companies was 40% of the dividend paid. It was reduced to 25% for an *avoir* fiscal used in 2001 and to 15% for that used in 2002. For individuals and companies qualifying under the parent-subsidiary regime, the *avoir* fiscal remained at 50%.

GREECE

The most important change in Greek corporate taxation in the last few years has been the reduction of corporate tax rate from 40% to 37.5% or 35% for resident corporations which are not quoted in the Stock Exchange (fiscal year 2002)[25].

GERMANY

With the adoption of the Tax Reduction Act by the *Bundestag* on 6 July 2000, the Tax Reform 2000 became reality. Following its approval on 14 July 2000 by the *Bundesrat*, the Tax Reduction Act entered into force on 1 January 2001 as scheduled. The resolution of the *Bundesrat,* calling for additional tax relief for SMEs to be included in the Tax Reform 2000, was followed by the German government by presenting the Supplementary Tax Reduction Act. Passed by the *Bundestag* on 10 November 2000, this Act was adopted by the *Bundesrat* on 1 December 2000. As a result, the additional components of the Tax Reform 2000 also came into effect on 1 January 2001.

One of the main elements of the Tax Reform 2000 was the reduction of corporation tax rates to a uniform 25% as from 2001.

As regards the taxation of dividends, the full imputation system is being replaced by the so-called half-income system to make cross-border investment within Europe more attractive. Under this system, only half of the distributed profits of a corporation will be included in the shareholder's personal income tax base. In return, it will no longer be necessary to credit the corporation tax paid by the company against the shareholder's income tax.

Capital gains from the sale of cross-corporation shareholdings will generally be exempted from tax. In order to prevent abuse, however, various restrictions will be imposed. Furthermore, under certain conditions, this provision will not apply to credit institutions and providers of financial services. The new rules enter into effect as from the 2002 tax year.

Private shareholders will be able to sell their stakes in corporations after a minimum holding period of one year without paying tax as before, unless they have a substantial interest. However, the threshold for what constitutes a substantial interest will be reduced from 10% to 1% as from 2002. If the sale is subject to tax – i.e. when shares are sold within the one-year holding period or represent a substantial interest – the half income method will apply.

Reforms were also introduced selectively benefiting unincorporated companies.

- Unincorporated companies will benefit from the significant cuts in income tax rates.
- Unincorporated companies deriving income from trade or business and subject to local trade taxes will see an additional reduction of their tax burden as the trade tax will be credited against their income tax liability in a standardised form. Their income tax will be reduced by an amount corresponding to 1.8 times the assessment basis for trade tax. The trade tax will still be deductible as operating expenditure. As a result of the mediation procedure, these provisions have been readjusted with respect to their precise objective in order to limit over-compensation. Below the line, however, the majority of companies will still be afforded full relief from trade tax.
- The tax allowance for the sale or closure of a business will be raised from approx. €30,680 to approx. €51,130 (from 2002: €51.200). Alternatively to the "one fifth rule", entrepreneurs retiring from business can now opt for the so-called "half-average tax rate".

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[25] See: IBFD (2002), *European Tax Handbook 2002*.

This provision entered into force as from the 2001 tax year and can be claimed once in a lifetime by entrepreneurs who have reached the age of 55 or have become permanently incapacitated. Retiring entrepreneurs thus have the option to have profits from the sale or closure of agricultural, business and professional undertakings and partnership shares taxed at the half-average rate.

- Company transfers and co-operations involving unincorporated SMEs will be facilitated by reintroducing the co-partner tax remission (§ 6 paragraph 5 of the Income Tax Law). This provision allows for a tax-neutral transfer of assets with undisclosed reserves and will help, in particular, unincorporated SMEs to cope with intergenerational succession.
- Advance depreciation provisions for new investment undertaken by SMEs – adjusted to the new depreciation conditions – will be retained. In the measures adopted to finance the reform, principal emphasis has been placed on restricting existing tax depreciation arrangements:
- The declining-balance tax depreciation rate for movable assets will be reduced from 30% to 20%.
- The depreciation rate for company buildings will fall from 4% to 3%.
- As from 2001, the official depreciation rate tables are based on more realistic useful life periods.
- The tax reduction for business income under Section 32 c of the Income Tax Law has ceased to apply. It has become irrelevant because of the new standardised trade tax imputation system.
- The rules on shareholder debt financing are reinforced with the aim of curbing abuse.

These measures are required to ensure sound financing of the far-reaching tax cuts and to strengthen the link between taxation and the economic capacity of the individual taxpayer.

The measures adopted in the short term are intended to benefit, in particular, small and medium-sized enterprises. As an additional component for small and medium-sized enterprises, a reinvestment reserve will make it easier for small and medium-sized partnerships to restructure their equity, providing relief of €650 million. In future, partnerships will be able to transfer profits from the sale of shares in corporations, up to a maximum of € 500,000, to new purchases of shares, but also to plant and depreciable movable assets. The reinvestment period is two or four years (for plant).

The tax environment for the restructuring of partnerships will, in addition, be further developed on the basis of the reintroduction of the so-called co-entrepreneur decree, and extended to real division as well as cases covered by Section 6b of the Income Tax Law. The law also contains provisions on the tax treatment of international transactions and the taxation of affiliated enterprises. The new provisions took effect from 2002.

In September 2002, after the floods in Central Europe, the German government announced the postponement of some measures of the Tax Reform planned to enter into force in 2003. The Corporate Tax rate was increased from the current 25% to 26.5%, for the fiscal year 2003, in order to finance the costs of repairing flood damage.

IRELAND

On 7 February 2002, the 2002 Finance Bill was published. In accordance with legislation that had already been enacted, effective from 1 January 2002, the standard rate of corporation tax was reduced from 20 to 16%[26]. The budget did not announce any changes with respect to either the 12.5% rate of corporation tax applicable to small companies earning trading income of less than €254000 in a year or the 25% rate applicable to non-trading income. From 1 January 2003 the standard corporation tax on trading income will be 12.5%.

Under ring-fencing rules for losses, introduced in the 2001 Finance Act, trading losses incurred in an activity subject to the standard rate or in a manufacturing activity could not be offset against profits taxable at the higher rate (that is, against income taxable at the 25% rate). The Bill provides that the relief will be available against other income on a value basis. These changes will apply to accounting periods ending on or after 6 March 2001.

The 2001 Finance Act provided for a reduction in the capital allowances write-off period from seven to five years for expenditure incurred on plant and machinery. The standard rate of VAT was increased from 20 to 21%, effective from 1 March 2002.

ITALY

The 2002 Finance act reintroduces the tax benefits regime, which allows companies to re-value business-related assets and share holdings if they pay a substitute tax on the potentially realisable capital gains resulting from the revaluation of the assets. The rates for the substitute tax are 19% for assets that may be depreciated or amortised, and 15% for other assets. The companies pay the substitute tax instead of corporate income tax and local income tax. The revaluation may result in the following tax benefits:

- The deduction of greater amounts of depreciation and amortisation with respect to the re-valued assets.
- Reduced capital gains on the transfer of the re-valued assets.
- Calculation of the 5% deduction for maintenance charges on the higher values of assets.

The Italian Parliament approved a new law containing a tax allowance called "Tremonti-bis" for new investments made by Italian companies and branches of non-resident companies. The allowance closely resembles the tax holiday "Tremonti" that was in force for tax years 1994 and 1995. The new tax allowance applies for years 2001 and 2002. Under the new law the allowance also applies to business training expenses. If the investment in new goods in a year is greater than the average investment amounts during the previous five years, a company may decrease its taxable income according to the following computation: tax allowance = (investment during that year – average of investments during the previous five years) x 50%.

The Budget Act 2003 proposes a reduction of corporate tax rate from 36% to 34%

LUXEMBOURG

The Luxembourg Parliament's 2002 Tax Reform Law of 21 December 2001

- reduced nominal corporate tax rates from 30% to 22%;
- reduced the Municipal Business Tax base from 4 to 3 percent, leading to an effective municipal tax rate down from 9.09 to 7.5 percent;
- reduced the effective corporate tax rate (overall tax rate) from 37,45% to 30,38%.

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[26] But see footnote 16 on page 20.

- reduced the domestic withholding tax rate for dividends from 25% to 20%.
- cut the proposed uniform withholding tax rate of 12% for all types of royalties to 10%;
- as a result of the decrease in the corporate tax rate, reduced the rate of the investment tax credit to a rate of approximately 12% of the acquisition price of qualifying assets.

The proposed measure regarding the rollover of capital gains derived from the exchange of shares or the conversion of a loan into shares in Luxembourg companies, EU companies and non-resident capital companies, was revised to provide that only shares in non-resident companies that are subject to a tax comparable to Luxembourg corporate income tax can benefit from this relief.

THE NETHERLANDS

In September 1999, draft legislation for the new Income Tax Act 2001 was submitted to the Lower House of the Dutch Parliament together with draft legislation governing its implementation. These bills represented the core of a major revision of the Dutch taxation system known as The Revision of Taxation 2001 process.

Both bills were accepted by the Lower House of the Dutch Parliament on 3 February 2000 and by the Upper House on 9 May 2000. The new Income Tax Act 2001 came into effect on 1 January 2001. The Income Tax Act 2001 contained many changes to the existing taxation laws, the most important being:

- introduction of the "box system"[27];
- introduction of the Investment Yield Tax;
- reduction of the rates in the existing taxation brackets;
- alterations to a number of deductions;
- personal allowances to be replaced by the Levy Rebate[28].

The standard rate of corporate income tax fell from 35% to 34.5%. A tax rate of 29% applies to the first €22,689 of taxable income (the lower rate was previously 30%).

PORTUGAL

The proposal for income tax reform presented by Portuguese government in December 2000 introduced major changes, particularly to prevent tax fraud and tax evasion. The Corporate Income Tax (IRC) changes included, among others, the use of *forfeitary* methods and deemed minimum income turnover taxation for small business, and new rules on the taxation of stock options, capital gains and group tax consolidation.

For dividends received, the proposal establishes a 100% participation exemption against the current 95% deduction in the following three situations:

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[27] From January 2001 there are three types of tax for taxable income. These types of income are brought together in three so-called boxes:

- Box 1: taxable income from work and home. The tax rate for income from box 1 is a rising scale with four brackets (from 32.35% to 52%);
- Box 2: taxable income from substantial interest. There is a fixed rate of 25%;
- Box 3: taxable income from savings and investments. There is a fixed rate of 30%.

[28] Under the Income Tax Act of 2001, the basic personal allowance has been replaced by the *heffingskorting* or Levy Rebate. This is in effect a discount on the amount of tax to pay. The Levy Rebate is independent of the incremental tax rate and comprises a general rebate together with a number of supplementary rebates.

- Dividends received by Portuguese resident entities from other resident entities if the recipients directly own 25% or more of the payer's capital and if their participation has been held for an uninterrupted period of at least two years or, if held for an insufficient period, the participation is held during the necessary time to complete that period. If this requirement is not met, a correction is assessed, without prejudice, for the tax deduction concerning international double taxation of the profits distributed.
- Dividends paid by entities from EU member countries to Portuguese entities, both of which qualify under the Parent Subsidiary Directive (PSD 90/435/EEC).
- Dividends paid by resident entities to Portuguese pure holding companies (*Sociedades Gestoras de Participações Sociais*) without any holding percentage or holding period requirement.

The 2002 Budget Law, which was approved as Law No. 109-B/2001 on 27 December 2001, introduced several significant tax changes, including a reduction in the corporate income tax rate. Key measures in the law, which is effective for tax years beginning on or after 1 January 2002, are summarised below.

- *Corporate Income Tax Rate*: The corporate income tax rate is reduced from 32% to 30%. Previously, the rate of 34% was reduced to 32%.
- *Offshore Companies*: The 2002 Budget Law introduced new measures to prevent entities resident in offshore jurisdictions from avoiding taxation in Portugal. If such companies hold real estate in Portugal that is not being leased or used for an economic activity, they are subject to tax on deemed rental income equal to 1/15 of the tax value of the real estate. However, this rule does not apply if the owner proves that the property is vacant and that it is not being used by an entity resident in Portugal. An existing separate law contains a list of offshore jurisdictions. Under the 2002 Budget Law, property owned by entities resident in a jurisdiction with a more favourable tax regime than Portugal is subject to municipal property tax at a fixed rate of 2%. The normal rates of this tax range from 0.7% to 1.3%.
- *Capital Gains of Non-resident Entities*: The 2002 Budget Law amended the tax exemption for capital gains derived by non-resident entities. The scope of the exemption is extended to include capital gains derived by non-residents on warrants and securities (equity and debt instruments) issued by Portuguese resident entities. The new law also provides that capital gains derived from the sale of equity interests in a Portuguese company by a non-resident entity are not exempt from tax if real estate represents more than 50% of the total assets of the company or if the Portuguese company is a holding or parent company and real estate represents more than 50% of the assets of a Portuguese subsidiary of the holding or parent company.

SPAIN

The Spanish government has announced a future reform to reduce corporate taxation. Some measures have in fact been adopted recently. On 28 September 2001, the Spanish government approved a package of tax measures focused on the improvement of small and medium-sized enterprises and the encouragement of private pensions. One of the measures adopted is the enlargement of the income amount, which is taxed at the reduced rate of 30%, from €3 million to €5 million.

The Budget Act 2002 (*Ley 23/2001 de Presupuestos Generales del Estado)* and the Finance Act 2002 (*Ley 24/2001 de Medidas Fiscales, Administrativas y de Orden Social)*) also provide several measures in the field of Corporate Taxation. The most significant are:

- The ten-year limit for loss carry-forwards has been increased to 15 years.
- The tax relief for expenditure on Research and Development is increased.
- New tax credit of 17% on capital gains taxation.
- The period limit for amortisation of goodwill will be 20 years instead of ten.

SWEDEN

Effective from March 2000, the Swedish government enacted new rules regarding repurchases of shares by quoted public companies. According to these rules, the repurchases must satisfy the following conditions:

- the fixed capital of the acquiring company must remain intact after the repurchase; and
- the shares repurchased may not exceed 10% of the company's total shares.

Under these rules, for resident shareholders, the amount of the payment received for the shares, less the acquisition cost, is treated as a capital gain; while for non-resident shareholders, the full amount received is treated as a dividend and is subject to Swedish withholding tax.

In order to correct distortions, and change a rule considered discriminatory toward foreign shareholders, new measures have recently been enacted, aligning Swedish Company Tax law to EU law. These rules, effective from January 2001, provide that a company from an European Economic Area (EEA) that is doing business in Sweden through a permanent establishment may qualify for a tax exemption with respect to dividends received from a Swedish company on shares connected to the permanent establishment if it satisfies the conditions that a Swedish company must satisfy to qualify for a tax exemption on dividends received from another Swedish company on business-related shares[29]. In addition, the right to credit or deduct foreign taxes is extended to foreign companies that are carrying out business in Sweden through a permanent establishment.

UNITED KINGDOM

The main measures in the UK Government's Pre-Budget Report of 27 November 2001 were:

- *Extension of starting rate band of corporation tax.* The 10% starting rate band of corporation tax was increased for the financial year beginning 1 April 2002 from the current level of £10,000 to .
- *Reform of the taxation of intellectual property, goodwill and other intangible assets.* Corporation tax relief is granted for intellectual property, goodwill and other intangible assets. Relief for newly-acquired assets will be given on a consistent basis, following the accounting treatment for amortisation of such assets in company accounts. Sales of intangible assets will be treated consistently as income (subject to a new tax relief for reinvestment).
- *Relief for company gains on substantial shareholdings meeting the following conditions:* a trading company or a member of a trading group disposes of shares in a trading company of a trading group; and a shareholding of at least 20% has been held throughout a 12-month period ending not more than 12 months before the disposal.

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[29] Shares are considered to be business related if they are fixed assets and if either of the following conditions are met: the shares represent at least 25% of the total votes of the company; or it is proven likely that ownership of the shares is attributable to the business carried out by the owner (the permanent establishment), or by companies related to the owner through ownership or organisation.

- *Research and development credit incentive for large companies*. This new incentive was announced in the 2001 budget but was finally included in the 2002 Finance Bill.

The 2002 Budget 2002 included further significant reforms of the corporation tax system in line with the key principles set out in the Pre-Budget Report. These included:

- A new regime for providing relief to companies for the costs of intellectual property, goodwill and other intangible assets to encourage business to take advantage of new opportunities in the knowledge-based economy.
- An exemption for capital gains and losses on substantial shareholdings to ensure that important business decisions on corporate restructuring and reinvestment are made for commercial, rather than tax, reasons. The main changes to the original draft legislation are that the percentage holding required to obtain the exemption is reduced from 20% to 10%, the threshold for a qualifying holding in a joint venture is reduced from 30% to 10%, and the requirement for joint venture partners to be companies is removed.
- A simplified and modernised regime for the taxation of corporate debt, derivative contracts and foreign exchange gains and losses.
- A new tax credit to boost research and development by larger companies.
- Changes to the taxation of foreign companies operating in the UK through branches.

The effective date for these measures was 1 April 2002.

At present, the UK government is considering further major reforms to the corporation tax system. It recently published a consultation document on Corporate Tax reform[30] in order to consult on further reforms and on the possible benefits that would arise from reducing differences between commercial profits and profits for tax purposes. Although the alternatives discussed in the document are only for consultation purposes, and no commitments for change have been made, the document provides interesting proposals and discusses the possibility of further reform in corporate tax, particularly in three main areas:

- *Taxation of gains and losses on capital assets*: the document sets out the possibilities for bringing the tax treatment of profits and losses on capital assets into line with their accounting treatment;
- *The Schedule System of calculating taxable income*: it discusses the effect of the schedular system as it applies within the current regime and how it might be rationalised;
- *Tax treatment of trading and investment companies*: it looks at the effect of the trading/investment distinction that features in many places in the existing regime, and it considers whether this distinction remains appropriate in the modern business world.

The consultation document also raises the issue of taxing groups on a consolidated basis, possibly as a reform subsequent to the main proposals.

[30] http:// www.inlandrevenue.gov.uk/consult_new/corporation_tax.htm For further details see Tomsett, E (2002), "UK Releases Additional Corporation Tax Reform Proposals", *World Tax Advisor*, September 2002.

II. Taxation in the Candidate Countries

Foreword

This section is focused on the main taxes applied in the thirteen candidate countries. First, an introduction about the enlargement covers the history of the process; describes the criteria which applicants need to meet, analysing especially those related to taxation; and covers the transitional arrangements.

Secondly, this study offers a current analysis of Personal Income Tax, Corporate Tax, Value Added Tax and Excise Duties in the candidate countries[31].

The section concludes with some reflections on the consequences of enlargement for the future of taxation in the European Union.

Background

The Copenhagen European Council in 1993 confirmed the legitimacy of the Central and Eastern European applications for membership. This marked the start of one of the EU's most ambitious projects in its history. In 1997 the Amsterdam European Council called for accession negotiations to begin in 1998.

Applications were received from ten countries; and negotiations got under way in March 1998 with a "first wave" of six countries: Cyprus, the Czech Republic, Estonia, Hungary, Poland and Slovenia. These were later joined by a "second wave" of five countries: Bulgaria, Latvia, Lithuania, Romania and Slovakia. In September 1998 Malta reactivated its application; and the Cardiff European Council launched the EU strategy to prepare Turkey for accession. In March 1999 the Berlin European Council reached agreement on the creation of new pre-accession financing instruments.

In December 1999 the Helsinki European Council reaffirmed the importance of the enlargement process, in which the 13 candidate countries (including Turkey) would participate on an equal footing. It also decided to convene bilateral intergovernmental conferences in February 2000 with a view to opening negotiations with Romania, Slovakia, Latvia, Lithuania, Bulgaria and Malta on the criteria for membership of the European Union and the corresponding Treaty changes that would be necessary. The European Council also announced the adoption of appropriate measures enabling the Intergovernmental Conference for revision of the Treaties to be officially convened in February 2000. The negotiations with Romania, Slovakia, Latvia, Lithuania, Bulgaria and Malta were officially launched on 15 February 2000.

In December 2000, the Nice Council ratified the institutional amendments required to enable the Union to receive those applicant countries that were ready from the end of 2002, allowing them to participate in the 2004 European elections

The Copenhagen European Council not only approved the principle of the EU's enlargement to embrace the associated countries of Central and Eastern Europe; it also defined the criteria which applicants would have to meet before they could join the Community.

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[31] This comparative analysis has been made using data from several publications: IBFD (2002) *European Tax Handbook,* and *Taxation and Investment in Central and East European Countries*; Ernst and Young (2002), *Worldwide Corporate Tax Guide, The Global Executive* and *Tax News International;* Deloitte and Touche (2002), *Central European Tax News* and *World Tax Advisor.*

These criteria concern:

- the stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities (the political criterion);
- the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the European Union (the economic criterion);
- the ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union (the criterion concerning adoption of the Community *acquis*).

Taxation

The economic criterion has probably been the key factor. As far as taxation is concerned, the EU *acquis* mainly covers indirect taxation, in particular the Value Added Tax (VAT) and excise duties regimes. In the case of direct taxation, the *acquis* is limited to legislation on corporate taxation and capital duty.

On the whole, candidate countries have an indirect taxation regime close to the EU's, although on a number of specific technical issues (e.g. exemptions, rate levels, tax refunds, etc.) they are not yet completely aligned with the *acquis*.

All candidate countries have requested transitional measures and a limited number of derogations, mostly in the field of VAT and excise duties. The level of rates is the most sensitive issue for candidate countries. The VAT rates they apply may differ from the levels determined by the *acquis*, and in most cases excise duty rates are considerably lower than in the EU. Governments fear the economic and social implications of significantly raising rates on – and hence the prices of – socially sensitive goods. All candidate countries have therefore requested transitional periods on specific goods or services, aiming at stretching the adjustment of rates over a longer period of time.

Some transitional periods limited in time (i.e. until not later than end-2007) are likely to be accepted: for example the maintenance of a reduced VAT rate on some categories of goods or services normally requiring the standard rate. However, as in the case of existing derogations (for example the UK's zero VAT rate) these will be conditional on the consequences for the proper functioning of the internal market being limited, and the social justification being clearly demonstrated.

The most sensitive issue to emerge is the excise duty on cigarettes. In the second half of 2001, in line with the accession "Road Map", the EU defined its position on requests for transitional periods on these excises, proposing transitional periods of up to three years. Since then, however, the EU itself has agreed measures significantly raising the minimum rates[32], a move which will have an additional impact on candidate countries. This has somewhat delayed provisional closure of the chapter with some countries.

In their negotiating positions, most candidate countries have declared that they accept and will apply the principles of the Code of Conduct for business taxation. The Commission is in the process of analysing the relevant legislation in candidate countries, with a view to identifying potentially harmful practices not in line with the Code of Conduct.

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[32] Council Directive 2002/10/EC of 12 February 2002 amending Directives 92/79/EEC, 92/80/EEC and 95/59/EC as regards the structure and rates of excise duty applied on manufactured tobacco.

Table 4: CANDIDATE COUNTRIES' TRANSITIONAL ARRANGEMENTS

COUNTRY	TRANSITIONAL ARRANGEMENTS
BULGARIA	Level of VAT turnover threshold for SMEs VAT exemption for international passenger transport Special excise regime for fruit growers' distillation for personal consumption Lower excise duty rates on cigarettes.
CYPRUS	Level of VAT turnover threshold for SMEs Zero VAT rate on foodstuffs, and pharmaceuticals Reduced VAT rate on restaurants VAT exemption for building land
CZECH REPUBLIC	Level of VAT turnover threshold for SMEs Reduced VAT rate on heating Reduced VAT rate on construction Lower excise duty rates on cigarettes until end-2006 Special excise regime for fruit growers' distillation for personal consumption
ESTONIA	Reduced VAT rate on heating Level of VAT turnover threshold for SMEs Lower excise duty rates on cigarettes Full alignment to the parent-subsidiary Directive
HUNGARY	Reduced VAT rate on heating Reduced VAT rate on restaurants Reduced excise rate for small-scale distilleries until end-2007
LATVIA (*)	Level of VAT turnover threshold for SMEs Lower excise duty rates on cigarettes VAT exemption for international passenger transport, royalties
LITHUANIA (*)	Level of VAT turnover threshold for SMEs Lower excise duty rates on cigarettes
POLAND (*)	Zero VAT rate on books Reduced VAT rates on restaurants Level of VAT turnover threshold for SMEs Lower excise duty rate on cigarettes
SLOVAKIA (*)	Reduced VAT rate on heating Reduced VAT rate on construction Reduced VAT rate on electricity, gas Level of VAT turnover threshold for SMEs Lower excise duty rates on cigarettes Special excise regime for fruit growers' distillation for personal consumption
SLOVENIA	Reduced VAT rates on construction works Reduced VAT rates on restaurants Level of VAT turnover threshold for SMEs

(*) Transitional arrangements requested

Source: European Commission, Directorate General for Enlargement (Slovakian Team) updated on July 2002.

Personal Income Tax

Personal Income Tax is applied at central government level in most candidate countries. In some cases these taxes are supplemented with one or several local taxes, though in the

majority of countries personal income taxes at subordinate levels of government are either non-existent or relatively unimportant in terms of yield.

Although Personal Income Tax rates at Central Government level are progressive in most of candidate, three countries, Estonia, Latvia and Lithuania, apply a flat rate. The maximum number of brackets is 6 and the average is approximately 3. The first positive rate is at its highest level in Lithuania (33%), and the lowest in the Slovak Republic (10%). The average minimum rate is 19.5%. Top marginal rates levied by central government range from 25% in Latvia to 50% in Slovenia. The average maximum rate is 36.7%.

Tax allowances are one of the most frequently-used ways of implementing standard tax relief. Allowances take the form of deductions from the income subject to tax, so that under progressive income tax schedules their value increases as income increases. Tax credits are lump-sum deductions from payable tax, so the value of tax credits is independent of the taxpayer's income level. Tax allowances and tax credits included in table 6 refer exclusively to basic relief available to all taxpayers and basic relief for earned income, under individual taxation.

Most candidate countries apply tax allowances, generally for the actual costs of certain work-related expenses and a standard non-taxable amount. Tax credits are only applied in Hungary and Turkey. Poland applies both kinds of relief.

Table 5: CANDIDATE COUNTRIES: CENTRAL GOVERNMENT INCOME TAX

(fiscal year 2001-2002)

Country	Number of brackets (a)	Maximum rate (%)	First positive rate (%)
BULGARIA	4	38 (b)	20
CYPRUS	3	40	20
CZECH REP.	4	32	15
ESTONIA	1	26	26
HUNGARY	3	40	20
LATVIA	1	25	25
LITHUANIA	1	33 (c)	33 (c)
MALTA	3	35	15
POLAND	3	40	19
ROMANIA	5	40	18
SLOVAK REP. (d)	5	38	10
SLOVENIA	6	50	17
TURKEY	6	40 (e)	15 (e)

(a) Excluding the zero rate as a bracket.

(b) The amendments to the Personal Income Act (2002) include a reduction in the top marginal rate from 38% to 29%, applicable to annual taxable income over BGN 12,000 (See *Central European Tax News*, February 2002, Deloitte and Touche, p. 13).

(c) In Lithuania, income earned at an individual's primary job with a Lithuanian company is calculated monthly and is taxed at a flat rate of 33%. The non-taxable minimum amount

established by the government is subtracted from the total before the tax rate is applied. Income earned from extra jobs in Lithuanian companies is taxed progressively at rates ranging from 10% to 35%. Income derived from foreign companies is taxed at 20%.

(d) In the Slovak Republic taxpayers may elect to apply special tax rates (ranging from 2% to 2.5%) if they meet the following conditions:

- Their only income is from agricultural production, forestry, water resources management or a trade (authorised business activity).
- Their income from the previous year is not more than Sk 1,500,000.
- They are not VAT taxpayers.
- They are not excise taxpayers.

From January 2002 tax rates and bands have been revised. They now range from 10% to 38% and there are five brackets. The former rates ranged from 12% to 42% and the number of brackets was seven. (See: *Central European Tax News*, February 2002, Deloitte and Touche, p. 37).

(e) In addition, in Turkey a surtax on income tax at a rate of 10% is applied to the tax on certain income other than salary income

Table 6: CANDIDATE COUNTRIES: PERSONAL INCOME TAX DEDUCTIONS

(fiscal year 2001-2002)

Country	Deductible expenses and other tax allowances	Standard reliefs (national currency)
BULGARIA	Yes (a)	BGN 1,200 (*)
CYPRUS	Yes (b)	5,000 CYP pounds (*) (c)
CZECH REP.	Yes (d)	CZK 38,040 (d)
ESTONIA	Yes (e)	EEK 12,000
HUNGARY	Yes (f)	No
LATVIA	Yes (g)	No
LITHUANIA	Yes (h)	Yes (i)
MALTA	No	Lm 3,000 (*)
POLAND	Yes (j)	Yes (j)
ROMANIA	No	Lei 1,273,000
SLOVAK REP.	No	SK 38,760 (k)
SLOVENIA	Yes (l)	No
TURKEY	Yes (m)	TL 262,8 million

(*) In these countries this is the amount taxed at 0%

(a) Deductions are permitted for properly documented expenses necessary to obtain business income. Gifts and donations to Bulgarian charities are deductible up to 5% of taxable income. Freelance workers and employees under civil contracts are allowed to deduct 35% of their income as expenses without providing documentation. Directors may deduct an allowance of 25% of directors' fees received without providing documentation.

(b) The range of deductible expenses allowed in Cyprus is limited. Professional tax paid to municipalities, membership fees for trade and professional organisations (if membership is mandatory), and undocumented charitable donations of up to £150 are allowed. If documented, charitable contributions up to £20,000 are fully deductible, and contributions in excess of £20,000 are 50% deductible.

(c) The following are the principal personal deductions and allowances in Cyprus:

- Interest payable on housing loans: £500;
- Rent relief (certain restrictions exist): £300;
- Contributions to social insurance and other approved funds: various;
- Life insurance premiums paid (certain restrictions exist): various;
- Husband or wife (apportioned if both have taxable income6:) £500;
- Each child under 16 years of age not receiving secondary education: £500;
- Each child receiving secondary education: £500;
- Each child receiving higher education in Cyprus: £1,500;
- Each child serving in the National Guard: £500;
- Old age (over 65 years of age): £1,500.

(d) Main non-standard tax reliefs are: charitable donations allowance and allowance for mortgage interest payments related to the purchase or improvement of housing. Basic relief for a single person is CZK 38,040. Taxable income is reduced by CZK 21,720 for a spouse living in the same household with the taxpayer. The personal deduction for each dependent child is CZK 23,520.

(e) Taxpayers may deduct the following expenses from employment income:

- Alimony payments made by a person required to pay alimony;
- Gifts to registered non-profit organisations and listed agencies of the state or local governments, up to 5% of taxable income;
- Educational expenses; and
- Interest paid on a loan to acquire an apartment or dwelling house.

(f) In Hungary deductions are applied as tax credits: The most important personal tax credits (expressed as a percentage of the applicable amount) for 2002 are as follows:

- Wage income 10%, up to a maximum of HUF 3,000 per month;
- Employee's contributions to mutual pension or health insurance: 30% up to a combined funds maximum of HUF 100,000;
- Income from intellectual activities: 25%, up to a maximum of HUF 50,000;
- Charitable contributions to foundations: 30%, up to a maximum of HUF 50,000;
- Increase of investments in certain qualifying securities: 20% up to a maximum of HUF 200,000;
- Life insurance and pension premiums: 20%, up to a maximum of HUF 50,000;
- Savings for a personal residence: 20%, up to a maximum of HUF 60,000;
- Repayment of loans used to acquire a personal residence: 20%, up to a maximum of HUF 35,000.

(g) In Latvia individuals may deduct the following expenses from the income reported on their tax returns:

- Contributions to private pension funds not exceeding 10% of taxable income;

- Medical expenses;
- Expenses for professional education;
- Income tax paid abroad may be credited against tax payable in Latvia up to 25% of the foreign income; and
- Donations to acceptable charitable organisations.

A parent may deduct LS 10.5 per child monthly.

(h) The following deductions from employment income are allowed in Lithuania:
- Certain insurance premiums;
- Business travel expenses within the amount specified by law;
- Certain charitable contributions; and
- Payments to pension funds up to 25% of the taxpayer's annual employment income.

(i) As of April 2000, the general non-taxable minimum amount applicable to both residents and non-residents is LTL 214 per month for income earned at a primary job in a Lithuanian company. For specific groups of taxpayers, including disabled persons and single parents, the non-taxable minimum amount is higher.

(j) A limited number of deductions and credits are allowed in Poland. A tax credit is available for certain expenses incurred by a taxpayer to renovate a private residence, contributions to scientific, charitable, educational, religious or cultural institutions, and expenses incurred to pay interest on a mortgage are deductible from income within certain limits. Small personal deductions or allowances may be taken in calculating income tax. The amount free from taxation in 2002 has been established as 2,727.16 PLN (See *Central European Tax News*, February 2002, Deloitte and Touche, p. 32).

(k) There is a basic relief of Sk 38,760 for a single person. An additional allowance of Sk 12,000 is given in respect of a spouse living in the same household, unless the spouse's own annual income exceeds Sk 38,760. Individuals receive personal deductions of Sk 11,400 (Sk 16,800 from 1 January 2002) for each dependent child.

(l) In Slovenia taxable income is reduced by the amount of social security contributions paid and by an amount equivalent to 10% of the average annual salary in Slovenia. In addition, the following deductions are available:
- 10% of the average annual salary in Slovenia for a dependent spouse; and
- 10% of the average annual salary in Slovenia for the first child (the deduction is increased by 5% of the average annual salary for each additional child).

(m) Specific work-related expenses are not deductible but a special tax credit is applied to all wage and salary earners. The basic requirement is to provide the appropriate invoice for five types of expenditures and to file a special expenditure deduction return. Base for the tax credit is 1/3 of expenses. Upper limit for the tax credit is 35 per cent of the tax base.

Corporate Taxes

There are many differences in the corporate tax systems operated by the candidate countries, including considerable variations in the tax rates and the tax base. In addition, there are, more specifically, differences in other aspects of corporate taxes. This chapter provides a brief summary of the key features of the systems.

Table 7: CANDIDATE COUNTRIES: CORPORATION TAX RATES

(fiscal year 2001-2002)

Country	Rate (%)
BULGARIA	15+10 (a)
CYPRUS	25 (b)
CZECH REP.	31
ESTONIA	26/74 (c)
HUNGARY	18
LATVIA	22 (d)
LITHUANIA	15 (e)
MALTA	35
POLAND	28 (f)
ROMANIA	25 (g)
SLOVAK REP.	25 (h)
SLOVENIA	25
TURKEY	30 (i)

(a) In 2001, the corporate tax rate was 20%, applied to companies with taxable profits of BNG 50,000 or more. Except for banks and other financial institutions, companies with taxable profits of less than BNG 50,000 were subject to tax at a rate of 15%. The municipal rate of 10% was imposed on the taxable profits of resident companies and branches of foreign companies. The municipal tax is a deductible expense for profits tax purposes. Effective from 1 January 2002, the profits tax rate is 15% for all companies regardless of the amount of taxable profit. The rate of the municipality tax remains at 10%. (For more details: *Bulgaria. 2002 Tax Changes*, Tax News International, June 2002, p.5).

(b) The government recently published proposals for a general tax reform, which will come into force before the end of 2003. One of the main changes is an important reduction in the corporate tax rate from 25% to 10%, a rate lower than that in any EU country (for more details see: Tailotis, A..(2001): *Cyprus: Tax Reform in Light of EU,* World Tax Advisor, Deloitte and Touche. December 2001).

(c) Resident companies and permanent establishments of non-resident companies registered with the Estonian authorities are not subject to tax on their income. They are subject only to tax at a rate of 26/74 on certain payments made for them: dividends, fringe benefits, gifts and payments not related to the business of the payer. A 26% rate applies to income derived by non-resident companies without a permanent establishment in Estonia.

(d) From January 2002 the tax rate is 22%. The tax rate will be gradually reduced to 15%: from January 2003 a 19% tax rate will be applicable to income for the fiscal year 2003, and from January 2004, the tax rate will be 15%. (See *Central European Tax News*, February 2002, Deloitte and Touche, p. 5).

(e) The normal profit tax rate in Lithuania was 24% in 2001. In 2002 the rate was reduced to 15%. A 13% rate applies for taxable income of small enterprises. (See *Central European Tax News,* February 2002, Deloitte and Touche, p. 8). A taxable profit that is retained for investment in capital assets is taxed at a rate of 0%. A 0% rate also applies to companies producing agricultural products and to specialised enterprises rendering services to agriculture, if such enterprises derive more than 50% of their sales from such activities.

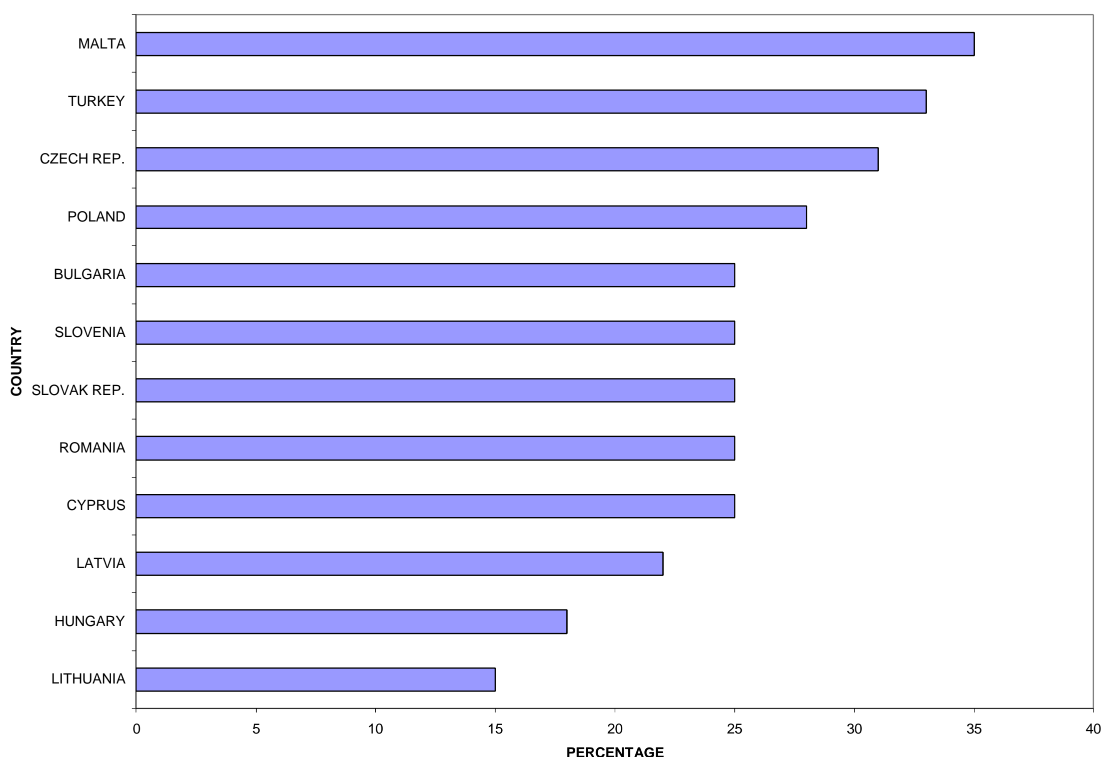
(f) The corporate tax rate in Poland has been reduced in the last few years from 34% in 1999 to 30% in 2000 , 28% in 2001, and it will be reduced to 24% in 2003 and 22% in 2004.

(g) The standard corporate income tax rate in Romania is 25%, and effective from 1 January 2002 the reduced rate of corporate profits tax imposed on income from export transactions is increased from 5% to 6%. (See *Romania. Recent Tax Changes*, Tax News International, March 2002, p. 16).

(h) In the Slovak Republic, the corporate income tax rate is reduced from 29% to 25% for tax years beginning on or after 1 January 2002 (See *Slovak Republic. Corporate Income Tax Amendments*, Tax News International, June 2002, p. 15).

(i) Companies in Turkey are subject to corporation tax at a rate of 30% and a 10% surtax is levied on the corporate income tax.

Figure 1: CANDIDATE COUNTRIES: CORPORATE TAX RATES



(fiscal year 2001-2002)

Structure of corporation tax rates

All candidate countries levy corporation taxes at the central government level, and only Bulgaria applies a tax at the local level. The rates vary from 15% (Lithuania) to 35% (Malta). In Estonia resident companies and permanent establishments of non-resident companies registered with the Estonian authorities are not subject to tax on their income. They are subject only to tax at a rate of 26/74 on certain payments.

Corporation tax base

Taxable income is calculated in similar ways under the different tax regimes. Income arising from all sources, including non-business income as well as business or trading income, is normally included in the base. Taxable income is computed according to sound commercial accounting practice, and is generally based on the profits shown in the company accounts. In order to arrive at the profit for tax purposes, some adjustments are often required by statute.

The general rule is that expenses incurred in earning taxable income, and in maintaining the assets used in the company's activities, are deductible.

In some countries there are measures that have the effect of correcting for inflation. This may be relevant to three aspects of the measurement of the tax base:

- the depreciation system;
- capital gains taxation; and
- the treatment of stocks.

In order to tax real income, capital gains in most of countries are partly exempt. Depreciation rules and rates may be favourable (accelerated depreciation). As regards the treatment of stocks, the use of the LIFO (last input, first output) method in some countries provides some adjustment for the impact of inflation on the cost of stock replacement.

Treatment of losses

All countries allow a company to carry the amount of trading losses forward, and no one allows a carry back of trading losses. The number of years over which trading losses can be carried forward ranges between five years (in most of them) and indefinitely (only in Malta).

Depreciation allowances

An allowance for the depreciation of assets is given in all countries. A variety of systems is used in different countries, the most frequent being straight-line depreciation (equal allowances over a number of years) and declining balance. In the latter case the actual allowance will be larger in the initial year and gradually diminish in subsequent years.

Machinery is generally depreciated through the straight-line method, except in Latvia and Malta, which use the declining balance method. In Poland and Turkey taxpayers have a choice of depreciation method, and in the Czech and Slovak Republics companies may elect to depreciate assets using the straight-line or the accelerated method.

For **buildings** the straight-line method is also the more common way of depreciation. Latvia is the only country where buildings are depreciated using the declining balance method, and in Turkey taxpayers may elect the method. Some countries allow accelerated depreciation: this is the case in the Czech and Slovak Republics, and in Romania, where it is only allowed in some exceptional cases and under certain restrictions.

Table 8: CANDIDATE COUNTRIES: TREATMENT OF TRADING LOSSES

(fiscal year 2001-2002)

	Carry forward (maximum years authorised)	Carry back (maximum years authorised)
BULGARIA	5 (a)	Not allowed
CYPRUS	5 (b)	Not allowed
CZECH REP.	7	Not allowed
ESTONIA	Data not available	Data not available
HUNGARY	5 (c)	Not allowed
LATVIA	5 (d)	Not allowed
LITHUANIA	5	Not allowed
MALTA	Unlimited	Not allowed
POLAND	3 or 5 (e)	Not allowed
ROMANIA	5 (f)	Not allowed
SLOVAK REP.	5	Not allowed
SLOVENIA	5	Not allowed
TURKEY	5	Not allowed

(a) Banks may carry forward losses for 10 years.

(b) With the tax reform announced by the government in Cyprus, the five-year limit on the carryforward of losses would be abolished and losses would be available for setoff against future profits without any time limit. (See Tailotis, A. (2001): *Cyprus: Tax Reform in Light of EU,* World Tax Advisor. Deloitte and Touche. December 2001).

(c) In Hungary losses incurred during the first four years of a company's existence may be carried forward indefinitely.

(d) Liepaja or Rezekne special-economic zones: losses may be carried forward for 10 years.

(e) Losses from one source of profits may offset income from other sources in the same fiscal year. Effective from 1 January 1999, losses incurred in fiscal years beginning after 31 December 1998 may be carried forward for five consecutive years to offset profits derived in those years from all sources. Up to 50% of the original loss may offset profits in any of the five fiscal years. If a loss is incurred in a fiscal year beginning in 1998, it may be carried forward three consecutive years to offset profits in each of the three years.

(f) In Romania losses incurred in foreign activities are not deductible in the year incurred and may not be used in future years.

Table 9: CANDIDATE COUNTRIES: DEPRECIATION SYSTEMS

(fiscal year 2001-2002)

	Method of depreciation		Rate of depreciation (%)			
			Machinery		Buildings	
	Machinery	Buildings	SL	DB	SL	DB
BULGARIA	SL	SL	20		4	
CYPRUS	SL	SL	10		3-4	
CZECH REP.	SL/AD	SL/AD	(a)	(a)	(a)	(a)
HUNGARY	SL	SL	14.5		2-6	
LATVIA	DB	DB		20-70		10
LITHUANIA	SL	SL	(b)		(b)	
MALTA	DB	SL		20 (c)	2 (c)	
POLAND	SL/DB	SL	5-20	2xSL	1.5-10	
ROMANIA	SL	SL	(d)		(d)	
SLOVAK REP.	SL/AD	SL/AD	(e)	(e)	(e)	(e)
SLOVENIA	SL	SL	33.5		5	
TURKEY	SL/DB	SL/DB	20	(f)	2-10	(f)

Symbols: SL: straight line; DB: declining balance; AD= accelerated depreciation.

Note: Data from Estonia are not available.

(a) In the Czech Republic taxpayers may elect to depreciate assets using the straight-line or the accelerated method. The method chosen does not affect the period of depreciation. Under the accelerated method, depreciation for the first year is calculated by dividing the cost of the asset by the applicable coefficient. For subsequent years, accelerated depreciation is calculated by multiplying the depreciated value of the asset by two and then dividing by the applicable coefficient, which is reduced by the number of years for which the asset has already been depreciated. For heavy machinery the period is 12 years, and the straight-line rate is 4.3% for first year and 8.7% for subsequent years, and the accelerated coefficient is 12 for the first year and 13 for subsequent years. For buildings the period is 30 years, the straight-line rate is 1.4% for the first year and 3.4% for subsequent years, and the accelerated coefficient is 30 for first year and 31 for subsequent years.

(b) Companies in Lithuania may establish the depreciation rates, subject to maximum norms set by the Ministries of Finance and Economy. These norms establish the minimum number of years over which assets may be depreciated. For plant and machinery the minimum period for depreciation is 3 years, and for industrial buildings this period is 10 years. Companies also may select the unit method. Under this method the amount of depreciation depends on the amount of products manufactured or services rendered.

(c) Under the Business Promotion Act, effective from 1 January 2001, qualifying companies may benefit from investment allowances and accelerated rates of depreciation on assets that are first used in Malta. The accelerated rate for plant and machinery is 33.33% and for industrial buildings is 5%.

(d) Assets may be depreciated using the straight-line method over their statutorily prescribed useful lives. These useful lives are from 4 to 10 years for plant and machinery and from 10 to 50 years for buildings and constructions.

(e) As well as in the Czech Republic, in the Slovak Republic taxpayers may elect to depreciate assets using the straight-line or the accelerated method. For heavy machinery the period is 15 years, and the straight-line rate is 3.4% for the first year and 6.9% for subsequent years, and the accelerated coefficient is 15 for the first year and 16 for

subsequent years. For buildings the period is 40 years, the straight-line rate is 1.5% for first year and 2.5% for subsequent years, and the accelerated coefficient is 40 for first year and 41 for subsequent years.

(f) Under the declining balance method, the Ministry of Finance may allow rates higher for certain types of assets. A company may change from the declining balance method to the straight-line method, but the reverse change is not permitted, at any time during the life of a fixed asset.

Treatment of inventories

A variety of methods is used to value stock for tax purposes. An important number of candidate countries (Bulgaria, Estonia, Hungary, Poland, Romania, Turkey) do not have specific tax rules for the valuation of inventories; they usually apply the generally accepted accounting principles. Inventories can be valued according to the FIFO (first input, first output) method in Cyprus, Slovak Republic and Slovenia. The LIFO (last input, first output) method is only allowed in Slovenia. In the Czech Republic and Malta inventories may be valued at the lower of cost or net realisable value, and Cyprus also allows this method. In Latvia and Lithuania inventories are valued at actual cost, and the Slovak Republic and Slovenia also allow the average cost method.

Capital Gains Taxes

In most countries capital gains are included in taxable income and taxed at the regular corporate tax rate, and no separate capital gains tax is imposed on companies. Four countries – Bulgaria, Estonia, Hungary and Latvia – distinguish between non-resident companies, with or without permanent establishments, and resident companies.

The rates vary in the candidate countries betweeen 2% (in Latvia, but only for non-resident companies) to 35% (Malta). In Estonia capital gains derived by resident companies and permanent establishments of non-resident companies registered with the Estonian authorities are exempt from tax. In Hungary capital gains derived by foreign companies without a permanent establishment in Hungary are exempt from Hungarian tax.

Table 10: CANDIDATE COUNTRIES : CAPITAL GAINS TAX RATES

(fiscal year 2001-2002)

Country	Rate (%)
BULGARIA	15-20 (a)
CYPRUS	20 (b)
CZECH REP.	31 (c)
ESTONIA	0-26 (d)
HUNGARY	0-18 (e)
LATVIA	2-22 (f)
LITHUANIA	24 (g)
MALTA	35 (h)
POLAND	28
ROMANIA	25
SLOVAK REP.	25
SLOVENIA	25
TURKEY	30 (i)

a) A 15% final withholding tax is imposed on gains derived by non-residents from disposals of shares and securities of Bulgarian companies, real estate and financial assets. The tax is imposed on the difference between the sales price and the book value of assets. Residents include capital gains in their taxable income, taxed at a rate of 20%.

b) In Cyprus, the capital gain is the difference between the sales proceeds and the original cost, adjusted to take into account increases in the cost of living index. Offshore companies are exempt from capital gains tax, except on property situated in Cyprus.

c) Except investment funds, mutual funds and pension funds, subject to tax at a rate of 15%.

d) Non- resident companies without a permanent establishment in Estonia are taxed at a rate of 26% on their capital gains derived from Estonian sources, and capital gains derived by resident companies and permanent establishments of non-resident companies registered with the Estonian authorities are exempt from tax.

e) Capital gains derived by Hungarian companies are included in taxable income and taxed at 18%, and capital gains derived by foreign companies without a permanent establishment in Hungary are exempt from Hungarian tax.

f) Resident companies (with certain exceptions) and non-resident companies operating through a permanent establishment in Latvia include capital gains in taxable income, and are taxed at 22%, while non-resident companies without a permanent establishment are taxed at a rate of 2% on proceeds received on sales of Latvian real estate.

g) In Lithuania, capital gains are included in taxable profit and taxed at the regular tax rate (24%) although some companies are taxed at reduced tax rates.

h) Taxable capital gains are added to taxable income and are subject to income tax at the regular corporate income tax rate (35%) in Malta. A provisional tax of 7% of the sales price must be paid by a seller that derives taxable capital gains. A reduction in this rate can be authorised if the seller establishes that the capital gain is less than 20% of the sales price. The seller may credit the provisional tax against corporate income tax

i) In Turkey a 10% surtax is levied on the corporate income tax and on the capital gains taxation. Effective from 1 January 1999 until 31 December 2002, net capital gains obtained by individuals from the sale of property is exempt from income tax, providing the related property has been owned for at least four years, or the amount of such income does not exceed the limit, which is TLR 3,500,000,000. In calculating the net capital gain by corporations, the cost of acquisition can be recalculated by the monthly wholesale prices indices of the State Institute of Statistics, excluding the month of sale, instead of the revaluation rate, effective from 3 July 2001.

Withholding Taxes on Dividends and Interest

Withholding tax rates on dividends vary significantly from country to country. Some countries distinguish between dividends paid to residents and dividends paid to non-residents, although most of countries apply the same rules to both residents and non-residents. Table 11 provides detailed information.

In some countries, there is no withholding tax on dividends in some particular cases, (Malta, Cyprus, Estonia, Hungary, Slovenia), while in other cases withholding tax rate on dividends is increased to 35% (Hungary). In Malta and Cyprus dividends paid to non-residents are not subject to withholding tax, while in Hungary and Slovenia the dividends not subject to withholding tax are those paid to resident companies, in most cases, regardless of whether they are paid out of taxed or untaxed profits. In Estonia, withholding tax is imposed on dividends paid to non-resident companies owning less than 25% of the capital of the payer,

non-resident individuals and non-residents from low-tax jurisdictions; other dividends are exempt from withholding tax. Two countries, Latvia and Romania, apply withholding taxes at a rate under 15%.

Interest withholding tax rates also vary broadly between countries. In some cases – Estonia, Lithuania, Romania, Slovenia, and for residents in Cyprus, and non residents in Malta – the withholding rate on interest is 0%. In others withholding rate on interest is 25%, Cyprus (for non residents) and the Slovak Republic, or even higher (26%) on some interest payments in Estonia. Latvia and Romania apply withholding tax on interest at a rate below 15%.

Rates depend on several circumstances. For further details, see Table 12.

Table 11: CANDIDATE COUNTRIES: WITHHOLDING TAX ON DIVIDENDS

(fiscal year 2001-2002)

Country	Withholding tax rate on dividends (%)
BULGARIA	15 (a)
CYPRUS	0-20 (b)
CZECH REP.	15 (c)
ESTONIA	0-26 (d)
HUNGARY	0-20-35 (e)
LATVIA	10
LITHUANIA	29
MALTA	0(f)
POLAND	15
ROMANIA	10
SLOVAK REP.	15
SLOVENIA	0-15-25 (g)
TURKEY	5-15 (h)

Withholding taxes on dividends for both residents and non-residents, and for both corporates and individuals. Those cases in which rates for residents differ from rates for non-residents, or rates for corporates differ from rates for individuals, are explained in the specific note. In all the countries rates may be reduced by Tax Treaties.

(a) A 15% withholding tax is imposed on dividends paid by Bulgarian companies to Bulgarian individuals and non-profit organisations and to foreign companies and individuals. However, remittances of profits by branches to their home countries are not subject to withholding tax.

(b) Withholding tax is not imposed on dividends paid to non-resident foreign corporations.

(c) Companies other than investment funds and mutual funds are allowed a tax credit equal to 50% of the tax withheld by them on dividends paid to shareholders.

(d) In Estonia, withholding tax at a rate of 26% is imposed on dividends paid to non-resident companies owning less than 25% of the capital of the payer, non-resident individuals and non-residents from low-tax jurisdictions. Other dividends are exempt.

(e) A 20% withholding tax is imposed on dividends paid to foreign companies unless the recipients invest directly the dividends in any Hungarian company. Dividends paid to Hungarian companies are not subject to withholding tax. A 20% withholding tax is imposed on dividends paid to individuals. For "excess dividends", this rate is increased to 35%. Excess dividends are defined as dividends paid in excess of a specified rate of return on equity, which is equal to double the prime discount rate of the National Bank of

Hungary. This discount rate is currently 11%, and as a result, the applicable rate of return on equity is 22%. These rules are contained in the Hungarian personal income tax law.

(f) Dividends paid to non-residents are not subject to withholding tax regardless of whether they are paid out of taxed or untaxed profits. Dividends received from foreign companies are included in taxable income. Malta operates a full imputation system. Under this system, the tax paid by the company is imputed as a credit to the shareholder receiving the dividends.

(g) Dividends paid out of untaxed profits by Slovenian companies to other Slovenian companies are subject to a withholding tax of 25%. Dividends received by Slovenian companies from the taxed profits of other Slovenian companies are exempt from tax. A 15% withholding tax is imposed on dividends paid to non-residents.

(h) In Turkey a 10% surtax is imposed on all withholding taxes. Dividends distributed by resident companies out of taxable income are subject to a 5% withholding tax if the payer is a public company or a 15% withholding tax if the payer is not a public company. All taxable and tax-exempt income of branches, after the subtraction of the corporate income tax (including surtax), is subject to a 15% withholding tax.

Table 12: CANDIDATE COUNTRIES: WITHHOLDING TAX ON INTEREST

(fiscal year 2001-2002)

Country	Withholding tax rate on interest (%)
BULGARIA	15
CYPRUS	0-25 (a)
CZECH REP.	15
ESTONIA	0-26 (b)
HUNGARY	18 (c)
LATVIA	5-10 (d)
LITHUANIA	0-15 (e)
MALTA	0-15 (f)
POLAND	20
ROMANIA	0-10 (g)
SLOVAK REP.	15-25 (h)
SLOVENIA	0
TURKEY	(i)

Withholding taxes on interest for both residents and non-residents, and for both corporates and individuals. Those cases in which rates for residents differ from rates for non-residents, or rates for corporates differ from rates for individuals, are explained in the specific note. In all the countries rates may be reduced by Tax Treaties.

(a) 25% for non residents while the rate for residents is 0%. A reduced rate of 20% is applied on interest income up to 40.000 pounds.

(b) Interest is exempt from withholding tax if it is paid by resident banks to resident and non-resident individuals or if it is paid to non-resident banks in certain circumstances. A 26% withholding tax is imposed on other interest payments to resident and non-resident individuals and non-resident companies.

(c) Except interest paid by the State Treasury or the National Bank, which is not subject to withholding tax.

(d) The 5% rate applies to interest paid by Latvian-registered banks, and the 10% rate applies to other interest payments.

(e) The 0% rate applies to interest on loans granted by foreign banks and international financial institutions on the list approved by the Lithuanian government. The 15% rate applies to other interest payments.

(f) In Malta the withholding rate on certain interest paid to residents is 15%, while for non-residents it is 0%.

(g) Withholding tax of 10% is only applicable to non-residents without a permanent establishment in Romania. The following types of interest are not subject to withholding tax: interest related to loans granted to the Romanian government, the Romanian National Bank or banking institutions authorised to act on behalf of the Romanian state; and interest paid with respect to treasury bonds.

(h) The 25% rate is applied by financial institutions to non-resident companies.

(i) In Turkey a 10% surtax is imposed on all withholding taxes. Interest withholding tax rates vary broadly:

- Interest:
- From Repurchase (REPO) Agreements: 20%
- From Certain Turkish Government Bonds and Treasury Bills: 4% to 19%
- From Private Sector Bonds: 12%
- From Deposit Accounts: 6% to 18%.

Value Added Tax

The Value Added Tax Systems applied in most of candidate countries are very close to that within the EU, although on some specific issues (e.g. exemptions, rate levels, tax refunds, etc.) they are not yet completely aligned.

The majority of candidate countries have requested transitional measures in the field of Value Added Taxation, and most of the countries are in a process of continuous change. Table 13 shows the current VAT rates in the accession countries, and highlights the main reforms and the specific details for each.

The standard rate of VAT in all countries is at least 15%, with the exception of Cyprus, where the standard rate was 10% until the second half of 2002, and where, effective from 1.7.2002 the rate is 13% (a further increase to 15% is planned for January 2003). The maximum standard rate is 25% (Hungary) and the average of the thirteen countries is 19.1%.

Most countries also apply one or two reduced rates, which range from 12% applied in Hungary to 1% applied in Turkey and 3% applied in Poland. A number of countries apply a 0% rate on some basic products or services.

Table 13: CANDIDATE COUNTRIES: VALUE ADDED TAX RATES (2002)

Country	Standard Rate (%)	Reduced Rate (%)
BULGARIA	20 (a)	-
CYPRUS	10 (b)	5 – 0
CZECH REP.	22	5 (c)
ESTONIA	18	5 (d)
HUNGARY	25	12-0 (e)
LATVIA	18	(f)
LITHUANIA	18	5 (g)
MALTA	15	0-5
POLAND	22	7-3-0 (h)
ROMANIA	19 (i)	-
SLOVAK REP.	23	10 (j)
SLOVENIA	20 (k)	8.5 (k)
TURKEY	18 (l)	1-8

(a) In Bulgaria the standard rate was 22% before 1.1.1999.

(b) An increase from 10% to 13% with effect from 1.7.2002 and a further increase to 15% is planned for January 2003.

(c) The reduced rate is imposed on water, agricultural and food products, pharmaceutical products, health services, construction, and other services.

(d) A 5% reduced rate is applied to some medical supplies and equipment with effect from 1-9-01 and also exists on the supply of heat to domestic and some charitable users.

(e) The Hungarian reduced rate of 12% is applied to basic foods, medicines and medical supplies, coal, mineral fuels, electrical energy and most services. The zero rate is applied to text books used in public education and specified medicines and medical materials.

(f) All goods and services which are currently exempt in Latvia (i.e. some medicines, medical supplies, baby-care products) and books, hotel accommodation, water, will be subject to a 9% reduced rate with effect from January 2003.

(g) From 1 January 2001 the supply of medical and veterinary services is exempt from VAT. The reduced rate of 5% will be applied to environmentally friendly foodstuffs, newspapers and magazines with effect from 2003 and medicines from 2004.

(h) From 31.10.2001 supply of internet connections is at a reduced rate of 7%, and press publications from January 2001. 3% on the sale of non-processed agricultural products and 0% on unprocessed food.

(i) From 1.2.1998 to 1.1.2000 the standard rate was 22%. Construction services are exempt.

(j) The reduced rate is applied to basic food, medicines and most services.

(k) As of January 2002 standard VAT rate was increased to 20% (from 19%) and the reduced rate was increased to 8.5% (from 8%).

(l) With effect from 15.5.2001, the standard rate was increased to 18% from 17%. The rate on luxury goods was increased to 26% from 25%. Luxury goods are taxed at rates ranging from 26% to 40% (e.g. VAT rate on passenger cars (1600 cm3) is 40%). Reduced rates are 1% and 8%.

Excise Duties

Current EU law permits the levying of excise duties only on alcoholic beverages; on tobacco; and on hydrocarbon fuels. All candidate countries levy such excises; but, as is apparent from Tables 14 and 15, the rates vary widely.

In the case of beer and wine, few problems will arise, since the EU minimum rates are low – in the case of wine, zero. Were a positive minimum rate on wine to be agreed, however (see later section on "The Taxation of Wine"), Malta and Slovenia would have to impose a positive duty instead of the current zero. In the case of spirits, certain countries might need to increase general duties, though EU rules permit lower rates for "regional" products and those from "'small distilleries".

However, as already indicated, the main problems occur in the case of tobacco duties. In July 2002 the minimum EU rate on 1000 cigarettes was raised from 57% of the retail selling price of the most popular brand to €60, and will rise again to €64 by July 2006. Greece and Spain, however, have derogations postponing the application of these rates until 2005 and 2008. But none of the candidate countries met even the 57% minimum.

The smuggling of cigarettes from low-tax countries has been a major problem for the EU for some time, and it can be argued that raising the rates in the candidate countries will help provide a solution. In rejecting any increase in the minimum excise, however[33], the European Parliament argued that this would merely lead to *"the invasion of even cheaper cigarettes from the Ukraine, Russia or even China".* A further disorganisation of the market would be added to the social problems of a several hundred percent rise in the price of cigarettes in the accession countries.

In the case of duties on fuel oils (petrol and diesel) the EU is already engaged on a major reform of the system (see later section on "The Taxation of Energy"). This includes a proposed increase in the minimum rate on diesel, and is likely to cause additional problems for Bulgaria, Cyprus, Estonia, Latvia, Lithuania and Romania, where rates are already below the existing minimum. In the case of petrol, duties will also have to rise significantly in Bulgaria, Cyprus and Estonia.

[33] See "Introduction" to this study.

Table 14: Excise duties in the candidate countries

Country	Beer	Wine (€/hl)	Intermediate Products (€/hl)	Spirits (€/hl)	Other alcohol	Cigarettes 000 piec
Bulgaria	€2.81/hl - €4.35/hl	€15/hl		€179/hl		filter-tippe 35% non-filter-tipped 17%
Cyprus	Domestic: €22.12/hl Imported: (€0.68/l - €0.77/l) + (5.4%-6%) tax	€1.21/l of pure alcohol	0	€1.21/l of pure alcohol		
Czech Republic	€0.69/hl/degree Plato	- still: €7.31/hl - sparkling: €68.41/hl	€665.8/hl of absolute alcohol	€7.65/l of alcohol	home made distilled spirits/liquors up to 30 litres/year = €3.1/l of alcohol	longer th 70mm: €21.62 up to 70m €18.71
Estonia	€3.51/hl per cent of beer	€66.46/hl Fermented beverage the ethanol content of which is up to 6%: €20.77/hl - over 6%: €41.54/hl	€102.25/hl		€9.27/hl/ 100% of alcohol	€11.1+ 2 of the ma retail pri
Hungary	€1.48/hl	€0.02/l other wine: €0.32/l	€0.41/l - €0.46/l	€2.66/hl - €6.17/hl	hand made: €6.17/hl other:	under 9 cı €13.99 17%

Country	Beer	Wine (€/hl)	Intermediate Products (€/hl)	Spirits (€/hl)	Other alcohol	Cigarettes 000 piec
		champagne: €0.32			€6.8/hl	above 9 cr €27.99+ 1 18-27 cm: €41.98 17%
Latvia	€5.55/100 l - €70.67/100 l	€50.47/100 l		€925.49/100 l	€70.67/100 l - €117.79/100 l	with filte €8.58 without €10.26
Lithuania	€0.11/l	€0.04 - €0.11 (per alcohol degree/l) sparkling wine: €0.07/alcohol degree/l		€0.08/alcohol degree/l	other fermented beverages: €0.03 - €0.11 (per alcohol degree/l)	€8.68
Malta	€0.75/hl/degre e Plato	0	€47.32/hl	€0.23/%vol/l		53.1% - €0.14 (p packet of
Poland	€1.33/hl/%per weight	€53.73/hl - €26.86/hl	€16.12/hl - €53.74/hl	€1386.76/hl 100% of spirit		foreign importe €23.78 domesti with filte €16.02 €20.37 without

Country	Beer	Wine (€/hl)	Intermediate Products (€/hl)	Spirits (€/hl)	Other alcohol	Cigarettes 000 piec
						filter: €15.56
Slovakia	€5.47/hl - €11.18/hl	€0 - €55.43/hl	€38.78/hl	€594.82/hl		up to 70 m €11.89 over 70 m €21.41
Slovenia	€7.21/1 vol%/hl	0	€65.88/hl		€731.31/100 vol %of alcohol strenght/l	45%
Romania	€1.20 - €1.50/hl/degree alcohol	non-foaming: €0.55/hl/alcohol degree foaming: €2.75/hl/alcohol degree		€180/hl/alcohol degree + 1%	€140 - €180/hl/alcohol degree	€2 + 25%
Turkey	45%/hl/degree alcohol	still and sparkling: 120%/hl still <8.5%: 35%/hl			alcoholic beverages: 12%/hl of absolute alcohol	0%
EU minimum	€0.748/hl °Plato or €1.87 per hl/degree alcohol	0	€45/hl	€550/hl or €1000 per hl. Pure alcohol		60% of ret price of m popular brand

Exchange rates as of 11.10.2002

Table 15: CANDIDATE COUNTRIES: EXCISE DUTIES ON PETROL AND DIESEL

(in euros per 1000 litres):

	BG	CZ	CY	EE	HU	LV	LT	MT	PL	RO	SK	SI	TU	EU min.
Unleaded petrol	128.6/214.6	325.3	219.3	224.4	368	282	285.7	332.5	387.8/363	341	269.9	363.9	457.2-482	**287**
Diesel fuel	47.13	244.6	35.1	163.7	317.3	176	132.3	255	288.6/259.5	116	256.2	318.4	319.4	**245**

Source: European Commission

Conclusions

Although most candidate countries have tax regimes reasonably close to those in the EU, in some key aspects there are wide differences.

The majority of candidate countries have VAT regimes similar to that in the EU; and the average standard VAT rate in the thirteen countries, at present 19.1%, is only 0.2 points below the EU average. Applicants have recently carried out reforms in the field of VAT, in order to comply with the main provisions of VAT Directives, mainly Directive 92/77/EEC[34].

In the case of excise duties, the main problem will be the need to increase the tax on cigarettes in most countries. Several countries will also have to increase the duty on diesel fuel, particularly if current Commission proposals on the minimum rates are adopted.

The most significant differences between the tax systems of the candidate countries and those within the EU are in the fields of Personal Income Tax and Corporate Taxation. The latter could create a number of problems.

The EU average of corporate tax rates is 29.3%, while the average corporate tax rate of the thirteen candidate countries (25.5%) is almost four percentage points lower, and after Cyprus' Tax Reform (which will come into force in January 2003, when the corporate rate will be reduced from 25% to 10%), the average will be lower still: 24.4%. There are also wide differences between EU Member States and candidate countries in every specific element of the corporate tax base.

These differences could add new problems to the process of tax co-ordination. In particular, the Commission's new strategy for the corporate tax base (see preceding section) will encounter additional complexities with the entry of new countries into the Union.

These will be in addition to the institutional difficulties created by enlargement. The need for unanimity in the Council of Ministers over tax legislation will clearly make it more difficult to achieve agreement. There is a strong case, therefore, for using qualified majority voting for certain aspects of tax legislation. Another way forward, however, would be the "enhanced co-operation" provisions of the Nice Treaty, which allow a subgroup of Member States to proceed with a policy opposed by a blocking minority.

[34] Directive 92/77/EEC establishes: a minimum standard rate of 15%; the option to apply either a single or two reduced rates over 5% to any of the goods and services listed in Annex H of the amended 6th. VAT Directive; derogations to apply a zero rate, a "super-reduced" rate or a "parking" (i.e. transitional) rate, pending the introduction of a definitive VAT system; the abolition of "luxury" or higher rates.

III. The Taxation of Savings Income

Background

Most Member States levy a tax on interest paid to their own citizens (see Table 16). However, only two – Greece and Portugal – levy withholding tax on interest paid to *non*-residents, including the residents of other EU countries.

Until the 1980s, the residents of one country wishing to deposit savings in another faced serious obstacles. In some cases there were direct controls on the purchase of foreign exchange, a consequence of which was to make it virtually impossible to avoid tax on any foreign-derived income. As such controls were removed, however, it became increasingly difficult for tax authorities to monitor such income.

A taxpayer in one Member State who receives income from an asset in another Member States is, of course, required to declare it when making normal tax returns in his or her home country. But in practice

> *"the free movement of capital... together with the existence of bank secrecy [...] increase[s] the potential for tax evasion by individuals*[35]*."*

Table 16: Withholding tax on residents' interest income (government bonds)

Country	% tax	Notes
Austria	25	Final if taxpayer so opts. Otherwise aggregated into total taxable income.
Belgium	15	Tax is final if taxpayer so opts. Otherwise aggregated into total taxable income. First BEF 56 000 tax-free.
Denmark		All interest income incorporated into total taxable income.
Finland	29	Final.
France	15	Final if taxpayer so opts. Otherwise aggregated into total taxable income.
Germany	31.65	Withholding tax is credited against tax on total taxable income.
Greece	15	
Ireland	24	Withholding tax is credited against tax on total taxable income. Rebated for pensioners, etc.
Italy	12.5	Final.
Luxembourg		All interest income incorporated into total taxable income, with first LUF 60 000 exempt.
Netherlands		All interest income incorporated into total taxable income, with first DFL 1 000 (double for married couples) exempt.
Portugal	20	Final, with option for payment on account against total tax.
Spain	18	Withholding tax is credited against tax on total taxable income.
Sweden	30	
United Kingdom	20	Withholding tax is credited against tax on total taxable income. Interest may be received gross in certain circumstances.

Source: *Tax systems in European Union Countries*, (OECD 2001).

[35] Quotation from the *Report of the Committee of Independent Experts on Company Taxation*, (the "Ruding Report"), Official Publications of the EC, ISBN 92-826-4277-1, March 1992.

As a result, a series of attempts have been made at European Community level to limit the scope for such evasion.

The first attempt was made in 1989, when the Commission published a draft Directive for *a common system of withholding tax on interest income*[36], to be levied at the rate of 15%. This so-called "Scrivener" proposal (after the then tax Commissioner) was eventually withdrawn when it failed to make any progress in Council.

The second attempt was in 1997, when the Commissioner then responsible for taxation, Mario Monti, proposed a *"package to tackle harmful tax competition in the European Union"*. This comprised three elements, the most controversial of which was "*to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community"*.

The draft Directive to put this into effect was published in 1998[37], and was based on a "coexistence model". Member States would *either*

- levy a 20% withholding tax on savings income paid to residents of another Member State; *or*
- they would provide information on payments to the tax authorities of the other Member State[38].

This proposal, however, ran into strong opposition from the UK Government. The draft Directive of 1989 had excluded the international market in "Eurobonds", worth some €4 000 billion in outstanding issues and largely based in the City of London. The latter, however, were included in the Monti proposal. As a result, the UK Government issued a paper in September 1999[39] arguing for their renewed exclusion, and pointing to the danger of the whole market moving outside Europe. There was also strong opposition from Luxembourg, which argued that a 20% tax would drive investment outside the EU, notably to alternative financial European centres like Zürich, Liechtenstein, the Isle of Man, etc. or even further.

The European Council meeting in Helsinki on 10-11 December 1999 reached an agreement to continue discussions on the draft Directive, based on the principle that

> *"all citizens resident in a Member State of the European Union should pay the tax due on all their savings income".*

The UK Treasury then published a second paper[40] arguing that this could not be achieved by a withholding tax, since there was no guarantee that the rate levied would actually correspond to the "tax due". Only an exchange of information between tax authorities, the paper argued, could achieve this.

After lengthy negotiations, a compromise was agreed at the Santa Maria de Feira European Council on 20 June 2000, under which the exchange of information model would be the

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[36] *Draft Directive for a common system of withholding tax on interest income,* COM(89)60.

[37] *Draft Directive to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community*, COM(1998)295.

[38] Actually, the Draft Directive contained *three* systems: Withholding Tax; Provision of Information; and Certificate of Notification, under which a taxpayer could prevent withholding tax being levied by proving that the interest had been declared to the appropriate tax authorities. This third option is retained in Article 13 of the revised draft Directive.

[39] *International Bonds and the Draft Directive on Taxation of Savings*, HM Treasury, September 1999.

[40] *Exchange of Information and the Draft Directive on Taxation of Savings*, HM Treasury, February 2000.

ultimate objective, to be introduced by all Member States within seven years after the adoption of the Directive. Meanwhile, some Member States might, as an alternative, introduce a withholding tax on interest paid to non-residents. The legislation would, however, be conditional on agreement being reached on similar measures with key third countries: in particular, the US, Switzerland, Liechtenstein, Andorra, Monaco and San Marino. A decision by unanimity would be taken by the end of 2002.

The third proposal

A revised proposal[41] was duly presented by the Commission in July 2001.

- Operation of the Directive would rest on the "paying agent principle": i.e. responsibility for ensuring the collection of the relevant information would rest on the last intermediary in any chain of intermediaries paying interest to a "beneficial owner" [42].
- The paying agent would be required to report, at a minimum:
  - the identity and residence of the beneficial owner;
  - the agents' own name and address;
  - the account number of the beneficial owner, or details of the debt-claim giving rise to the interest; and
  - details of the amounts involved.
- For Austria, Belgium and Luxembourg, however, there would be "transitional provisions" for a 7-year period. They would introduce a withholding tax at a rate not below 15% for three years following the entry into force of the Directive. This would rise to not less than 20% for another four years.
- The payment of a withholding tax would *not* discharge the beneficial owner's tax liability in the Member State of residence – for example, if the beneficial owner's marginal tax rate were to be higher than the rate of withholding tax. In such cases, the Member State of residence would be entitled to levy additional tax *"in accordance with its domestic law, subject to compliance with the Treaty"*. The Member State of residence would also be required to avoid double taxation through a tax credit/rebate procedure (see Table 17). (How far such procedures can be operated in practice, in the absence of information exchange, is nevertheless open to some question – see '"Coexistence" issues' later).

Table 17: Example of procedures for the avoidance of double taxation

Withholding tax deducted	Tax due in country of residence	Tax payable (+) or tax rebate (-) in country of residence
15	25	25-15 = + 10
15	10	10-15 = - 5

- The collecting country would retain 25% of withholding tax revenues. The rest would be cleared to the countries where the taxpayer was resident.

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[41] Revised draft Directive to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community, COM(2001)400, July 2001.

[42] The "beneficial owner" would be defined as *"any individual who receives an interest payment or any individual for whose benefit an interest payment is secured, unless he can provide evidence that he has not received it for his own benefit*". (Article 2 of the revised draft Directive).

- All other Member States would adopt the exchange of information system following the entry into force of the Directive; and Austria, Belgium and Luxembourg would do so after seven years.
- Mixed investment funds would be covered, on the "look-through" principle (that is, only that proportion of the income from a fund which derived from interest would be subject to the Directive), when 40% of the holdings were interest-bearing[43].
- Bonds issued before 1 March 2001 would not be subject to the Directive until the end of the transitional period ("grandfathering") to limit the effect on existing securities.

There continued, however, to be a number of obstacles to adoption of the draft Directive.

Third countries and "equivalent" measures.

The most serious problems arose from the agreement that implementation of the Directive should be conditional upon "equivalent" measures being introduced in key third countries.

Contacts between the Commission and tax authorities in the main third countries involved had, in fact, already been established at an early stage. However, a further unanticipated problem arose during 2001 concerning the Commission's mandate to negotiate. A number of countries, notably the UK, maintained that negotiations on taxation with third countries was primarily the responsibility of the Member States rather than the Commission.

A compromise formula was eventually agreed on 16 October 2001 to enable the opening of formal negotiations with the US, Switzerland, Liechtenstein, Monaco, Andorra and San Marino. The Commission would act "jointly" with the Council Presidency, on the basis of a mandate, and "in close and regular consultation" with the inter-governmental High-Level Group on Tax. The aim of the negotiations was to sign permanent agreements, but with provision for later amendment.

Success or failure, it emerged, would turn on whether all participants could reach a common definition of "equivalent".

The position of Switzerland

The initial position of the Swiss government – supported in principle by Liechtenstein, Monaco, Andorra and San Marino – was as follows:

- A withholding tax might be acceptable (and was formally suggested in a paper published on 3 September 2002).
- Swiss bank secrecy laws were, however, "non-negotiable".
- In consequence, arrangements for the *automatic* exchange of information, as contained in the draft Directive, would be unacceptable.
- The exchange of information *on request* might be acceptable in cases of "tax fraud" – i.e. in cases which were a matter of criminal law and which fell under the Swiss penal code.
- But no exchange of information, either automatic or on request, would be acceptable in cases of "tax evasion", a civil offence under Swiss law.

[43] Full definitions of "interest payments" are contained in Article 6 of the new draft Directive.

- Any discussion of the taxation of savings income should take place within the framework of wider EU-Switzerland bilateral negotiations. Following the agreements of 1999, six major subjects had been under discussion (including the free movement of persons and the right of asylum), to which the tax issue was added.
- The negotiating mandates agreed at the level of the Swiss Federal Council must also be agreed by the separate cantons. Any outcome of the negotiations would have to follow the same constitutional path, and might also need to be ratified through a referendum.
- Any agreement would also be subject to other third countries – for example, Hong Kong, Singapore and Japan – also adopting "equivalent measures"; and also to the adoption of such measures by the associated and dependent territories of EU Member States.

Switzerland already charges a 35% withholding tax on interest from *Swiss-based* sources; and this is applied whether the recipient is resident in Switzerland or not. No tax is levied, however, when interest from a source *outside* Switzerland is paid into a Swiss bank account.

The position of the United States

The position of the United States was in principle favourable to the Directive. As current tax Commissioner Bolkestein reported to the ECOFIN meeting of 4 June 2002 in Luxembourg, the US Treasury was willing to establish an exchange of information system with the EU. Indeed, a regulation to this effect had already been drafted. In order to combat tax fraud and tax evasion, the US had already concluded a network of bilateral tax treaties involving information exchange.

The Commissioner also reported, however, that some serious reservations remained within the US administration about the conclusion of formal agreements between tax administrations on the exchange of information. This was founded on an historical unwillingness, in principle, to disclose information to "oppressive regimes" about the financial affairs of their citizens. The EU had therefore proposed that any system should only apply to specifically listed countries to which the designation "oppressive" could not be said to apply.

In September 2002 a statement by the chief economic adviser to the White House, Glen Hubbard, also cast doubt on the willingness of the US administration to accept any automatic exchange of information.

Progress of the negotiations

Following unproductive talks between the President-in-office of ECOFIN, Danish Finance Minister Thor Pedersen, and the head of Switzerland's Treasury Department, Kaspar Williger, ECOFIN discussed the possibility of bringing certain pressures to bear on Switzerland at its meeting on 6-7 September 2002. Articles 57 and 58 of the Treaty, for example, permit restrictions on the free movement of capital. Both the Commission and some Member State governments, however, expressed reluctance to impose any sanctions on a "good neighbour".

At the end of November 2002, the Commission published a Communication[44] outlining the state of play in the negotiations with third countries. In relation to the **negotiations with Switzerland**, this outlined the four-point plan for a settlement which had been put to the Swiss negotiators in October.

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[44] *Report Concerning the Negotiations with Third Countries on Taxation of Savings Income,* SEC(2002)1287 of 27.11.2002.

1. The introduction by Switzerland of a withholding tax, as proposed by the Swiss themselves.
2. Provisions for voluntary disclosure by the beneficial owner (as under the Certificate of Notification procedure).
3. Exchange of information *on request* (i.e. *not* automatically).
4. A review clause to allow further developments after the end of a transitional period.

The negotiations on this package produced some progress in the field of the withholding tax. Switzerland was ready to apply the same rates as Belgium, Luxembourg and Austria – that is, 15% during the first three years of the transitional period, and 20% thereafter. The rate could be 35%, provided the three EU Member States applied the same rate. The 75%/25% revenue-sharing arrangement was acceptable.

Less progress, however, was made in the field of information-exchange. As Commissioner Bolkestein told Parliament's Economic and Monetary Affairs Committee on 4 November 2002, the major sticking-point remained whether the information exchanged would cover only criminal matters, or be extended to civil matters (see above).

In the case of **negotiations with Andorra, Liechtenstein, Monaco and San Marino** similar progress, or lack of it, had been made on the basis of the four-point plan.

In the case of **the United States**, there was agreement of the need for "a full and effective administration of taxes based on information exchange on a bilateral basis". However,

> *"the US is not prepared at this stage to give a formal statement in relation to the savings directive".*

Table 18: Taxation of savings: state of play December 2002.

	First 3 years	Next 4 years	Following years
Feira agreement	Austria, Belgium and Luxembourg 15% withholding tax. All others automatic information exchange.	Austria, Belgium and Luxembourg 20% withholding tax. All others automatic information exchange.	All automatic information exchange.
Commission proposal	Switzerland to introduce 35% withholding tax and exchange of information on request. Voluntary disclosure. Rest as Feira.	Switzerland 35% withholding tax and exchange of information on request. Voluntary disclosure. Rest as Feira.	To be determined under review clause.
Swiss proposal	Austria, Belgium, Luxembourg and Switzerland 20% withholding tax. All others automatic information exchange.	Austria, Belgium, Luxembourg and Switzerland 35% withholding tax. All others automatic information exchange.	Switzerland 35% withholding tax, and certain information on request. Others automatic information exchange, or possibly continued 35% withholding tax.

The results of the negotiations were reported to ECOFIN at the beginning of December. The UK conceded that the introduction by Switzerland of a 35% withholding tax might make automatic information exchange unnecessary. Luxembourg and Austria, however, objected that the measures accepted by Switzerland were not "equivalent" to those to be imposed on EU Member States: for example, after the end of the transitional period the latter would have to provide information automatically, Switzerland only on request. A compromise was suggested by the Danish Presidency, under which Austria, Belgium and Luxembourg would continue to levy a 35% withholding tax beyond the end of the transitional period – in effect, a return to the original "coexistence model". Both countries, however, considered that rate excessive. A further Swiss proposal suggested a 20% tax for all four countries during the first three years of the transitional period, rising to 35% only in the next four.

ECOFIN again discussed the various options at its meeting of 11 December 2002, including a proposal from the Presidency that a decision be postponed beyond the end-year deadline to allow negotiations with Switzerland to continue. This was accepted. Following further negotiations on "technical aspects" of the Swiss proposal, and further discussions were scheduled for 21 January 2003. On 7 January 2003 Commissioner Bolkestein forecast that "*a genuine agreement is in the pipeline.*"

Meanwhile, at the end of 2002 a major reform of savings taxation was announced by the German Government. Income from savings is to be taken out of the normal income tax regime, and become subject to a 25% flat rate withholding tax.

In January 2003, the incoming Greek Presidency of the Council proposed a new compromise. Austria, Belgium and Luxembourg would introduce a withholding tax at the initial rate of 15-20%, which would eventually rise to 35%. Whether all countries should subsequently adopt information exchange would be decided by unanimity in the light of international developments. Otherwise Austria, Belgium and Luxembourg would be able to maintain withholding tax (and banking secrecy).

The 21 January agreement

These proposals proved the basis for the political agreement reached by the ECOFIN Council meeting of 21 January 2003. Subject to the conclusion of agreements with Switzerland, Liechtenstein, Monaco, Andorra and San Marino, a "coexistence model" would be implemented within the EU itself until a new vote by unanimity in Council (see Table 19). At the same time, "*the exchange of information, on as wide a basis as possible, is to be the ultimate objective of the European Union in line with international developments.*"

Table 19: Savings Tax: the 21 January 2003 agreement

2004-2006	2007-2009	2010+	Following agreement with Switzerland, US, etc.
Austria, Belgium & Luxembourg **15%** withholding tax. Other 12 automatic information exchange.	Austria, Belgium & Luxembourg **20%** withholding tax. Other 12 automatic information exchange.	Austria, Belgium & Luxembourg **35%** withholding tax. Other 12 automatic information exchange.	Vote by unanimity on whether all to adopt *automatic* information exchange, depending upon Switzerland, Liechtenstein, San Marino, Monaco and Andorra adopting, and US "committed to", information exchange "*upon request as defined in the OECD agreement*".

A number of details in the agreement should be noted:

- **Revenue-sharing**. Those countries adopting a withholding tax – both within and outside the EU – will retain 25% of the revenue collected, and remit 75% of it to the saver's country of residence. Switzerland, however, may "*even be prepared to reduce the percentage of 25 depending on the 'overall balance of the agreement*".
- **Information on request**. The agreement with Switzerland, etc. should involve an immediate system of information on request "*for all criminal or civil cases of fraud or similar misbehaviour on the part of taxpayers."* Implementation, however, may be through bilateral agreements between individual countries.
- **Equivalence**. The conditions for an eventual full move to information exchange by EU Member States do not incorporate *exact* equivalence of measures in Switzerland, etc. Whereas the Directive establishes a system of *automatic* exchange, the OECD model only provides for information *on request*. For this reason, the agreement envisages Switzerland permanently retaining the 35% withholding tax.
- **Voluntary disclosure by the beneficial owner.** Where a taxpayer declares interest income obtained from a Swiss, etc. paying agent to the tax authorities in the Member State of residence, the tax rate applied will be that applied to domestically-earned interest, rather than the Swiss rate (i.e. the system originally proposed under the Certificate of Notification procedure).
- **Review clause**. The Contracting Parties to the agreements with Switzerland, etc. will "*consult with each other at least every three years*" on the functioning of the agreements. In any case, changes may be needed if and when Austria, Belgium and Luxembourg switch to information exchange.
- **Other third countries**. As well as continuing to press for the adoption of information exchange by Switzerland, etc., the Commission is invited to enter into discussions during the transitional period with "*other important financial centres*" with a view to a more general adoption of "*measures equivalent to those to be applied within the EU*".

"Coexistence" issues

Some questions continue to arise from the fact that three Member States, together with Switzerland, etc., will be operating a withholding tax procedure during an initial 7-year period, or even permanently.

Article 12 of the draft Directive requires the country levying the withholding tax to transfer 75% of the revenue to the country of the beneficial owner "*within a period of 6 months following the end of the tax year of the Member State of the paying agent"*. The accompanying notes to the Articles of the Directive also state that

> *"In transferring this revenue, the Member State levying the withholding tax is not required to provide any information on the identity of the beneficial owner".*

This raises the question of how a beneficial owner's member State of residence will be able to ensure that the full tax due on the interest, under its domestic law, is actually calculated and paid; or how a credit/rebate system (see Table 17) can be operated. In practice, withholding tax is likely to discharge the beneficial owner's tax liability.

Associated and Dependent Territories

Also critical to the adoption of the Directive have been the discussions on its application in the associated and dependent territories of Member States. Aruba and the Dutch Antilles, associated with the Netherlands, have agreed to co-operate. The United Kingdom, however, has faced some embarrassing difficulties in relation to certain linked territories, notably Jersey and other Channel Islands. The constitutional position of these is complex: they, like the Isle of Man, are not part of the UK, but are direct dependencies of the Crown. The UK also has responsibility for the Caribbean territories of Anguilla, the Virgin Islands, the Caiman Islands, Monserrat and the Turks and Caicos Islands.

The UK government, like that of the Netherlands, was able to inform the 4 June 2002 ECOFIN that the proposed information exchange system could be applied to their associated and dependent territories "as a general standard". In December it confirmed that the Channel Islands would be able to apply an information-exchange system from 2004.

In concluding the 21 January 2003 agreement, the Council assessed that

> *"sufficient reassurances have been obtained with regard to the application of the same measures applying the same procedures as the 12 Member States or as Austria, Belgium and Luxembourg, in all relevant dependent or associated territories (the Channel Islands, Isle of Man, and the dependent or associated territories in the Caribbean) and asks the Member States concerned to ensure that all relevant dependent or associated territories will apply those measures from the date of implementation of the Directive,"*

Linkage with the rest of the "Monti Package"

A third obstacle to adoption of the Savings Directive arose from the fact that the proposal formed part of the "Monti package". Austria and Luxembourg inserted a statement into the minutes of the 26/27 November 2000 ECOFIN meeting that they would agree to the Directive on the taxation of savings

> *"only when there has been a binding decision on the roll-back of the sixty-six measures within the Code of Conduct*[45]*."*

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[45] The Code of Conduct was agreed by the Council in December 1997. It covers:

> *"those business tax measures which affect, or which may affect, the location of business activity in the Community in a significant way,* identified as *those tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than that which generally apply in the country in question".*

The Council agreement on the Code envisaged the establishment of a "follow-up" group. This was established in March 1998, and met for the first time on 8 May 1998, when it elected as its first chairman the UK Treasury Minister, Dawn Primarolo. It has therefore become known as the "Primarolo Group".

The Group's first task was to examine a list, compiled by the Commission largely on the basis of information supplied by Member States, of national tax provisions which appeared to lie within the scope of the Code.

The Group examined 271 tax measures within the Member States themselves, in *European territories for whose external relations a Member State is responsible under Article 299.4 of the EC Treaty* (i.e. Gibraltar) and in *Dependent or Associated Territories.* Of these, 66 were given a "positive evaluation", on the grounds that they *did* affect *in a significant way the location of business activity in the Community.*

Following the publication of its final report in November 1999, the Primarolo Group was given a further mandate. Member States have until 2003 to rescind those tax measures identified as harmful, and the Group

The 21 January 2003 ECOFIN "took note" of the progress achieved by the Code of Conduct Group (Business Taxation), and considered that there was "an agreed basis" for evaluating the rollback of the identified "harmful tax practices". There would be further reports from the Group in March 2003 and at the end of the year.

Agreement had also been substantially achieved in November 2000 on the third element of the package: the draft Directive to eliminate withholding taxes on cross-border interest and royalty payments between companies.

An extension to "legal persons"?

The European Parliament's Economic and Monetary Affairs Committee has on a number of occasions debated whether the scope of the Directive should be extended.

The proposed measures – whether in the form of a withholding tax or taxation in the country of residence as a result of information exchange – would apply only to individual taxpayers. During the Committee's consideration of the Commission's 1998 proposal, Parliament's *rapporteur*, Mr. Pérez Royo, tabled amendments which would have extended coverage to "legal persons"[46]. These amendments were vigorously opposed by the Commission (and rejected by the Committee) on the grounds that they went in the opposite direction to the policy of *eliminating* withholding taxes in the corporate sector.

It is nevertheless true that it is always open to (in particular wealthy) individual taxpayers to transform themselves into legal persons; and also that much interest income reaches individuals *via* bodies which would not be subject to the proposed Directive: pension funds, life assurance bodies, etc.

Some economic considerations

a) Distortions of tax systems

The prevention of revenue loss through tax evasion has been the main objective of the attempts to enact the draft Directive. But it has not been the only one.

First, if one factor of production (i.e. capital) becomes increasingly mobile and avoids taxation, the tax burden is likely to shift to immobile factors, notably labour. The result will be a rise in "non-wage" labour costs, which in turn will increase unemployment.

This has been a major argument advanced by the EU Commission for greater tax co-operation, notably in the Delors White Paper of 1993[47]; and has also been an important argument in favour of the savings tax Directive. The White Paper showed statutory charges on labour rising from 34.4% of the then ten Member States' GDP in 1970 to 37.3% in 1980 and 39.6% in 1990[48].

The situation is not, however, entirely clear-cut. Taking *the tax base as a proportion of GDP*, that accounted for by labour fell from 67.4% in 1980 to 59.5% in 2000. That accounted for by

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was charged with monitoring this "roll-back". The Primarolo Group continues to report regularly at the end of each year, and when requested to do so by Council.

46 See "draft report of the Committee on Economic and Monetary Union" (PE 228.241) of 18 November 1998.

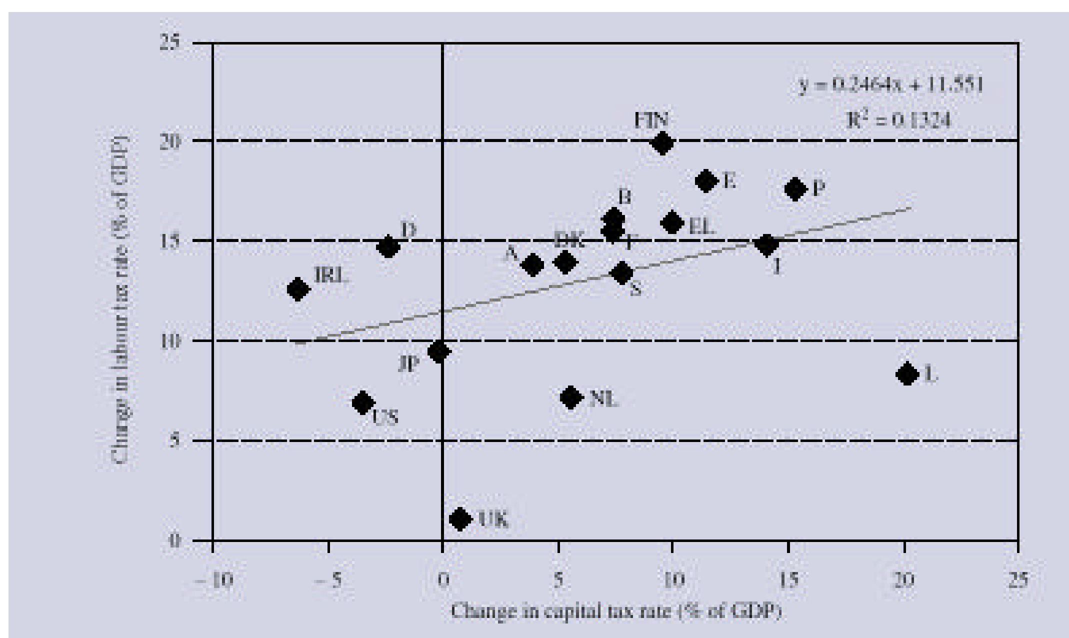
47 "Growth, Competition and Employment: the challenges and ways forward into the 21st century" ("Delors White Paper"), *Bulletin of the European Communities*, Supplement 6/93.

48 The same percentage was given for the then Community of twelve.

capital rose from 22.3% to 27.9%. *Tax rates* on *both* rose: on labour from 32.5% in 1980 to 37.3% in 2000, on capital from 22.3% in 1980 to 27.9% in 2000[49]. The Commission study of 2000 on *Public Finances in EMU* concluded that

> *"There is no evidence that tax competition has reduced the tax burden on capital, which has remained broadly stable over the past three decades[50]. Neither is there evidence that changes in labour tax rates keep pace with those of capital. As shown in Graph 16* [see Figure 2] *there does not seem to be a close link between changes in the burdens on labour and capital in the long run".*

Figure 2: Changes in rates of tax on labour and capital, 1970-99



Source: *Public Finances in EMU*

b) Distortions of markets

Even if it is unclear whether a loss of revenue from interest income significantly distorts tax systems, it may nevertheless distort capital allocation. Professor Cnossen has recently observed that

> *"the ongoing internationalization and liberalization of capital markets[…]suggest that interest is hardly taxed[…]* [which] *favors international debt finance, skews investors' portfolios and results in an arbitrary division of the interest tax base between lending and borrowing Member States.*"

At the same time, it is possible that measures to counter tax avoidance of the kind proposed in the draft Directive could increase, rather than diminish, distortions of this kind. This would

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49 See Martinez-Mongay, C. (2000), "ECFIN's Effective Tax Rates, Properties and Comparisons with other Tax Indicators", *Commission Economic Paper* 146, quoted in Cnossen, S. (2001), *Tax Policy in the European Union: a Review of Issues and Options*, Erasmus University.

50 *This concurs with OECD data[...] and Carey and Tchilingurian.* See Carey, D. and Tchilingurian, H. (2000), "Average effective tax rates on capital, labour and consumption", OECD *mimeo*; and (1999), *Surveillance of tax policies: a framework for EDRC country reviews*, ECO/CPE/WP1(99)9.

be the case, for example, if implementation of the Directive were to result in a flight of investment capital to third-country financial centres. Hence the importance of negotiating the application of "equivalent measures" by such centres.

IV. Other developments in the field of taxation

The Taxation of Energy

Background

The Commission's original proposals for the rates of excise duties on mineral oils, within the context of the Single Market programme were for absolute harmonisation, based on average rates (for petrol and LPG, the arithmetic average; for fuel oil, a weighted average). Even when conceding that only mimimum rates would generally be feasible in the case of excises, the Commission argued that single rates or bands should be applied to mineral oils because "*the risks of competitive distortion...are greater in this area than for alcohol and tobacco"*.

Nevertheless only minimum rates were eventually fixed, a decision was transposed into two Directives: on the harmonisation of the structures of excise duties on mineral oils (92/81/EEC)[51], and on the approximation of the rates of excise duties on mineral oils (92/82/EEC)[52]. The Directives lay down a minimum tax rate for each type of mineral oil, depending on use: as a fuel, for industrial or commercial purposes or for heating.

- leaded petrol: ECU 337 per 1000 litres;
- unleaded petrol: ECU 287 per 1000 litres on the understanding that " *in every case the rate of duty shall be below that charged on leaded petrol"*;
- gas oil: ECU 245 per 1000 litres with reduced rates for heating oil;
- heavy fuel oil (diesel): ECU 13 per 1000 kg.;
- LPG and methane used as a propellant: ECU 100 per 1000 kg.; in other cases ECU 36 per kg. or ECU 0 per kg.
- kerosene used as a propellant: ECU 245 per 1000 litres; otherwise ECU 18 per 1000 litres, or ECU 0.

Every two years, "*and for the first time not later than 31 December 1994"*, these rates were to be reviewed "*on the basis of a report and where appropriate a proposal from the Commission"*. The Commission's first report was not formally published until September 1995[53]. Earlier drafts had proposed various changes to the minimum rates, making unleaded rather than leaded petrol the basis for the standard minimum and narrowing the gap between petrol and diesel rates. But the final report made no formal proposals.

In fact, the minimum rates of excise duty have not been reviewed since entry into force of Directive 92/82/EEC. They have not even been adjusted for inflation. In the meantime, Member States have chosen to pursue widely varying approaches within this framework, so that the current rates of excise duty on diesel fuel in Member States range from €245 to around €750 per 1000 litres (see Table 18).

In 1997, the Commission made a new proposal[54]. This sought to build on the existing system for the taxation of mineral oils by extending it to all energy products, and in particular to

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[51] OJ L316, 31.10.1992, p. 12, as last amended by Directive 94/74/EC (OJ L365, 31.12.1994, p.46).

[52] OJ L316, 31.10.1992, p. 19, as last amended by Directive 94/74/EC (OJ L365, 31.12.1994, p.46).

[53] *Report on the rates of excise duties*, COM(95)285, September 1995.

[54] Proposal for a Council Directive restructuring the Community Framework for the Taxation of Energy Products, COM(97)30, of 12.3.1997.

products which are directly or indirectly substitutable for mineral oils: coal, coke, lignite, bitumens and products derived from them; natural gas; and electricity.

Table 20: Excise duties on fuel, February 2002

(€ per 1000 litres):

	B	DK	D	EL	E	F	IE	I	L	NL	A	P	FIN	S	UK
Unleaded petrol	507	548	624	296	396	574	401	542	372	627	414	479	560	510	742
Diesel fuel*	290	370	440	245	294	376	302	403	253	345	282	272	305	337	742

**Diesel fuel with a sulphur content of less than 50 ppm.*

Source: *European Commission*

In the case of electricity, the tax would be on the electricity itself rather than the fuel inputs, although a rebate would be possible where "environmentally preferable" fuels were used for generation. Various rebates, etc. would be made available to certain industries with high energy costs. The legislation would have introduced *minimum excise* duties (see Table 19).

Table 21: Commission proposal of 1997 on energy taxation

Energy products used as motor fuels	
Petrol (€per 1000 l)	417
Kerosene (€per 1000 l)	310
Natural gas (€per gigajoule)	2.9
Gas oil (€per 1000 l)	310
LPG (€per 1000 kg)	141
Energy products used as motor fuels for certain industrial and commercial purposes	
Gas oil (€per 1000 l)	32
LPG (€per 1000 kg)	41
Kerosene (€per 1000 l)	30
Natural Gas (€per gigajoule)	0.3
Energy products used as heating fuels	
Heating gas oil (€per 1000 l)	21
Kerosene (€per 1000 l)	7
Natural Gas (€per gigajoule)	0.2
Solid energy products (€per gigajoule)	0.2
Heavy fuel oil (€per 1000 kg.)	18 or 22
LPG (€per 1000 kg)	10
Electricity (€per Mwh)	1

In June 2002 the Spanish Presidency proposed guidelines to the Seville European Council to give direction to work on the energy tax proposal. In the Council's discussions, Member States had stressed the need for special tax treatment for the road haulage sector and passenger transport industry to offset increases in fuel costs, while acknowledging the significant competitive distortions caused by different national rates of diesel taxation. The Commission undertook to present a new Community proposal.

The new Commission proposals

On 24 July 2002 the European Commission duly presented its new proposal[55]. This would to gradually harmonise Member States' excise duty on commercial diesel fuel, and align minimum excise rates on non-commercial diesel and unleaded petrol.

The proposal would, by 2010, raise the minimum rate of excise duty on diesel from the current €245 per 1000 litres to a harmonised common "central" rate. The central rate would be set at €350 in 2003 and would be adjusted for inflation on the basis of the consumer price index from 2003 onwards. Between 2003 and 2010 the rates applied by Member States would have to be within a fluctuation band of €100 either side of the central rate. This band would be narrowed every year by €28 through the raising of the lower limit and the reduction of the upper limit by €14 each. In 2009 and 2010 the fluctuation band would be narrowed by €30 by raising the lower limit and lowering the upper limit by €15 each. This would create a harmonised rate with no fluctuation band by 2010. By that stage the central rate, adjusted for inflation, should have reached – or even exceeded – €410.

The Commission is proposing harmonisation for excise duty on commercial diesel fuel because minimum rates would not be sufficient to end distortions on haulage and coach transport markets. Hauliers and coach operators operating across frontiers or in another Member State usually have vehicles with large tanks and so can take advantage of the very significant differences in national excise duties on diesel fuel by filling up in Member States with the lowest rates of excise duty, and so reduce their running costs. Such detours lead to tax revenue losses for Member States and also have negative effects on the environment due to the longer distances driven than would be the case if the different duty rates did not exist.

Those Member States, such as the United Kingdom, which currently apply a rate of excise duty to diesel more than 1.5 times higher than the central Community rate, would be able to apply a rate outside the fluctuation band for a period of seven years from 2003, but would have to adopt a convergence plan to bring their excise duty within the band by 31 December 2009. In practice, the ability of individual Member States to pursue higher environmental protection goals or to raise additional revenue by applying much higher rates of excise duty on fuel than neighbouring countries is limited to some extent by the fact that their road hauliers and coach operators operating on international routes can simply buy their fuel in a neighbouring country.

The seven-year transition period (2003-2010) would allow Member States with a low duty on diesel fuel to increase their rates gradually without disturbing the equilibrium of the companies concerned. Moreover, it limits budgetary difficulties in the Member States which have to reduce their current levels of excise duties.

As for non-commercial diesel, the proposal would apply the same minimum level of excise duty as unleaded petrol by 2006 since there are no environmental or other reasons to justify the present lower minimum rate on diesel[56]. Given that the minimum Community rate of excise duty for unleaded petrol has not been reviewed since 1992, a correction for inflation would give a rate of around € 360 per 1000 litres of fuel. Therefore, on 1 January 2006, the

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[55] Proposal for a Council Directive amending Directive 92/81/EEC and Directive 92/82/EEC to introduce special tax arrangements for diesel fuel used for commercial purposes and to align the excise duties on petrol and diesel fuel, COM(2002)410, 24 July 2002.

[56] Under the present rules, the minimum level of excise on diesel (€245 per 1000 litres) is less than the minimum level of excise on unleaded petrol (€287 per 1000 litres).

minimum rates of excise duty for non-commercial diesel fuel and unleaded petrol should become the same and should be set, initially, at €360 per 1000 l. Once the lowest rate of duty on commercial diesel exceeds €360 under the gradual move towards harmonisation of the rate, that minimum rate must also become the minimum rate for non-commercial diesel fuel and unleaded petrol. Thus the minimum duty rate on non-commercial diesel and unleaded petrol will never be lower than that on commercial diesel and will be constantly adjusted in line with inflation. The common approach to the taxation of excise duties on diesel used by road hauliers and coach operators is one of the objectives laid out in the Commission's White Paper on European Transport Policy for 2010[57].

Environmental impact of the proposal

The proposal would increase levels of excise duty on diesel fuel (both commercial and non-commercial) in most Member States. This would represent an incentive to use fuel more efficiently and transport more freight by rail, which in should lead in turn to a general reduction in emissions of pollutants such as nitrous oxide, volatile organic compounds, sulphur dioxide and particulates as well as a general reduction in CO_2 emissions. Moreover, aligning the minimum rates of excise on non-commercial diesel and on unleaded petrol would help to remove an unjustified fiscal incentive to use diesel rather than petrol. Hydrocarbon (HC) and NOx emissions from cars registered in 2000 were twice as high when the fuel used was diesel as when it was petrol. Diesel engines also emit significantly higher volumes of particulates than petrol engines.

However, one Member State (the UK), which currently applies a rate of excise duty to diesel more than 1.5 times higher than the central Community rate, will have to reduce excise duty significantly. Since this will be dependent on the introduction of infrastructure charging, it will offset the environmental drawbacks.

By increasing the levels of excise duty on diesel in most Member States, the proposal would encourage energy efficiency, thereby making the Union less dependent on imported energy. Moreover, higher excise duty on diesel fuel would tend to slow down the growth in consumption of a product for which the European Union does not have sufficient refining capacity to meet demand.

Economic effects

The alignment of the rates of excise duty for commercial diesel fuel will significantly reduce distortion of competition and will make the Single Market function more smoothly. Each year, the differences between the amounts of excise duty levied on commercial diesel fuel in the different Member States will be reduced gradually so that by 2010 it will be subject to one – harmonised – rate of excise duty throughout the European Union.

The proposal will not have an inflationary impact in the medium term – greater price stability should also result – except in Member States whose rate is lower than the new Community minimum rate. According to the Commission the inflationary impact could in most cases be compensated at Member State level by a reduction in other transport taxes. Additionally, if the inflation rate in the European Union exceeds or is forecast to exceed 2.5%, the automatic indexing has a ceiling of 2.5%.

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[57] *European transport policy for 2010: time to decide*, COM (2001) 370, 12.9.2001.

Budgetary impact

Where excise duties on commercial diesel fuel have to be reduced, this will not necessarily imply a reduction in overall budgetary resources since the reductions could be compensated by other revenues, such as taxes on other products or infrastructure charges, as well, of course, as increases in duties on non-commercial motor fuels. The proposal allows maximum flexibility as to the tax instruments to be used. However the Commission emphasises that it does not in any way seek to increase overall levels of taxation in the Member States, and considers that the proposal will encourage the restructuring of national systems of vehicle taxation in the widest sense.

Implications for Candidate Countries

The Commission considers that the proposal would not create significant additional difficulties for the candidate countries in comparison with the excise duty rates on energy products, which are currently under discussion in the Council on the basis of the Commission's 1997 energy tax proposal.

The fluctuation band around the central rate is large enough to allow some candidate countries to join the planned convergence mechanism without significant additional difficulties. However, taking into account their present level of excise duties (some applicant countries have excise duty rates under the minimum set in 1992); their ongoing economic transition; and their relatively low income level; many candidate countries will face significant economic and social difficulties if minimum rates rise further. The Commission might therefore contemplate the progressive introduction, over a limited period, of special minimum rates for applicant countries.

Electricity and gas: the Spanish proposals

The Spanish Presidency in its Report on Energy Taxation to Seville European Council of June 2002 proposed minimum levels of taxation of those energy products not yet subject to harmonised excise duties – mainly natural gas and electricity:

Natural gas. For business consumption: EUR €0.15 per gigajoule, and for non-business consumption €0.30 per gigajoule. However, Member States in which the share of natural gas in final energy is less than 15% may apply an exemption or a reduction, in whole or a part, for up to ten years or until such time as that shares reaches 25%. Once a 20% share is reached, the Member States concerned should start the progressive introduction of taxation.

Electricity. For business consumption €0.50 per megawatt hour, and for non-business consumption €1 per megawatt hour. Above these minimum levels, Member States will have the option of determining the tax base. For a current comparison of taxes on electricity and gas in the 15 EU Member States, see tables 20 and 21, respectively.

Some Member States do not apply these forms of taxation: Greece and Ireland do not apply taxes on electricity or gas, Portugal does not apply tax on electricity, and Luxembourg and Spain do not tax natural gas. The rest apply these taxes at rates, in most cases, near or above the minimum. Nevertheless, the Report includes transitional periods and special rules for those Member States with difficulties in implementing the new proposed minimum levels of taxation.

Table 22: TAX ON ELECTRICITY IN EU MEMBER STATES (2

	Indirect Tax (other than VAT)	Chargeable event	Taxable basis	Applicable tariff	Exen
AUSTRIA	Electricity Tax (Elektrizitätsabgabe)	Supply or usage of energy. Refund is possible under specified conditions	Amount of electricity supplied or used	€0.015/kWh	-Electricity used and transport of mineral oil. - Electricity pro if less than 5000
BELGIUM	Levy on energy (Cotisation sur l'énergie)	Supply of electricity	Amount of electricity supplied	€1.36342 per Mwh	Specific social t the sector for electricity
DENMARK	1. Tax on Energy (Elafgift) 2. Tax on Distribution (Eldistributionsbidrag) 3. Tax on carbon dioxide (Kuldioxidafgift) 4. Contribution for electricity saving measures (Elsparebidrag)	Supply of electricity	Amount of electricity supplied	1. DKK 0.52/kWh; 2. DKK 0.04/kWh; 3. DKK 0.1/kWh; 4. DKK 0.006/kWh	Electricity d electricity us plants/CPH
FINLAND	1. Additional duty 2. Strategic stockpile fee	Release from network into consumption (output-taxation)	Amount of electricity released	1. Category 1 (households and services): € 0.0069/kWh - Category 2 (mining industry, industrial manufacturing) : € 0.0042/kWh 2. Stockpile fee € 0.00012/kWh	Electricity pro nominal max possible refunds

	Indirect Tax (other than VAT)	Chargeable event	Taxable basis	Applicable tariff	Exen
FRANCE	Special municipal and departmental taxes	Supply of low and medium tension electricity	Price of the electricity supplied (30 or 80% of the amount net of tax on the invoice)	0 to 8% (municipal) + up to 4% (department)	Reduced rates consumption
GERMANY	Electricity Tax (Stromsteuer)	Supply or usage of electricity	Amount of electricity supplied or used	17.90 €/MWh	Electricity used and for night sto
GREECE	No	Not applicable	Not applicable	Not applicable	Not applicable
IRELAND	No	Not applicable	Not applicable	Not applicable	Not applicable
ITALY	Electricity Tax plus local, regional and national surtaxes where applicable	Release for consumption	Amount of electricity consumed	€ 0.0031/kWh when sold for use outside the dwelling	Electricity used production, pro powered by ren energy
LUXEMBOURG	Consumption tax on electricity (Taxe de consommation d'électricité)	Supply of electricity	Amount of electricity consumed	€ 0.236/kWh (annual consumption below 1 mio kWh) € 0.166 (annual consumption between 1 and 100 mio kWh) € 0.025/kWh (annual consumption above 100 mio kWh)	No

	Indirect Tax (other than VAT)	Chargeable event	Taxable basis	Applicable tariff	Exen
NETHERLANDS	Regulating energy tax (Regulerende Energiebelasting)	Supply of electricity	Amount of electricity supplied	€ 0.0601 per kWh if consumption is less than 10,000 kWh per annum € 0.02 per kWh if consumption is between 10,000 & 50,000 kWh per annum € 0.0061 per kWh if consumption exceeds 50,000kWh per annum	Refunds possi supplies (e.g. ch
PORTUGAL	No	Not applicable	Not applicable	Not applicable	Not applicable
SPAIN	Administrative charge for the services rendered by the National Commission of Energy	Supply to the end consumer - transportation services	VAT assessment base X 1.05113	4.86%	IC supply of en energy for own c
SWEDEN	Energy tax on electric power	Supply to the buyer or own consumption	Amount of electricity consumed	From SEK 0.125/kWh to SEK 0.181/kWh (SEK 0.0/kWh for use in industrial manufacturing processes, commercial greenhouse cultivation)	Electric power producers, use electric power, p specific use
UNITED KINGDOM	Climate Change Levy (as from 01/04/01)	Industrial and commercial supply for lighting, heating and power	Amount of electricity supplied	GBP 0.0043/kWh	Export supplies produce energy, schemes

Table 23: TAX ON GAS IN EU MEMBER STATES (2002)

	Indirect Tax (other than VAT)	Taxable event	Taxable basis	Applicable tariff	Exemp
AUSTRIA	Gas duty (Erdgasabgabe)	Supply or usage of gas. Refund is possible under specified conditions	Amount of gas supplied or used	€0.0436/m³	-Gas used for produc storage of gas - Gas used for transp processing of miner
BELGIUM	Levy on energy (Cotisation sur l'énergie)	Supply of gas	Amount of gas supplied	€0.33888 per Gigajoule (GJ)	Specific social tariff the sector for distribu gas
DENMARK	1. Tax on energy (Gasafgift) 2. Tax on carbon dioxide (Kuldioxidafgift	Supply of gas	Amount of gas distributed	1. DKK 2.02/m³ 2. DKK 0.22/m³	Natural gas delivere gas used to produce
FINLAND	1. Additional duty 2. Strategic stockpile fee	Importation or consumption	Amount of gas	1. €0.0173/m³ 2. €0.0008/m³	Use for industrial pr the production of ele
FRANCE	Special tax called TICGN (and subsidiary tax, TIFP)	Consuming more than 5 GWh per year	Not applicable	Special tax: € 1.13/1000 m³. Art 266 quinquies of French Customs Code	Not applicable
GERMANY	Mineral oil tax (Mineralölsteuer)	Removal from gas recovery or storage facility, import	Amount of gas	30.30 €/MWh	Yes, reduced rates (purposes
GREECE	No	Not applicable	Not applicable	Not applicable	Not applicable
IRELAND	No	Not applicable	Not applicable	Not applicable	Not applicable

	Indirect Tax (other than VAT)	Taxable event	Taxable basis	Applicable tariff	Exemp
ITALY	Natural Gas Tax (plus local & regional surtaxes where applicable)	Release for consumption	Amount of gas consumed	€0.0103 cm³ for industrial use	Use of natural gas fo of electricity
LUXEMBOURG	No	Not applicable	Not applicable	Not applicable	Not applicable
NETHERLANDS	Regulating energy tax (Regulerende Energie Belasting)	Supply of gas	Amount of gas supplied	€0.124 per m³ if less than 5,000 m³ per annum consumed; € 0.0579 per m³ if consumption is between 5,000 and 170,000 m³ per annum; €0.0107 per m³ if consumption exceeds 170,000 m³ per annum	Natural gas used in t electricity. Reduce r greenhouses
PORTUGAL	Excise Tax	Moment of use of gas	Kg	€1.48/1,000Kg	Natural Gas
SPAIN	Not applicable	Not applicable	Not applicable	Not applicable	Not applicable
SWEDEN	1. Energy tax 2. Carbon dioxide tax	Supply or consumption by a registered person	Amount delivered or consumed	1. SEK 223/1,000m³ 2. SEK 1,039 up to SEK 1,1441/1,000m	Deductions possible production of taxabl power
UNITED KINGDOM	Climate Change Levy (as from 01/04/01)	Industrial and commercial supply for lighting, heating and power	Amount of gas supplied	GBP 0.0015/kWh	Export supplies, sup produce energy, sup schemes

Notes to Tables 20 and 21:

Mwh = Megawatts per hour (1Mwh = 1000 Kwh)
1 Gigajoule = 1 000 000 000 joules
1 Kwh = 3 600 000 joules = 0.0036 gigajoules

Kwh = Kilowatts per hour
1 watt= 1 joule/second
1 m^3 of gas is equivalent of

The Taxation of Motor Vehicles

Background

In 1997 the Commission published a study on *Vehicle Taxation in the European Union*[58]. All Member States, this noted,

> *"rely heavily on a range of tax instruments to ensure significant budgetary receipts from both private and commercial road users".*

But various pressures had resulted in "*large differences in the overall strategies followed".*

The study listed vehicle taxation under three broad categories:

1. **Taxes on the acquisition, purchase or registration of a vehicle.** All Member States levy **Value Added Tax** on the purchase of new vehicles. Under the special regime introduced under the transitional VAT system, this is levied in the country of destination, even if the purchaser is the final consumer. For this purpose, "new" vehicles are defined as those which have travelled less than 6 000 kilometres, or which have been in service for less than six months. VAT is usually deductible as input tax in the case of commercial vehicles. Passenger cars are in some Member States fully deductible; in others partially deductible; and in others not deductible at all. Before 1993, a number of Member States applied "luxury" VAT rates (or special excise duties) on motor vehicles, which were abolished under the transitional system.

   In most cases, however, these were replaced by **registration taxes (RT)**, usually related to the characteristics of the vehicle, and payable on the issue of registration plates and documentation. Ten of the fifteen Member States currently apply a registration tax, ranging in 1999 from an average of €267 in Italy to €15659 in Denmark. However, a flat-rate **registration charge** is also levied in some countries (for details see Table 22).

2. **Taxes on the possession or ownership of a vehicle.** Vehicles are in general not permitted to circulate on the public highway without the payment of an **annual circulation tax (ACT)** – usually through the purchase of a *vignette* to be displayed on the windscreen. These can be at a flat rate, or, like registration taxes, be related to the power, age or other characteristics of the vehicle.

   ACT is charged on passenger cars used by private persons in all Member States except France (which abolished this tax in 2000). Tax bases and tax levels applied vary greatly: the average Annual Road Tax paid in 1999 ranged from €30 per vehicle per year in Italy to €463 in Denmark.

   In addition, all vehicle users are required to carry at least third-party **insurance**, the premiums on which can incur tax.

3. **Taxes on the use of vehicles.** The **fuel** used by motor vehicles is subject in all Member States to both **VAT** and **excise duties**. Under Community law, the excise on leaded petrol must be higher than that on unleaded petrol; and the tax on the diesel used by commercial vehicles is usually lower than that on petrol. A number of Member States also charge **tolls** for the use of some motorways. Six Member States operate a *Eurovignette* system, the purchase of which allows access to their motorways.

[58] *Vehicle Taxation in the European Union*, XXI/306/98 of 8 September 1997.

The diversity between national systems has created problems for the Single Market. For example, successive surveys have revealed that the pre-tax price of identical models of car can vary by more than 20% between different Member States. This has given rise to a running dispute between the car manufacturers and their distributors on the one hand, and car purchasers, independent distributors and "parallel traders" on the other.

- The latter have argued that the ability of motor manufacturers to sell cars through tied dealer networks (the result of the recently reviewed "block exemption" from normal competition policy) has enabled them to segment the Single Market, and maintain higher prices and profit margins in some parts of the Market than in others. Despite efforts by the Commission to ensure that any model of car must be purchasable in one Member State for delivery in another ("full-line availability"), the manufacturers are accused of making this, in practice, as difficult as possible.
- The manufacturers have replied that the segmentation of the market largely results from differences in national taxation systems. The level of tax may depend on definitions of vehicle category, which can vary widely. As a result, the same model may have to be produced to different specifications in different countries. More significantly, the very large differences in tax rates – particularly of registration taxes, which can vary between 0% of the pre-tax price in the UK and 180% in Denmark – have meant that broadly similar *post-tax* prices are divided in different proportions between *pre-tax* price and taxation. The lowest pre-tax prices are found in those countries with the highest taxes.

The 1997 study observes, pointedly, that

> *"Member States with a large car production tend to have relatively low registration taxes or no taxes at all."*

Several problems also arose in the case of **the taxation of vehicles in use**. The application of VAT to commercial transactions in used vehicles is governed by the 7th.VAT Directive[59] and has worked relatively smoothly. Application of the destination principle to vehicles owned and in use by final consumers, however, has given rise to substantial problems. The paper observed, for example, that

> *"the treatment of individuals moving, either temporarily or permanently from one Member State to another with their cars can, in some cases, be more restrictive now than prior to 1993."*

Under current Community law, **a vehicle used in a country other than that in which the user is normally resident** does not become liable to tax in the country of use provided it is not there for more than six months in the year. Numerous problems arise, however, in applying this rule: establishing and proving residence; the question of who can drive a vehicle which is taxed in another country, etc. The situation when a vehicle moves between countries on **transfer of residence** is theoretically covered by a Directive on *"tax exemptions applicable to permanent imports...of the personal property of individuals*[60]*"*.

The study observed, however, that this Directive has in effect become obsolete, since import taxes are prohibited within the Single Market, and other taxes are not covered.

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[59] 7th.VAT Directive, 94/5/EEC of 14 February 1994.

[60] Directive on tax exemptions applicable to permanent imports[...]of the personal property of individuals, 83/183/EEC of 28 March 1983.

The study also drew attention to the special problems in the **car rental sector**.

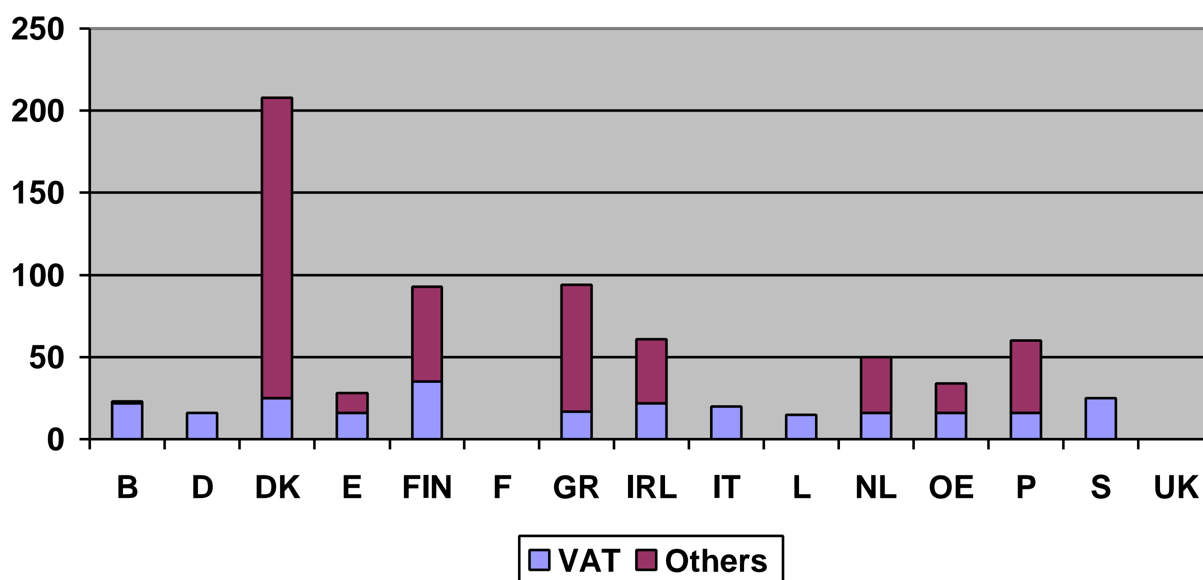
> *"At present, a vehicle registered in one Member State cannot be hired for use in another Member State by a resident of that latter Member State".*

There was, in effect, no free movement of rental cars. But if there were to be, the study added, most car rental firms would probably operate from the countries with the lowest taxes.

In 1998 the Commission tabled a comprehensive proposal, covering both temporary and permanent movements of vehicles[61]. Following the passage of amendments by the European Parliament, a revised proposal was made[62]. Under this, the levying of new registration taxes on transfer of residence would have been prohibited. In the case of temporary use, the six months rule would have been made more flexible. Where there were "professional ties", for example, the period would have been nine months; and provisions would have existed permitting use by persons other than the owner; on hire cars; and for special circumstances like scrapping following irretrievable damage.

The Council, however, held only limited discussions on the text. In its Communication of 2001[63], the Commission therefore promised a further examination of the whole area of vehicle taxation, with the aim of acting through co-operation rather than legislation.

Figure 3: Taxes on cars (2000c capacity) as a % of pre-tax price



Source: *Taxation of Passenger Cars in the European Union. COM(2002)431, 06.09.2002*

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[61] Proposal for a Directive governing the tax treatment of private motor vehicles moved permanently to another Member State in connection with the transfer of residence or used temporarily in a Member State other than that in which they are registered, COM(1998)30.

[62] Revised proposal for a Directive governing the tax treatment of private motor vehicles moved permanently to another Member State in connection with the transfer of residence or used temporarily in a Member State other than that in which they are registered, COM(1999)165, revising COM(1998)30.

[63] *Tax policy in the European Union - Priorities for the years ahead*, COM(2001)260, May 2001.

The new Commission proposals

On 9 September 2002 the European Commission presented a comprehensive strategy on the taxation of passenger cars in the European Union[64]. This echoed the findings of the study concerning the problems caused by differing national systems.

> *"The operation of 15 different vehicle tax systems within the EU has resulted in tax obstacles, distortions and inefficiencies.....[T]he car market in the EU is still a long way from a true single market".*

From the point of view of the **citizen** there was no freedom to "*buy a car in the Member State of his choice, and to pay purchase-related taxes in that State"*. From the point of view of the **motor industry**, the variety of tax systems had a negative effect on competitiveness and the ability to create new jobs. About 20% of European car price differentials were due to the widely differing tax levels (see Figure 3 and Table 22), the Commission estimated.

Table 24: MAIN TAXES ON CARS IN THE EUROPEAN UNION

COUNTRY	REGISTRATION		CIRCULATION TAX		FUEL TAXES (a)	
	TAX	*CHARGE*	*BASIS*	*APPROX. RANGE (eur)*	*PETROL*	*DIESEL*
AUSTRIA	Tax base is base price excl. VAT. Rate is differentiated with fuel consumption maximum rate is 16%	€109	Tax base is kW (12 x [kW – 24] x €0,55)	Min. €66 (+ approx. €73 road toll)	0.408	0.283
BELGIUM	Tax base is cm3, Rate is differentiated with cm3. Range from €62 to €4,958	€62	Tax base is Fiscal HP (cm3), Small supplementary tax for diesel cars	€57 (HP = 4) to €1,449 (HP = 20)	0.505	0.305
DENMARK	Tax base is price incl. VAT. Rate is differentiated with price 105% up to €7,122 and 180% of remainder	€144	Tax base is fuel consumption Differentiated petrol/diesel Increase 2% annually (in fixed prices)	€62 (>20 km/l) to €2,272 (< 4.5 km/l)	0.524	0.404
FINLAND	Tax base is CIF price excl. VAT. Rate is 100% Fixed deduction in tax is €774	None	Tax base is total (max) weight for diesel cars, flat rate for petrol cars	€118 E.g. 1,100 kg: €277	0.560	0.325
FRANCE	None	Avr.€25 x horse-power	Tax base is Fiscal HP Rates. Varies with county		0.620	0.373
GERMANY	None	€26	Tax base is cm3 Differentiated petrol/diesel		0.593	0.409
GREECE	Tax base is base price excl. VAT.	None	Tax base is Fiscal HP (cm3)	€73 (< 9 FHP) to €382 (> 17	0.298	0.245

[64] *Taxation of Passenger Cars in the European Union - options for action at national and Community levels.* COM(2002)431, 06.09.2002.

COUNTRY	REGISTRATION		CIRCULATION TAX		FUEL TAXES (a)	
	TAX	*CHARGE*	*BASIS*	*APPROX. RANGE (eur)*	*PETROL*	*DIESEL*
	Rate is differentiated with cm3 Range from 7% to 88%			FHP)		
IRELAND	Tax base is price incl. VAT. Rate is differentiated with cm3 22.5% if cm3 < 1,400. 25% if 1400. 30% if cm3 > 2000.	None	Tax base is cm3	€124 (< 1,000 cm3) to €1,078 (> 3,000 cm3)	0.348	0.249
ITALY	Fixed amount, €151	€118	Tax base is kW (linear relationship)	€28 (11 kW) to €806 (316 kW)	0.520	0.382
LUXEM-BOURG	None	€29	Tax base is cm3	E.g. €37 (< 1000 cm3) to €337 (8000 cm3)	0.372	0.253
NETHER-LANDS	Tax base is base price excl. VAT. Rate is differentiated between petrol/diesel Petrol: 45.2% - €1,540 Diesel: 45.2% + €350	€41	Tax base is Weight Differentiated petrol/diesel Vary between districts	E.g. 1,100 kg: €385 (petrol) and €761 (diesel)	0.590	0.334
PORTUGAL	Tax base is cm3	€25	Tax base is cm3 Differentiated petrol/diesel	€14 (< 1,000 cm3) to €298 (> 3,500 cm3	0.289	0.246
SPAIN	Tax base is base price excl. VAT. Rate is differentiated with cm3 7% for small cars 12% for bigger cars	€62	Tax base is Fiscal HP (cm3)	€13 (0-8 HP) to €112 (> 20 HP)	0.372	0.270
SWEDEN	None	None	Tax base is weight Differentiated petrol/diesel	E.g. 1,000 kg: €78 (petrol) and €299 (diesel)	0.528	0.356
UNITED KINGDOM	None	€40	Tax base is CO_2 (b)	€159 (< 150 g CO_2) and increases gradually up to €246 (> 185 g CO_2) for petrol. The tax is approx. €15 higher for diesels	0.815	0.865

Source: COWI study, Table 2.2, 2.3, 2.4 {SEC(2002)858}

(a) Euro per litre

(b) After March 2001

The cross-border transfers of cars

The Commission Communication identifies a number of fiscal obstacles to the free movement of cars – either permanently or temporarily – from one Member State to another.

- **Double taxation.** Though ACT is sometime reimbursed, unexpired RT never is (this is the subject of current legal action in the Court of Justice).
- **Procedural complexity.** The Communication lists five sources of additional administrative costs faced by the motorist. It also notes

  a lack of comprehensive and easily accessible information on this issue.
- **Excessive estimation of residual values.** Second hand cars coming from another Member State are often taxed at higher RT rates than similar cars circulating in the same market.
- **Registration "fees"**. If the transfer of a vehicle coincides with a change of residence, no new RT tax should be payable (see earlier) – only ACT from the moment of use in the new country of residence. However, administrative "registration fees" are sometime levied, which often appear excessive, and can be confused with "registration taxes" or "registration charges".
- **Place of residence**. A citizen may, in some circumstances, wish to register a car in a Member State other than that of normal residence. This can give rise to double taxation.

A Commission working paper exists analysing current law in the this field, and the jurisprudence of the ECJ. It is available on the Internet at addresses: http://citizens.eu.int/originchoice.htm or on http://europa.eu.int/citizens.

Commission proposals

The Commission proposes two general objectives.

1) Removing tax obstacles in the Internal Market for passenger cars
2) Fiscal measures as one of the tools for reducing CO_2 emissions by cars

The priority is to ensure the smooth functioning of the Internal Market and to advance other policy objectives in line with Kyoto Protocol.

In order to achieve the first objective, the Commission recommends:

- A gradual reduction of Registration Tax levels with a view to its total abolition. This action should take place over a transitional period of about 5 to 10 years and should take into account the specific conditions in each Member State.
- A gradual transfer of revenues from Registration Tax to Circulation Tax in order to provide more fiscal stability for the budget, given that Circulation Tax is a more stable source of revenue than Registration Tax
- A Registration Tax refund system to ensure, during the transitional period, a *pro rata* refund of the residual RT in all cases where a passenger car, registered in one Member State, is exported or is moved permanently to another Member State. This would resolve double taxation relating to Registration Tax.

As regards the second objective, the Commission proposes:

- Registration Tax and Circulation Tax should be restructured and be turned into CO_2 based taxes, in order to optimise the effect of taxation on the reduction of CO_2 emissions.

Table 25: POLICY RECOMMENDATIONS IN THE FIELD OF TAXATION CARS

TIMING	PROPOSAL	ADVANTAGES	DISADVANTAGES
Short term	• A harmonised Registration Tax Refund System	• Resolves double taxation problems and other fiscal consequences of cross-border transfer cars	-
	• General Rules with regard to the method of calculation of Registration Tax on used cars imported by other Member States	• Reduces complexity in the procedure necessary for moving one car from one State to another and improves the functioning of Internal Market	-
Transitional period	• Gradual reduction of Registration Tax	• Improves the functioning of the Internal Market and the competitiveness of the European car industry, given that Registration Tax is identified as one of the biggest problems on the current car taxation systems	- Reduces fiscal revenues, if this measure is not compensated with an increase in other taxes
	• Gradual transfer of revenue from Registration Tax to Circulation Tax, and to some extent to fuel taxes	• Provides more fiscal stability for the budget (Circulation Tax is a more stable source of revenue than Registration Tax) • Compensates the reduction of fiscal revenues in a budget neutral context • Improves the functioning of the Internal Market and the competitiveness of the European car industry	
	• Restructuring of the Circulation Tax and Registration Tax bases in an environmentally friendly direction (e.g. inserting a CO_2 specific element in the tax basis)	• Optimises the effect of taxation on the reduction of CO_2 emissions	
	• Approximation of Circulation Taxes among all Member States, in particular as regards tax bases	• Improves the functioning of the Internal Market • Prevents car market fragmentation	
Long term	• Total abolition of Registration Tax	• Improves the functioning of the Internal Market and the competitiveness of the European car industry	

Excise duties : The Taxation of Wine

Background

Article 93 of the Treaty requires the adoption of measures to harmonise "*turnover taxes, excise duties and other indirect taxes*" where this is "*necessary to ensure the establishment and functioning of the Internal Market*". In principle, this provides a legal base for substantial changes to indirect tax systems and rates.

This is particularly true in the case of excise duties. Both the rates and structures of the duties vary widely between Member States, which can affect competition within the Single Market in a number of ways. Levying duties on products from other Member States at higher rates than on those domestically produced is discriminatory, and forbidden by EC Treaty Article 90. Very large discrepancies in the duty on a particular product can result in tax-induced movements of goods, which damage legitimate trade.

The effects of large tax-induced movements of excisable goods also, of course, go beyond internal market or competition policy considerations. They include, notably:

- loss of revenue to national exchequers (and also to the Community Budget); and
- the encouragement of fraud and other criminal activities.

Attempts have therefore been made since the early 1970s to harmonise both structures and rates; but progress has been slight, in part because of considerations other than the purely fiscal. For example, high levels of duty have been imposed in some Member States as part of general policies to discourage drinking and smoking. On the other hand, wine and tobacco are important agricultural products in some Member States.

The Commission's initial proposals to harmonise the structure of excises on beer, wine and spirits were made in 1972 (COM(72)225). Work on these in Council was suspended at the end of 1974, and remained so despite Communications in 1977 (COM(77)338) and 1979 (COM(79)261). New draft legislation (COM(85)15) was also blocked.

The Single Market programme of 1985, however, created a new impetus. All the existing texts on **structures** were eventually replaced by a new proposal (COM(90)432); and this became Directive 92/83/EEC in October 1992. It defined the products on which excise is to be levied (products are roughly divided into the separate tax categories of wine; beer; spirits; and "intermediate" products) and the method of fixing the duty (e.g. in the case of beer by reference to hl/degree plato or hl/alcohol content).

The Commission's initial proposals on **rates** (COM(87)328) were that for each product there would be a single Community rate, fixed as the average of existing national rates. For both wine and beer this would have been ECU 0.17 per litre, for spirits ECU 3.81 per 0.75 litre bottle. Unlike VAT, however, few national alcohol excises are close to the average rate. No Member State found the proposals acceptable.

The Commission then proposed a more flexible approach (COM(89)527). Instead of single, harmonised rates there would be *minimum* rates and *target* rates, on which there would be long-term convergence. In the end, following the "Luxembourg agreement" on taxation between Member States, only minimum rates were retained in Directive 92/84/EEC. The levels agreed were:

- alcohol and alcoholic beverages (i.e. spirits): ECU 550 per hl/alcohol
- intermediate products: ECU 45 per hl.
- still wine and sparkling wine: ECU 0 per hl.

- beer: ECU 0.748 per hl/degree plato or ECU 1.87 per degree of alcohol

Under the terms of the Directive, the Council should have reviewed these rates by the end of 1994, and adopted any necessary changes. No Commission proposals, however, had been published by the year's end. A draft text suggested raising the minimum rates on spirits, intermediate products and beer to maintain their real value; and raising the minimum for wine from zero to ECU 9.925 ECU per hl. However, this text was not adopted. A *Commission Report on the rates of excise duties* was eventually published in September 1995 (COM(95)285 final). Instead of suggesting new levels of minimum excise rates, the report proposed that the whole issue should be examined in the course of general consultations on excise duties with national administrations and with trade and other interest groups.

For some years after that not much happened. The Commission promised, and was reported to be preparing, new proposals; and various unofficial "leaked" texts were indeed circulated. Only in September 2002, however, did the Commission as a whole discuss a firm legislative proposal – and reports of the meeting recorded sharp disagreements.

The Competition Issue

One key issue in the debate is the extent to which different alcoholic drinks can be considered competing products. Article 90 (formerly 95) of the Treaty clearly forbids the imposition of a tax on products from another Member State in excess of that imposed on "similar" domestic products. In some cases the situation has been relatively clear-cut – for example, the ECJ found in its judgement on case 168/78 that France was in breach of the Article in taxing spirits made from grain (e.g. whisky) at a higher rate than made from grape (e.g. brandy).

In Case 170/78 against the UK for disproportionate levels of tax on wine and beer, however, the "similarity" of the products was less obvious. Nevertheless, the second paragraph of Article 90 also prohibits taxes which provide *indirect protection to other products.* In finding against the UK, the Court took the view that wine and beer could be considered competing substitutes since *the two beverages are capable of meeting identical needs*; and that the higher rate of tax on wine therefore constituted indirect protection.

The Commission has traditionally taken the view that *all alcoholic drinks are more or less in competition*[65]. In practice, the much higher rates of duty on spirits (that is, distilled products) than on wines, beers and ciders (that is, fermented products) have not been challenged – except, of course, by the distillers themselves, who have argued that a glass of wine or beer is in direct competition with a measure of spirits with a "mixer" (e.g. a gin and tonic).

All attempts to introduce a simple system of excise duty based on alcoholic strength have quickly foundered.

In order to obtain factual evidence on the issue, the Commission instituted a research project into *competition between alcoholic drinks* which reported in February 2001[66]. This concluded that the issue was by no means straightforward.

> *"....[T]here is a range of factors that influence alcoholic drink consumption and the degree of switching by consumers between categories of drink. For example, consumers' attitudes to consuming wine may change over a number of years leading to*

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[65] Communication concerning the major problems relating to the proposed Council Directives to harmonize the structures of consumer taxes, other than VAT, on beer, wine and alcohol, COM(79)261, June 1979.

[66] *Study on the competition between alcoholic drinks: final report*, Customs Associates Ltd., February 2001.

an increase in wine consumption at the expense of other drink categories. Thus, in many circumstances, the switching to wine will be independent of the price of wine relative to other drinks, i.e. the switching would occur even if relative prices were stable over time….

From our analysis it is possible to conclude that there is no systematic pattern of whether certain types of beverages are complements or substitutes for each other…..[T]he estimated cross price elasticities between drinks indicate a lack of price sensitiveness between alcoholic drinks."

The research did not find, however, that price and tax levels were *completely* irrelevant. Broadly, the consumption of beer, wine and cider was relatively insensitive to excise duty changes. That of sparkling wine, spirits and intermediate products was.

Consequences for tax policy

Whatever the implications for competition policy and the Internal Market, these findings are clearly relevant to the issue of a wine tax. They provide ammunition for both sides.

- On the one hand, if price competition between alcoholic drinks is low, it cannot be considered "unfair" to tax beer and spirits, but not wine.
- On the other hand, if the consumption of wine is price inelastic, it is unlikely that a wine tax in countries now charging a zero rate would cause a catastrophic fall in consumption.

In order to provide some guidance as to possible consequences of new legislation, the study examined a number of "What if?" scenarios. It observed that the existing minimum rates of excise on alcoholic beverages, which have not changed since 1992, were "*becoming less relevant each year due to inflation*".

"The Directive had some effect in 1993, but without updating would appear to be generally ineffective in its current form."

Among possible alternatives to the *status quo* were:

- All countries might apply the *minimum* rates, indexed to inflation. The main effect would be a switch from wine and beer consumption to spirits in Northern Europe.
- There might be a return to the original proposal for *target* rates, indexed to inflation, towards which each country would move. These might be set at the *median rate* for each drink category. Here, the effects would depend significantly on the cross-elasticities.

  The consumption of spirits might again rise in Northern Europe, as might the consumption of beer; but that of wine might rise or fall. In most of Southern Europe the consumption of spirits would fall, with that of still wine either falling or remaining roughly constant.

The cross-border issue

Finally, the study looked at the effect of rate differences on the cross-border movement of products. Substantial rate differences exist between the UK and France; between Sweden and Denmark; and between Denmark and Germany. In the case of still wine, the difference is €3.4 as opposed to €250 per hectolitre for France and the UK; €94.81 or €141.87 as opposed to €226.85 in the case of Denmark and Sweden; and €0 as opposed to €94.81 or €141.87 in the case of Germany and Denmark (see Table 24).

Under the legislation establishing the Single Market, commercial movements across internal frontiers take place under a system of duty-suspension, with tax becoming due only when the

products are released for consumption. Goods bought and taxed in one Member State by a final consumer are in principle in free circulation: i.e. they can be taken into another Member State without paying further tax. The huge disparities in rates of duty on tobacco products and alcoholic beverages, however, have made it impossible for Member States to accept complete free movement for excisable goods. The principle only applies when the product is for "final consumption", and when the consumer personally transports the goods.

To aid the enforcement of these provisions, certain "indicative allowances" have been set. In the case of wine, this allowance is 90 litres of wine, of which 60 can be of sparkling wine.

These provisions have, however, given rise to a certain degree of confusion. *Legitimate* movements are not limited to the indicative allowances – they can in theory be infinite, provided they are for the traveller's own personal consumption (though there is no firm definition of "personal"). Movements only become clearly *illegal* if the products are subsequently presented for resale.

The UK Customs and Excise has recently been held by the High Court to have applied excessive search and seizure procedures on ordinary travellers; and faces action at EU level. Since 2000, some 20,000 vehicles are reported have been impounded, and nearly 3 billion cigarettes. The Court, however, maintained that there had to be "*reasonable grounds for suspecting an individual of holding goods bought in another Member State for commercial purposes"* before he or she could be stopped and searched. At the end of October 2002 the UK Treasury responded by raising the indicative allowance for cigarettes from 800 to 3,200 per person. Most recently, a case against fifteen men accused of massive excise duty fraud (in this case declaring goods to have been "exported" to another Member State tax free, which were actually sold in the UK) has collapsed as a result of incorrect Customs and Excise procedures.

As far as the scale of cross-border movements is concerned, the main conclusions of the Customs Associates study in the case of alcoholic beverages were that:

- Revenue losses through *legitimate* cross-border shopping were modest, with the UK losing the most (€400 million a year), but mostly through movements of beer.
- Losses through illegal cross-border smuggling, however, presented "*a very different picture"*. There was "*significant smuggling into the UK*, once again *particularly of beer*, and *some smuggled spirits in Sweden"*.
- In absolute terms, the UK was losing most revenue. In terms of market share, however,

> *"the problem is more acute in Denmark and Sweden, where about a quarter of spirits consumed are bought outside the consumers' own member state*."

Figures for the UK gave revenue losses of €2.6 and €2.7 billion in 1999-2000 as a result of all smuggling, falling to only €400 million in 2001, following the drive by Customs against cross-Channel movements. But wine played a negligible part in the totals.

Table 26: Tax Rates on Wine (2002)

		Standard rates					
		Still wine			Sparkling wine		
Minimum duty		€0			€0		
		Excise per hectolitre		VAT	Excise per hectolitre		VAT
		Nat. curr.	€	(%)	Nat. curr.	€	(%)
Country	***Currency***						
Austria	€		0	20		144	20
Belgium	€		47.0998	21		161.1308	21
Germany	€		0	16		136	16
Denmark	DKR	6-15% vol.705 15-22% vol. 1055	94.81 141.87	25 25	6-15% vol.1055 15-22% vol. 1405	141.87 188.94	25 25
Greece	€		0	18		0	18
Spain	€		0	16		0	16
Finland	€		235.46	22		235.46	22
France	€		3.4	19.6		8.4	19.6
UK	£	154.37	250.03	17.5	220.54	357.21	17.5
Ireland	€		273.01	21		546.01	21
Italy	€		0	20		0	20
Luxembourg	€	<= 13% vol. > 13% vol.	0 0	12 15		0	15
Netherlands	€		59.02	19		201.24	19
Portugal	€		0	5		0	5
Sweden	SKR	2208.0	226.85	25	2208.85	226.85	25

Source: Excise Duty Tables, August 2002, Commission DG for Taxation and the Customs Union

V. The OECD and Tax Havens

Background

In April 1998 a report[67] was adopted by the OECD Council – with Luxembourg and Switzerland abstaining – authorising work on nineteen recommendations for action against "harmful tax practices". A Forum on Harmful Tax Practices was established to carry out the work, which presented a progress report[68] in June 2000. "Harmful" was defined as any tax practice which effectively eroded the tax base of other countries, in particular by facilitating tax avoidance. Where these were identified in any of the 29 OECD Member States themselves, they were to be eliminated within five years.

The main focus of the report's attention, however, was on non-OECD-members, and in particular on "tax havens". The main criteria for identifying these were:

- no, or only nominal, effective tax rates;
- lack of effective exchange of information;
- lack of transparency; and
- absence of a requirement of substantial activities.

The Forum initially identified 47 possible havens. However, six of these – Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino – issued "advance commitment" letters prior to publication of the report, undertaking to eliminate the offending practices by 2005. Following its investigations, the Forum eventually listed 35 jurisdictions "*found to meet the tax haven criteria of the 1998 Report"* (see Table 25).

Table 27: Jurisdictions meeting the OECD "tax haven" criteria in 2000

Andorra	Guernsey/Sark/Alderney*	Niue (New Zealand)
Anguilla (UK)	Isle of Man*	Panama
Antigua and Barbuda	Jersey*	Samoa
Aruba (Netherlands)	Liberia	Seychelles
Bahamas	Liechtenstein	St. Lucia
Barbados	Maldives	St. Christopher & Nevis
Belize	Marshall Islands	St. Vincent & the Grenadines
British Virgin Islands (UK)	Monaco	Tonga
Cook Islands (New Zealand)	Monserrat (UK)	Turks & Cacos (UK)
Dominica	Nauru	Virgin Islands (US)
Gibraltar (UK)	Netherlands Antilles	Vanuatu
Grenada		

** Neither the Channel Islands nor the Isle of Man are part of the United Kingdom, but are direct dependencies of the Crown (e.g. the Queen holds the title of "Lord of Man").*

The jurisdictions listed were encouraged to co-operate with the OECD in eliminating the practices identified as harmful. Those that failed to make a commitment by 31 July 2001, or which failed to carry out a commitment already made, would be included on a "List of

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[67] *Harmful Tax Competition: An Emerging Global Issue*, April 1998.

[68] *Towards Global Tax Co-operation: progress in identifying and eliminating harmful tax practices,* June 2000.

Uncooperative Tax Havens". A second progress report on harmful tax practices was published by OECD in November 2001[69]. As in the case of earlier reports, both Luxembourg and Switzerland abstained from its adoption, in which they were joined by Belgium and Portugal. The report observed that OECD's initial stance had been modified as a result of bilateral and multilateral international discussions. It was conceded that

> *"every jurisdiction has a right to determine whether to impose direct taxes and, if so, to determine the appropriate tax rate."*

including a nominal or zero rate. The fourth criterion in the 1998 paper – a lack of substantial activities by a body being taxed in a haven – was dropped through difficulties in determining exactly what was meant by "substantial". In addition, the deadline for making commitments was extended from the original July 2001 date to 28 February 2002. Jurisdictions would then have a year after making a commitment – rather than the original six months – to develop implementation plans.

Recent developments

When this extended deadline closed, only seven of the territories on the OECD's original black list had failed to file the necessary commitment letters. These remaining "Uncooperative Tax Havens" were:

Andorra	Liechtenstein	Liberia	Monaco
The Marshall Islands	Nauru	Vanuatu	

Two OECD member states, however, were also mentioned by the OECD when these territories were officially "named and shamed" on 18 April: Switzerland and Luxembourg. These had been "permanent abstainers" on any OECD initiatives.

Non-OECD countries now have until the end of 2005 to abolish any identified harmful tax practices. OECD member states, however, have only until April 2003. The issue therefore now arises as to whether the OECD will apply financial sanctions to those failing to meet the deadlines. It has been made clear that any "defensive measures" may be applied to OECD member states as well as non-member states:

> *"At the end of the day there is only going to be one distinction: co-operative versus uncooperative*[70]."

The question also arises as to the status of the commitments given by the cooperating jurisdictions. OECD is working on the assumption that they have all been made in good faith and that they will all be fully implemented. On the other hand, it has also been made clear that the list of uncooperative tax havens is "dynamic".

> *"That means that if a jurisdiction ceases to co-operate by failing to fulfil its commitments, it will be put on the list...*[71]*".*

Meanwhile, the OECD has been working with eleven of the jurisdictions which made early commitments[72] to devise a legal framework for co-operation. As in the case of the current

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69 *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report,* OECD, 14 November 2001.

70 Mr. Jeffrey Owens, Head of OECD's Centre for Tax Policy and Administration, annex to a speech at the Friedrich Ebert Foundation Conference on Money Laundering and Tax Havens, New York, 8-9 July 2002.

71 Owens, *op.cit.*

version of the EU's draft Directive on savings taxation (see Chapter III), the main instrument will the exchange of information between tax authorities. A model agreement for such exchanges has already been drawn up by the OECD Global Working Group on Effective Exchange of Information, which was jointly chaired by the Netherlands and Malta[73].

The Model Agreement

The agreement drawn up by the working group is not intended to be a binding instrument. Instead, it provides two models for implementing the commitments made by the OECD countries and the co-operative jurisdictions:

1) A bilateral version, for pairs of jurisdictions.
2) A multilateral version, which "*is not a 'multilateral' agreement in the traditional sense"* but "*provides the basis for an integrated bundle of bilateral treaties"*.

Information exchange would cover all the taxes listed in the Agreement. A country's tax authorities would also be able to enter the territory of another *"to interview individuals and examine records with the written consent of the persons concerned"*.

The model Agreement, however, contains some important limitations on the scope of information exchange.

- It is made clear that the Agreement only covers exchange of information upon request, and *not* the automatic exchange of information, as in the case with the EU's draft Directive on savings taxation (though the commentary to the Articles does observe that "*contracting parties may wish to expand their co-operation ...by covering automatic and spontaneous exchanges and simultaneous tax examinations*)".
- It is made clear that the Agreement only covers tax matters: " *contracting parties are not at liberty to engage in fishing expeditions or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer"*.
- The Agreement lists a number of grounds on which a request for information may be declined. A requested party "*shall not be required to obtain or provide information that the applicant Party would not be able to obtain under its own laws...,"* the purpose being "*to prevent the applicant Party from circumventing its domestic law limitations by requesting information from the other Contracting Party, thus making use of greater powers than it possesses under its own laws"*. Trade, business, industrial, commercial or professional secrets would be protected. Confidentiality would have to be respected.

Tax Reforms in Associated and Dependent Territories

Recently, the **Netherlands Antilles** government has introduced a general corporate tax regime, in order to comply with OECD requirements, known as the New Fiscal Regime of the Netherlands Antilles (NFR), which is broadly comparable to the OECD countries corporate tax system. The NFR provides for a flat 34.5% profit tax rate (inclusive of the 15% island surcharges), which, in principle, applies to all taxpayers. Simultaneously with the introduction of the NFR, the Netherlands Antilles abolished its offshore regime. However,

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[72] These are: Aruba, Bermuda, Bahrain, the Cayman Islands, Cyprus, the Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino.

[73] *Agreement on Exchange of Information on Tax Matters*, OECD, 2002.

grandfather provisions provide that all offshore companies established before 1 January 2002 that meet certain requirements would be *grandfathered* through 2019. Substantially all offshore investment holding, finance and licensing companies meet these requirements.

To compete with tax-exempt jurisdictions, the NFR also introduced a tax-exempt company. The NFR introduces a company that is exempt from profit tax (the Exempt Company). Any Netherlands Antilles private limited liability company may qualify as an Exempt Company. The NFR imposes certain stringent conditions that are designed to ensure that Exempt Companies are not used for illegal activities.

Gibraltar has announced a future tax reform, which would abolish taxation of company profits and replace it with a payroll tax (a fixed tax per employee) and a business property occupation tax. The total sum to be paid out in tax (payroll tax + business property tax) will be ceilinged at 15% of profits or at 500,000 pounds. In addition, two sectors, financial services and utilities, would be subject to "top up" taxes on their profits at a rate of 8% and 35% respectively. At present the main rate of corporate tax in the U.K. is 30%, while under the planned reform in Gibraltar the maximum rate of would be 15%.

The European Commission, fearing that the new tax reform of Gibraltar will benefit the Gibraltar companies compared to UK companies, has recently opened a formal investigation procedure into the planned reform of Gibraltar's company taxation. At this stage, the Commission has not been able to rule out the possibility that the new system would grant State aid to certain enterprises and has doubts that such aid would be compatible with the EU rules. This is the first time that an entire corporate tax system has been notified to the Commission for approval under the State aid rules.

The **Isle of Man** (IoM) has also announced a significant tax reform proposing the introduction of a zero standard rate for all companies, except for certain regulated financial sector businesses, which could be taxed at a rate of 10%. This reform would become effective for companies by 2006.

Currently, Manx resident companies owned by non-residents and which do not trade in the Isle of Man and do not have any source of income in the island (apart from interest from the IoM Government or bank interest) are exempt from tax, while resident companies are taxed at a standard rate of 18% (fiscal year 2001-2002)[74]. This exemption for non-resident companies is identified as a harmful tax measure, which is in the scope of the EU Code of Conduct (Measure F062 Primarolo Report). In addition, the IoM government made a commitment to abolish "ring-fencing" (the tax-exempt company regime) in response to the OECD initiative on harmful tax competition.

According to IoM government, the new tax strategy – a zero rate corporate rate applied to resident and non-resident businesses – would remove the differential in tax rates that currently exists in a way that governments officials believe will satisfy the OECD initiative on harmful tax competition and the requirements of the EU Code of Conduct.

In Guernsey, although there is no an official announcement, there are also teams reviewing its tax system with a view to proposing changes.

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[74] 15% for fiscal year 2002-2003.

VI. Taxation and the United States

In 2001 the US government initiated a process of tax reforms, focused on significant tax cuts. After the terrorist attacks of 11 September 2001 new tax incentives for economic recovery were also proposed. This section outlines the current situation; covers both adopted and proposed measures; and analyses recent developments, including US/EU tax disputes.

The US Tax System

Taxes in the United States are levied at federal, state and local levels. The federal (central) government imposes income taxes, excise duties and estate and gift taxes, while state and local governments apply franchise, income and capital-based taxes as well as sales, property, estate and gift taxes. State and local laws are enacted by the legislatures of each state or local government, and therefore, vary among the jurisdictions.

Personal Income Tax

The federal Personal Income Tax is applied at the following rates for 2002. The income brackets are indexed annually for inflation.

Table 28: Personal Income Tax Rates in US (2002) (Single Individual)

Taxable income exceeding $	Taxable income not exceeding $	Tax on lower amount $	Rate on excess (%)
0	6,000	0	10
6,000	27,950	600	15
27,950	67,700	3,892	27
67,700	141,250	14,625	30
141,250	307,050	36,690	35
307,050	-	94,720	38.6

Table 29: Personal Income Tax Rates in US (2002) (Married filling joint return)

Taxable income exceeding $	Taxable income not exceeding $	Tax on lower amount $	Rate on excess (%)
0	12,000	0	10
12,000	46,700	1,200	15
46,700	112,850	6,405	27
112,850	171,950	24,266	30
171,950	307,050	41,996	35
307,050	-	89,280	38.6

The United States also imposes an Alternative Minimum Tax (AMT) at a rate of 26% on alternative minimum taxable income, up to $175,000, and at a rate of 28% on alternative minimum taxable income exceeding $175,000 (long-term capital gains are taxed at a rate of 20%). The primary purpose of AMT is to prevent individuals with substantial income from

using preferential tax deductions (such as accelerated depreciation), exclusions (such as certain tax-exempt income) and credits to substantially reduce or to eliminate their tax liability. It is an alternative tax because, after an individual computes both the regular tax and AMT liabilities, the greater of the two amounts constitutes the final liability.

Most States also impose some form of individual income tax. In addition, some local governments (cities and counties) levy an individual income tax, although this is not generally the case. State individual income tax structures are usually related to the federal tax structure by the use of similar definitions of taxable income, with some appropriate adjustments. City or municipal income tax rates are generally 1% or lower (although the rate for residents in New York City is approximately 3.648%). State income tax rates generally range from 0% to 12%.

Corporate Tax

A corporation's taxable income exceeding $75,000 but not exceeding $10 million is taxed at the rate of 34%. Corporations with taxable income between $335,000 and $1 million are effectively taxed at 34% on all taxable income (including the first $75,000). Corporations with taxable income of less than $335,000 receive partial benefit from the graduated rates of 15% and 25% that apply to the first $75,000 of taxable income. A corporation's taxable income exceeding $15 million but not exceeding $18,333,333 is subject to an additional tax of 3%. Corporations with taxable income in excess of $18,333,333 are effectively subject to tax at a rate of 35% on all taxable income. These rates apply both to U.S. corporations and to the income of foreign corporations effectively connected with U.S. trade or business.

An *Alternative Minimum Tax* is imposed at a flat rate of 20%. It is "alternative" because corporations are required to pay the higher of the regular tax or AMT. To the extent that AMT exceeds regular tax, a minimum tax credit is generated and carried forward to offset the taxpayer's regular tax to the extent it exceeds the AMT in future years.

Capital gains are taxed at a maximum rate of 35%.

Withholding taxes on dividends and interest are 30%, applicable also to payments to non residents. Rates may be reduced by treaty.

Depreciation allowances: Tangible depreciable property is generally depreciated under a modified accelerated basis. Assets are grouped into eight classes of property and each class is assigned a recovery period and a depreciation method. For buildings, the depreciation method is straight-line and the recovery period is 39 years, while for machinery, methods are double-declining balance or straight-line and the period is 7 or 12 years.

Inventories: Inventory is generally valued for tax purposes at either cost or the lower of cost or market value. In determining the cost of goods sold, the two most common inventory flow assumptions used are last-in, first-out (LIFO) and first-in, first-out (FIFO).

Treatment of trading losses: In general, losses may be carried back 2 years and forward 20 years to offset taxable income in those years.

Sales Taxes

Most US states, counties and cities levy sales taxes. These are cumulative, and rates vary across the US. As in the case of VAT within the EU, there are also varied exemptions or special rates for food, pharmaceuticals and various services. Certain purchases made by residents of relatively higher-taxed states in states with lower or zero rate are in theory subject to an additional "user tax" – a system which is, however, difficult to enforce.

Sales taxes differ fundamentally from VAT in that they cannot be deducted as input tax at the various stages of a production chain, and therefore cannot be fully rebated on exports. This has led to assertions by the US that the VAT system constitutes a form of export subsidy.

Table 30: US state sales tax rates

Alabama	4%	**Kentucky**	6%	**N Dakota**	5%
Alaska	0%	**Louisiana**	4%	**Ohio**	5%
Arizona	5%	**Maine**	5.5%	**Oklahoma**	4.5%
Arkansas	5.125%	**Maryland**	5%	**Oregon**	0%
California	5.75%	**Massachusetts**	5%	**Pennsylvania**	6%
Colorado	2.9%	**Michigan**	6%	**Rhode Island**	7%
Connecticut	6%	**Minnesota**	6.5%	**S Carolina**	5%
Delaware	0%	**Mississippi**	7%	**S Dakota**	4%
DC	5.75%	**Missouri**	4.225%	**Tennessee**	6%
Florida	6%	**Montana**	0%	**Texas**	6.25%
Georgia	4%	**Nebraska**	5%	**Utah**	4.75%
Hawaii	4%	**Nevada**	6.5%	**Vermont**	5%
Idaho	5%	**N Hampshire**	0%	**Virginia**	3.5%
Illinois	6.25%	**New Jersey**	6%	**Washington**	6.5%
Indiana	5%	**New Mexico**	5%	**W Virginia**	6%
Iowa	5%	**New York**	4%	**Wisconsin**	5%
Kansas	4.9%	**N Carolina**	4%	**Wyoming**	4%

Recent US Tax Reforms

The Economic Growth and Tax Relief Reconciliation Act of 2001[75], provides significant tax relief to American taxpayers. These tax cuts are the largest since 1981. President Bush signed the Tax Cut Bill on June 7, 2001[76].

The main highlights of the President's Tax Plan were:

- Replacing the marginal income tax rates of 15, 28, 31, 36, and 39.6 percent with a simplified rate structure of 10, 15, 25, and 33 percent.
- Doubling the child tax credit to $1,000 per child over 10 years, and applying the credit to the Alternative Minimum Tax (AMT).
- Reducing the marriage penalty by reinstating the 10 percent deduction for two-earner couples.
- Eliminating the death tax.

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[75] Joint Committee on Taxation*: Summary of provisions contained in the Conference agreement for H. R. 1836: The Economic Growth and Tax relief Reconciliation Act of 2001.* JCX-50-01, May 26, 2001. Became Public Law no 107-16.

[76] However, as enacted, the entire Act will expire after December 2010, which means that Congress will continually revisit the Act during the years to come.

- Expanding the charitable deduction to non-itemisers.
- Making the Research and Experimentation (R&E) tax credit permanent.

Nevertheless, the US Congress did not adopt the President's request that it permanently extend the Research and Experimentation tax credit, which expires in 2004. Nor did it permit a deduction for charitable contributions by taxpayers who do not itemise their deductions, and there were other changes.

Congress responded to President Bush's tax cuts with a package centered around across-the-board tax rate reductions, including an immediate rebate. It eliminated the phase-out of personal exemptions and the 3 percent reduction of itemised deductions for high-income taxpayers. Congress created a new bracket by splitting the 15 percent bracket into two brackets: a 10 and a 15 percent tax bracket and provided a higher standard deduction for married couples, increased the child credit to $1,000, and expanded a number of education incentives. Rate reductions began in 2001 and will be phased in by 2006. The Act increases the child tax credit over 10 years, the credit will be doubled to $1,000 by 2010.

Table 31: SCHEDULE OF INCOME TAX RATE REDUCTIONS IN THE US

Calendar Year	Portion of 15% rate reduced to:	28% rate reduced to:	31% rate reduced to:	36% rate reduced to:	39,6% reduced to:
2001	10%	27.5%	30.5%	35.5%	39.1%
2002-2003	10%	27%	30%	35%	38.6%
2004-2005	10%	26%	29%	34%	37.6%
2006	10%	25%	28%	33%	35%

Source: Joint Committee on Taxation

Table 32: INCREASE IN THE CHILD TAX CREDIT

Taxable Year	Credit amount per child
2002-2004	600 $
2005-2008	700 $
2009	800 $
2010	1,000$

Source: Joint Committee on Taxation

Tax Policy in the aftermath of the terrorist attack

After the terrorist attacks of September 11, several measures were proposed in order to provide tax incentives for economic recovery. The main provisions of the *Economic Stimulus Package*[77] were:

[77] House Ways and Means "Stimulus" Tax Bill, H.R. 3090 approved by the House Ways and Means Committee on October 12, 2001. See: Technical Explanations of the "Economic Security and Worker Assistance Act of 2001" to provide tax incentives for economic recovery and assistance to displaced workers prepared by the staff of the Joint Committee on Taxation: *Technical Explanation of the Economic Security and Worker Assistance Act of 2001*, JCX-91-01, December 19, 2001.

Business Tax Provisions

- 30% bonus depreciation for 36 months. Allow taxpayers to claim an additional first-year depreciation deduction equal to 30% of the adjusted basis of qualifying property.
- Increase the small business expenses period to 24 months. Increase the amount that can be claimed as expenses from $24,000 to $35,000. In addition, increase the beginning of the phase-out threshold from $200,000 to $325,000.
- Extend Net Operating Loss carryback period for 36 months. Allow taxpayers the option of extending the NOL carryback period from 2 years to 5 years. The 5-year carryback period would be allowed for losses generated in 2001-2002.
- Reduce cost recovery period for leasehold improvements. Reduce the cost recovery period for leasehold improvements from 39 years to 15 years.
- Alternative Minimum Tax reform. Repeal the depreciation preference under the AMT and the 90% limitations on use of foreign tax credits and net operating losses.

Individual Provisions

- Supplemental stimulus payments. Provide $300 (single), $500 (head of household), or $600 (couples) payments to individuals who filed U.S. tax returns in 2000.
- Accelerated rate reduction. Reduce 27.5% tax rate to 25%.
- Alternative Minimum Tax relief. "Hold harmless" so that accelerated rate reduction does not subject taxpayers to the AMT. In addition, repeal the depreciation preference under the AMT and the 90% limitations on use of foreign tax credits and net operating losses.

On 19 December of 2001, the House of Representatives passed H.R. 3529, the "Economic Security and Worker Assistance Act of 2001", which included most of provisions of the economic stimulus package.

The 2003 Tax Package

At the beginning of 2003, President Bush announced a further package of tax reforms. In addition to bringing forward a number of scheduled tax reductions[78], he proposed the abolition of tax on stock dividends.

At present, the US applies the pure classical system to dividends: i.e. companies are first taxed on their profits; then shareholders pay separate income tax on their dividends. This differs from the systems in most other countries, where shareholders receive some allowance for the tax already paid.

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[78] The President's Plan would speed up tax reductions promised in 2001. The proposal would make all the tax rate reductions from the 2001 tax law effective this year, and retroactive to January 1, 2003:

- For income earned after January 1, 2003, the following tax rates would be in effect: 10%; 15%; 25%; 28%; 33%; 35%.
- Reduce the marriage penalty this year, instead of waiting until 2009.
- Raise the child tax credit from $600 to $1,000 per child this year, instead of in 2010.
- Move several million working Americans into the lowest tax bracket of 10 percent now instead of waiting until 2008.

The current "double tax" system in the US has created some distortions of the capital markets: for example, instead of paying dividends to shareholders, companies have been encouraged to distribute profits by share "buy-backs".

US companies moving offshore

Recently, several prominent US companies renounced their corporate citizenship in favour of relocating offshore to avoid paying taxes, and the list of corporate defectors is growing longer each day. Stanley Works company, whose tools have been building America for 159 years, announced last February it would move its headquarters to Bermuda to save about 30 million a year in US taxes. Among the benefits of "inverting" are the ability to remove foreign income from the U.S. taxing jurisdiction, and reduce U.S. tax on income earned in the United States through interest payments to a new foreign affiliate.

These "inversion transactions[79]" have received significant attention from the press as well as the US Congress. Although some bills include provisions to curtail the tax benefits of these transactions: *HR 3884 (Corporate Patriotic Enforcement Act of 2002); HR 3922 (Save America's Jobs Act of 2002); S. 2119 (Reversing the Expatriation of Profits Offshore Act of 2002)*, the US Treasury recognised in its Report*: Corporate Inversion Transaction: Tax Policy Implications (17 May 2002)* that the legislative efforts to avoid inversion transactions were too narrowly focused, and that other very significant planning opportunities remained available to multinational corporations for reducing their US tax liability. On June 2002, the House Ways and Means Committee held a hearing on "inversion transactions", at which the Bush Administration unveiled a set of legislative and regulatory proposals.

The *American Competitiveness and Corporate Accountability Act of 2002 (HR 5095*) incorporates some provisions contained in previous bills and goes much further. The Act removes the tax advantages of foreign corporations with U.S. operations and imposes a 3-year moratorium on inversions. In particular the legislation:

- reforms the rules governing the deduction of interest payments by U.S. subsidiaries to their foreign parents;
- ensures that companies pay a tax when they transfer assets offshore; and
- ensures that top executives pay tax on their stock options at the time of an inversion transaction, much like shareholders pay tax on their stock.

EU/US disputes

On 20 August 2001, the WTO (World Trade Organisation) confirmed that the *US Foreign Sales Corporations Replacement and Extraterritorial Income Exclusion Act* was incompatible with WTO rules. The compliance panel concluded that the Foreign Sales Corporation (FSC) Replacement Act, enacted by the US on 15 November 2000, was a prohibited export subsidy, violated the Agriculture Agreement and discriminated in favour of US goods in breach of WTO rules. In addition, on 30 August 2002, the WTO arbitrators authorised the EU to impose sanctions at the level of US $ 4,043 million.

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[79] An inversion transaction is a type of restructuring of a company that minimises or eliminates US taxation of the group's foreign source income. An inversion transaction occurs where a US parent of a multinational group becomes a subsidiary of an existing or newly-formed foreign company located in a low tax or no tax jurisdiction, such as Bermuda.

The *FSC Replacement and Extraterritorial Income Exclusion Act* provided an income tax reduction on export income. In general, US-based companies are taxed on their world-wide income, whereas most countries tax only income generated within their own jurisdictions. In order – the US argued – to maintain a level playing field, the FSC scheme provided an exemption to the general rule established in the US Internal Revenue Code.

Background

The history behind this ruling goes back to 1971, to the Domestic International Sales Corporation (DISC) scheme, the FSC scheme's predecessor. DISC was declared an illegal export subsidy by a GATT panel in 1976. (The panel ruling was adopted by the GATT in 1981.) The US replaced the DISC with the FSC in 1984. The EU contested the legality of the FSC when it was adopted, but did not pursue the matter at the time due to the opening of the Uruguay Round trade negotiations.

Following further complaints by European companies, and in view of the increasing amount of FSC subsidies being granted by the US, the EU resumed bilateral contacts with the US in 1997, but no progress was made. The EU therefore took up the matter under the WTO dispute settlement procedure. Consultations followed in December 1997, February 1998 and April 1998, but without resolution. The EU therefore requested a WTO panel to look at the issue, which reported on 8 October 1999. The FSC was found to constitute a prohibited export subsidy under the Subsidies Agreement, and (in relation to agricultural products) an export subsidy in violation of the Agriculture Agreement.

The US appealed to the WTO Appellate Body, and on 24 February 2000 the Appellate Body confirmed the panel findings as to the illegality of the FSC scheme. The US was given until 1 October 2000 to withdraw the FSC scheme as required by the Subsidies Agreement.

The FSC Replacement and Extraterritorial Income Exclusion Act (ETI Act) was signed into law by President Clinton on 15 November 2000. The ETI Act, however, did not modify the substance of the export subsidy scheme. As a result, on 17 November 2000, the EU launched a further Panel on compliance, and at the same time presented a request for countermeasures for an amount of $4 billion, accompanied by a broad list of products. The US requested arbitration on the amount.

Table 33: US tax legislation - timetable of the EU/US dispute

1971	Domestic International Sales Corporation (DISC) scheme introduced in US.
1972	EC brings GATT complaint against DISC.
1976	GATT rules that DISC constitutes an export subsidy.
1984	US replaces DISC with Foreign Sales Corporation (FSC) scheme.
1997	EU brings WTO case against FSC.
2000	US loses WTO appeal on FSC, and enacts Extraterritorial Income Exclusion Act (ETI) to replace FSC.
2002	US loses WTO appeal on ETI. EU also given go-ahead to impose $4bn. a year trade sanctions against US. US introduces the American Competitiveness and Corporate Accountability Act.

On 20 August 2001, the WTO compliance panel examining the FSC Replacement Act, issued its report in full support of the EU. The panel found that the FSC Replacement Act constitutes a prohibited export subsidy because, although companies established outside the US do not need to export to obtain the tax reduction, those within the US can only obtain it

by exporting. The FSC Replacement Act also violated the Agriculture Agreement as it could be used to circumvent the commitments given by the US not to grant, or to reduce, export subsidies on agriculture products.

The US appealed the ruling on 15 October 2001; but the WTO Appellate Body confirmed the panel findings on 14 January 2002. On 30 August 2002, the WTO arbitrators also authorised the EU to impose sanctions at the level of US $ 4,043 million by increasing the customs duties on certain selected products up to 100%.President Bush took a first important step at the last EU-US Summit by stating that the US Administration will do everything in its power to comply. Another important step has been accomplished with the introduction of the Thomas bill in Congress that is manifestly intended to bring the US into compliance.

The American Competitiveness and Corporate Accountability Act of 2002

In order to comply with the WTO decisions and remove the export subsidy, the *American Competitiveness and Corporate Accountability Act of 2002 (H.R. 5095)* includes a tax reform package that is WTO compliant and also introduces measures to enhance American competitiveness. The main provisions are the following:

- Repeals the ETI (Extraterritorial Income) rules
- Repeals the anti-deferral foreign base company sales and services rules
- Reforms interest allocation rules
- Reduces foreign tax credit baskets from nine to three
- Extends the foreign tax credit carryover period from 5 to 10 years
- Repeals the 90% limitation on the use of foreign tax credits for AMT (Alternative Minimum Tax) purposes
- Recharacterises overall domestic losses
- Increases small business expensing limits for tax purposes from $24,000 to $40,000 and increases eligible investment limits from $200,000 to $325,000
- Provides look-through treatment for payments between related controlled foreign corporations
- Provides look-through treatment for sales of partnership interests
- Repeals the primarily duplicative foreign personal holding company and foreign investment company rules
- Applies look-through rules to dividends from non-controlled companies (10/50 companies)
- Provides deferral for pipeline transportation income
- Provides for attribution of stock ownership through partnerships to determine certain tax credits
- Provides deferral for commodity hedging income for materials used in manufacturing operations
- U.S. Property not to include certain assets acquired by dealers in ordinary course of business
- Provides for equitable treatment of certain mutual fund dividends
- Provides an election not to use average exchange rate for foreign tax paid other than in functional currency
- Repeals withholding tax on dividends from certain foreign corporations

The bill simplifies the U.S. taxation of foreign income. For example, reducing the number of "baskets" into which foreign tax credits must be categorised from nine to three will cut the number of separate calculations that a taxpayer is required to make and to track. The repeal of the 90% limitation on the use of foreign tax credits for AMT purposes also reduces complex duplicative calculations and record-keeping.

Many of the provisions reform inequitable rules and increase the fairness of the Tax Code. For example, the interest allocation provisions are reformed so that a company is not always required to allocate its U.S. interest expenses against foreign source income, particularly when the U.S. loan proceeds are used solely to support U.S. operations. The bill also extends the period during which foreign tax credits can be carried forward and, thus, allows taxpayers to more fully utilise foreign tax credits to prevent double taxation.

Several of these provisions also allow multinational corporations to make decisions and arrange their operations based on real-world business considerations rather than tax factors. For example, the repeal of the foreign base company sales and services rules allows companies to streamline their overseas operations. In addition to the competitiveness provisions that provide companies with an incentive to incorporate in the United States, the bill includes provisions to avoid "inversion transactions".

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