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Tax on earnings before interest and taxes instead of profit – fair, simple and competitive: a conceivable initiative of EU Member States for a common consolidated corporate tax base

Lorenz Jarass and Gustav M. Obermair*

According to reports from Brussels in February 2008, the European Commission and President Barroso have, at least for the time being, taken the project of a common consolidated corporate tax base (CCCTB)[1] from the priority list for 2008. Some Member States that have established preferential tax regimes for corporations apparently see the project as an attempt towards a general harmonization of business taxation, a weakening of their tax sovereignty that would jeopardize their attractiveness for international corporations. Since these Member States are crucial for the ratification of the new European Treaty (the low tax country Ireland is a referendum state!), their opposition to the CCCTB project would endanger the entire ratification process which has absolute priority for the Commission and its president.

The proposal elaborated in the following article to introduce as a common tax base all compensation of capital, as measured by earnings before interest and taxes (EBIT) may be developed completely independently from such considerations:

- It is an initiative that can be taken by any individual Member State to improve and stabilize its tax revenue from corporation and business taxation.
- The revenue would be collected at the site of the enterprise, where the earnings are obtained, irrespective of the statutory tax residence of the final beneficiaries of profit, interest, royalties and license fees, thus independent of bilateral or multilateral tax treaties.
- An Action Group of Member States that would benefit from such a broadened tax base could and should join the initiative in order to reduce the options for legal tax avoidance.

As a result such an initiative could be made to function:

- without necessary unanimity, since only Action Group Members would participate,
- without any requirement for EU-wide tax base harmonization,
- without any difficult and artificial apportionment of the tax revenue, since the proposed tax base EBIT has anyhow to be reported in the IFRS standard obligatory in the EU since 2005.

Thus the broadened tax base EBIT could be enacted by an Action Group of states with an inherent appeal to ever more states to join this action.

1. The erosion of the traditional tax base 'profit'

Historical developments going back to the 1920s have resulted, more or less, in all the Member Countries of the OECD and other states around the world, in the following general system of taxation of returns derived from business activities:

- profits are the only part of capital returns that are taxed at the enterprise;
- interest, licence fees, royalties etc., however, are taxed, if at all, at the tax residence of the beneficiary.

When most investment and returns were domestic, this double system tax regime did not give rise to significant distortions. The largest part of the earnings from economic activities in a given country was taxed in this very country; the tax revenue was spent there and served to finance the infrastructure in the widest sense, from roads to law courts, from water supply to

* Lorenz Jarass, Professor at University of Applied Sciences Wiesbaden, Germany, MS (Stanford University, US), Member of the German Federal Committee on Enterprise Tax Reform 1998/1999 and Member of the German Federal Scientific Advisory Board on Local Tax Reform 2002/03. Gustav M. Obermair, Professor em. at University of Regensburg, Germany.

[1] For information regarding CCCTB see the official homepage of EC, TAXUD, http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm. See also Twelfth Meeting of the CCCTB WG, 10-12 December 2007, Brussels, http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/article_4650_en.htm.

Fig. 1 : Interest and royalties remain increasingly untaxed in EU Member States

	1985		2005		
	traditional uncoordinated tax systems of EU Member States				
	companies in traditional national economies		multinationals in today´s global economy		
(1) origin of capital	equity	loans	equity	loans	licences
(1a) invested by	domestic shareholders	local banks, partners etc.	international capital market		
	⇩	⇩	⇩	⇩	⇩
(2) compensation of capital	profit	interest	profit	interest	royalties
(3a) thereof taxable in EU Member States	all	most	all	little	
(3b) times statutory tax rate	⇩ 50%	⇩ 40%	⇩ 25%	⇩ 0%	
(3c) = tax paid in EU Member States	by company and by domestic shareholders	by domestic creditor	by company and by domestic shareholders	goes largely untaxed abroad to international capital markets	

schools and universities – all the public institutions that are a necessary prerequisite for any economic activity.

The globalization of production and trade, the liberalization of the international capital markets and the resulting increasing global flow of financial instruments have, however, resulted in a completely new situation;[2] already since the late 1990s this process has been described, e.g. in the annual ECOFIN reports, as 'erosion of the tax base business income'.

1.1. Taxable profits have increasingly been converted into tax-free interest

The erosion of the tax base 'profit' is due to two dominant effects (see figure 1):

- Domestic revenue from this tax base shrinks because companies increasingly get their external capital not, as previously, from domestic banks, but from international financial institutes. As a consequence the interest part of their earnings is no longer taxed domestically and in many cases not taxed at all. Thus the globalization of the financial market leads to a kind of 'automatic' tax planning.
- In addition, internationally operating companies are making increasing use of 'active' tax planning by a reshuffling of their assets: domestic equity is replaced by foreign loans thereby converting profit into interest, royalties, leasing rates and the like which are transferred tax-free abroad. Any enterprise undertaking activities in two or more countries has opportunities for this kind of transnational tax planning even within the EU due to widely differing tax bases and rates.

The quantity 'profit' as defined in tax laws, formerly a measure of a company's success, is thus reduced to a residual category which approaches zero in many cases of very profitable enterprises, cf. section 1.2 of this article below. This is also the reason why, today, the performance of an enterprise is no longer measured in terms of its profit shown in its books, but rather in terms of 'earnings before interest and taxes' (EBIT).

The continued use of the residual 'profit' as tax base results in a reduction as well as a substantial redistribution of national corporate income tax revenue. Some states appear to gain additional revenue from intra-European profit shifting by multinationals at the expense of those states, like Germany, in which the same enterprises continue to conduct a large part of their productive activities.[3]

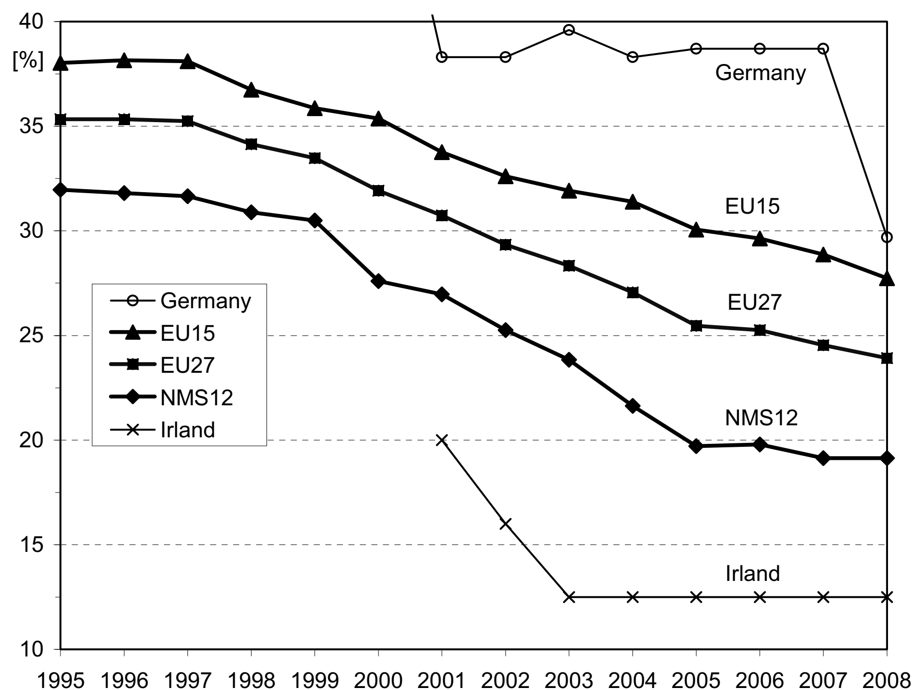
Hence there is a growing awareness in many EU Member States that business taxation exclusively on the traditional basis 'profit' has negative consequences not only for the tax revenue, but – in the longer run – also for the stability of the economy[4] and employment: big companies, now largely dependent on the goodwill of their foreign creditors, become quite unstable in periods of economic crisis. On the other hand, small

[2] A. Rädler, 'Recent trends in European and international taxation', *Intertax* 2004, nos. 8/9, pp. 365-376. See also 'Fundamental Reform of Corporate Income Tax', OECD Tax Policies Study no. 16, 11/2007.

[3] See H. Huizinga (Tilburg University) and L. Laeven (IMF), 'International Profit Shifting within European Multinationals. European Economy', Economic papers, no. 260, European Commission, Brussels, December 2006, http://ec.europa.eu/economy_finance/publications/economic_papers/2006/ecp260en.pdf.

[4] 'The contribution of taxation and customs policies to the Lisbon Strategy', draft report, provisional (2007/XXXX(INI)), European Parliament, Committee on Economic and Monetary Affairs, Rapporteur: Sahra Wagenknecht, 6 March 2007.

Figure 2 Development of top statutory tax rate on corporate income 1995–2008 in percentage



Source: *Taxation Trends in the European Union* (European Commission, 2007), p. 92, Tab. II-4.1; for *2008 European Tax Handbook* (IBFD, 2007).

and medium enterprises, as a whole still the largest employers of labour, not having access to such financial instruments, pay the full domestic taxes, can no longer compete and are thus driven out of the market.

1.2. Increasing discrimination against domestic small business

Example: IKEA Germany was (in 2003) financed – without any equity – entirely through loans of €1.3 billion. Of its gross turnover of around €2.3 billion, 3 per cent was paid as a licence for the use of the trademark 'IKEA' (known as a 'management fee'). Both the interest for the loans and the licence fees are legally deducted as costs in Germany and transferred finally to Switzerland, thereby escaping almost all taxation in Germany and the EU.

Expenses for financing the ongoing expansion into Russia can also be deducted in Germany, whereas the resulting profits are taxable neither in Germany nor the EU. The result is that, despite being very profitable, IKEA Germany pays hardly any taxes in Germany or in any other EU Member States and, as described above, pushes efficient, family-owned furniture stores, which pay their domestic taxes of up to 40 per cent, out of the market.

At the level of enterprises these developments lead to an increasing tax discrimination against domestic and, in particular, small businesses that cannot 'internationalize' their profits. Many states have established preferential tax regimes for international corporations (tax havens). As a result a growing share of the domestic surplus in non-tax haven jurisdictions is legal, for example, via transfers to international holdings, or arguably illegal, e.g. via incorrect transfer pricing methods, transformed into non-domestic income and thus transferred to tax havens.

1.3. Corporate tax rates – the race to the bottom

As a result of non-taxation of paid interest at the enterprise the international capital market can more or less choose where their capital returns are taxed regardless of where they are produced. Consequently, particularly countries with higher statutory tax rates are experiencing the increasing erosion of the tax base business income. To keep at least some tax revenue they are forced to follow the race to the bottom with respect to their statutory tax rates for enterprises (see Figure 2).

Since 1995, Member States have been forced to reduce dramatically corporate income tax rates. The tendency has continued: in 2007 no country has increased its corporate tax rate, but quite a few have decreased it. Bulgaria dropped to minus 5 points to 10 per cent and thus became the Union's second country after Cyprus to levy a 10 per cent rate. The Netherlands (minus 4.1 points to 25.5 per cent) Greece (minus 4 points to 25 per cent) Spain (minus 2.25 points to 32.5 per cent) and Slovenia (minus 2 points to 23 per cent). Belgium, which levies a relatively high rate (34 per cent) has not cut its general rate, but has introduced a 0 per cent tax rate on profits up to a profit rate of a ten-year government bond interest rate. Germany, down from 54 per cent in 1993, but in 2007

Figure 3 Non-EU-countries would gain at the expense of EU Member States if common consolidated corporate tax base is exclusively profit

	2015? *EU Common Consolidated Corporation Tax Base (CCCTB)*					
(1) origin of capital	equity	loans	licences	equity	loans	licences
	from international capital market					
	⇩	⇩	⇩	⇩	⇩	⇩
(2) compensation of capital	profit	interest	royalties	profit	interest	royalties
	if CCCTB is exclusively ´profit´			*if CCCTB is ´earnings before interest´*		
(2a) thereof taxable in the EU	all	little		all		
(3b) times statutory tax rate	⇩ 25%	⇩ 0%		⇩ 20%		
(3c) = tax paid within the EU	*less*	*little*		*more*		
	result: capital compensation produced *inside EU* goes increasingly *untaxed* to international capital market *outside EU*			is taxed *D2* regardless whether the beneficiary is inside or outside EU		

still top runner with 40 per cent, has reduced to 29 per cent since 2008, while other countries have already announced further rate cuts. If these rate cuts continue the rates in the old EU Member States will soon come close to those of the new Member States which, in turn, are driven towards further rate cuts well below 15 per cent.

1.4. Questionable remedies

The continuous rate cuts and the establishment of preferential tax regimes have resulted in deteriorated public services, cuts of pensions, an increased burden of taxes and contributions on wage earners and consumers etc. This may be one reason why the European ideal gets less support from the vast majority of its population. In addition it has reduced the capacity of Member States to stimulate the economy through public infrastructure investments.

The ever-growing and non-transparent apparatus of national rules and regulations, bi- or multinational agreements, supranational directives and international controls can at best only reduce the harmful effects discussed. It appears that the statutory tax rate has little effect on the actual tax payments of big business. It is not so much the level of the statutory tax rate that determines the tax payments, but, rather, the extent to which the tax base bears any resemblance to the total capital returns of a corporation. In other words, it is not primarily the statutory rate of the tax, but mainly the width of the tax base for capital returns and its enforcement that determines the actual tax payments.

If taxation of international business is so difficult, one drastic solution could be that governments relinquish all claims on business income as a tax base and shift taxation entirely towards individual income, property and consumption. There are, however, good reasons to keep the range and variety of tax bases as wide as possible and tax them evenly at relatively low rates: this keeps the revenue more stable against economic fluctuations and reduces the temptation to avoid any one specific tax.

2. Tax on earnings before interest and taxes instead of on profit

2.1. Including only profit in the EU consolidated tax base will be inadequate

If the proposed 'common consolidated corporation tax base'[5] would again be exclusively the residue 'profit', a growing part of the capital returns would continue to be declared as interest, royalties and the like and transferred to non-EU-countries (see Figure 3), non-EU countries would continue to gain at the expense of Member States.

[5] Implementing the Community Programme for improved growth and employment and the enhanced competitiveness of EU business: Further progress during 2006 and next steps towards a proposal on the Common Consolidated Corporate Tax Base (CCCTB). Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, Commission of the European Communities, COM(2007) 223 final, 4 May 2007; see also COM(2006) 823, 824, 825, 19 December 2006, COM(2005) 532, 25 November 2005.

2.2. Taxing all compensation of capital

On the macro level, the share of the gross domestic product that is paid to and for the benefit of the production factor labour is in National Accounting commonly designated by the term 'compensation of employees' or 'compensation of labour'. The remaining part of gross domestic product, called 'operating surplus' or 'property and entrepreneurial income', is equivalent to what – in analogy to 'compensation of labour' – could be called 'compensation of capital'. It consists of three essential components:

- compensation for the use of equity – i.e. profit for the owners;
- compensation for the use of outside monetary capital – i.e. interest paid to creditors and the interest contained in leasing rates;
- compensation for the use of intellectual capital – i.e. payments for outside rights and knowledge[6] like licence fees for brand names, royalties paid to patent holders etc.

To counteract the developments described above we propose to replace the traditional tax base 'profit' by 'compensation of capital'.

In order to be applicable for actual tax collection, the national accounts category 'property and entrepreneurial income' or, roughly equivalent, 'compensation of capital' has to be transferred to the operating level, i.e. from the level of national accounts to the level of tax subjects, which is the level of individual enterprises and their accounting. On this level the closest equivalent for 'compensation of capital' as detailed above is 'earnings before interest and taxes' (EBIT), which is widely used in business administration and enterprise evaluation and is calculated in all international accounting standards like IFRS or US-GAAP. To revitalize the taxation of business income the tax base, therefore, ought to be extended from 'profit' to 'EBIT'.

2.3. Features of the proposed tax on 'earnings before interest and taxes (EBIT)'

One essential feature of this tax is the mode and place of levying it: all three compensation components, not only profit, but also paid interest and royalties are taxed at the site of production irrespective of a potential taxation of received dividends, interest and royalties at the tax residence of the beneficiary.

Specifically, the proposed tax on EBIT would have the following features:

- A common tax base for all compensation for the deployment of capital, covering interest paid to creditors, both domestic and foreign, licence fees, royalties, etc. and the remaining profits.
- A tax rate that could differ between states.
- The tax is to be paid at the enterprise regardless of the tax residence of the final beneficiaries of the different types of compensation of capital, i.e. interest, profit etc.
- The tax on EBIT could therefore reliably be collected with low compliance costs at the location of each enterprise.

The tax base EBIT does not cause any additional compliance cost for the companies, because earnings before interest, share of interest contained in leasing rates, licence fees etc. are already established in the balance sheets and have to be reported according to International Financial Reporting Standard (IFRS) which is obligatory in the EU since 2005 for all stock listed companies and is used by almost all international companies. It should be kept in mind that EBIT is the leading instrument used by financial analysts for the evaluation of any company to be bought or sold.

The remuneration of employees, i.e. wages and salaries, would continue to be taxed only under the personal income tax regime as (successfully) applied in most states.

2.4. Financial instruments and internet trading in intangible assets

The growing sectors of financial services and the production of intangible assets elude a clear definition of the country of production and, therefore, avoid taxation according to 'the residence of the producer' principle. At the same time, payments to service providers that could be taxable can easily be transferred to a state with a preferential tax regime.

Payments for financial services, including payments for derivatives and similar financial products that are increasingly used to replace traditional financing through bank loans, would, under the authors' proposal, be treated as interest payments and, therefore, taxed at source, i.e. at the seat of the business entity using the service or instrument. Similarly, payments for intangible assets used in a given state would be subject to the source tax in this state. Complicated supranational control systems for the taxation of the trade with financial services and other intangible assets may, therefore, be avoided.

2.5. Tax on earnings before interest and taxes – international examples

2.5.1. The new US tax reform proposals

With regard to the arguments advanced it should be noted that the 'growth and investment tax plan' of the US President's Advisory Panel on Federal Tax Reform of November 2005[7] resembles the authors' proposal in almost all respects, i.e.:

- the uniform taxation of all capital returns produced in the US, i.e. interest payments to creditors, licence fees and similar would not be deductible for tax purposes;

[6] This part of the compensation of capital is not included in the usual definition of EBIT.

[7] President's Advisory Panel on Federal Tax Reform, 'Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System', 1 November 2005, available at www.taxreformpanel.gov/final-report/.

- a low flat tax rate of 30 per cent on this widened tax base; and
- the abolition of the 'world income principle', which would end a form of tax avoidance that also affects Member States, such as Germany.[8]

2.5.2. The Italian regional tax IRAP

The Italian regional tax '*Imposta Regionale sulle AttivitÁ Produttive*' (IRAP) taxes all values created within an enterprise at a rate of 4.25 per cent. IRAP resembles the proposed tax on EBIT; in addition it taxes all compensation of employees. In exchange for IRAP the former regional trade tax on profits with a tax rate of around 19 per cent and a payroll tax of around 9 per cent for health insurance have been abolished: truly a very successful transition to a tax system with a broad tax base and a low statutory tax rate.

IRAP has been considered by the ECJ. The ECJ has held in its decision of 3 October 2006 that IRAP does not violate EC law.[9]

2.5.3. German business tax reform 2008

From 2008 Germany[10] will cut statutory corporate tax rates from 39 per cent to 29 per cent and broaden the tax base: for corporate and trade tax interest can be deducted only up to 30 per cent of 'earnings before interest', with several escape clauses. Of the remaining deductible interest, 25 per cent has to be added to the trade tax base. Both new features represent a certain degree of approach towards the basic concept of the proposed tax on EBIT.

3. Implementation by enhanced cooperation: EU Action Group

The implementation would best be achieved by an Action Group agreement of EU Member States. The obvious advantages for both governments and business – a fair, simple and competitive tax system – could create a drive inherent in the system that invites affiliation. In the end the group agreement could become the principle of EU wide business taxation.

3.1. EU Action Group

'The current institutional framework which provides for decision making by unanimity in the area of taxation is unlikely to change in the short to medium term. It is therefore important to explore new and creative approaches, that is to say find pragmatic solutions to the main cross-border tax problems affecting Member States and market operators',[11] explained the former EC Director for Analyses and Tax Policies, M. Aujean, and added that the proposed CCCTB might not include all Member States. Already in March 2006, the EC Tax Commissioner L. KovÃcs proposed first steps towards the harmonization of the corporate income tax base concerning only an Action Group of Member States.[12] This means that the European Commission is, at least in principle, in a position to accept such an Action Group procedure based on enhanced cooperation provided in the Treaty.

3.2. No requirement for EU-wide tax harmonization

In principle, the proposed tax on EBIT could be enacted as taxation-at-source through national legislation in any state that currently suffers from what could be regarded as unfair tax practices. In order to be efficient and to avoid new avoidance strategies on the part of global enterprises, the introduction of such legislation should, however, be coordinated amongst a larger group of important industrial nations, possibly under the auspices of the European Union. It could be implemented by a continuous changeover from residence to source principle by means of domestic, treaty and European tax law.

The initiative would, under the authors' proposal, consist of the following agreement amongst an Action Group of states. Within the Action Group, all capital compensation would be subject to a tax to be paid in the state in which the corresponding production of goods and services is taking place according to the principle of taxation in the residence state of production. Tax havens outside the Action Group would, therefore, become less attractive, as all capital compensation produced within the Action Group states would be taxed in these states.

The existing and growing problems with respect to the taxation of multinationals are due to a number of factors. These include the flexibility regarding the assignment of profits to individual subsidiaries in different states, the use of hybrid financing, the difficulty of controlling the accuracy of transfer pricing and the treatment of royalties. Under the authors' proposal, these problems would be considerably reduced, at least concerning those multinational transactions that take place within the Action Group members.

[8] Currently, most worldwide financing and administrative costs are deductible in the home state, even though only a small fraction of the proceeds derived from abroad are taxed in that state.

[9] Case C-475/03, *Banca popolare di Cremona coop. arl v Agenzia Entrate Ufficio Cremona*, judgement of the Court (Grand Chamber) of 3 October 2006, http://eur-lex.europa.eu/LexUriServ/site/en/oj/2006/c_294/c_29420061202en00030004.pdf.

It must be emphasized that the proposed tax on earnings before interest would be an enterprise-based tax to be collected by the state of production. The tax base would only be income from the deployment of capital and would have nothing to do with VAT, which includes the cost of labour in its base and is collected in the state of consumption.

[10] *Entwurf eines Unternehmensteuerreformgesetzes 2008* (proposal for a reform of enterprise taxation), BT-Drs. 16/4841, 27 March 2007; decided finally in the German Bundestag in May 2007.

[11] M. Aujean, 'European Commission launches comprehensive strategy to promote tax co-ordination in the EU', Editorial to *EC Tax Review* 2007, no. 2.

[12] 'If unanimity will not be achieved, the Commission will examine the possibility of resorting to the enhanced cooperation mechanism', Commissioner L. Kovács, 'The European Commission's business taxation agenda', Oxford, 23 March 2006, p. 6, http://ec.europa.eu/taxation_customs/resources/documents/common/about/speeches/OXFORD_speech.pdf.

3.3. No requirement for redistribution mechanism and apportionment formula

There is one decisive advantage of this proposal as compared to other ways of levying a tax on a common consolidated base in the European Union: the controversial debate on a correct and fair apportionment and redistribution mechanism for the revenue thus collected in the various Member States is avoided. The obvious reason: the question does not even arise due to the principle of taxation in the state of value production. This represents a 'natural' sharing mechanism: each member of the Action Group would, under the agreement, receive corporation tax revenue from all capital compensation produced at a site within this Member State irrespective of the seat state of the corporation that owns the production site and irrespective of the tax residence of the final beneficiaries of the interest, royalties etc. and of the profit.

As far as the income tax of the final beneficiary is concerned nothing would change: the Action Group member could, in addition, levy taxes on the final beneficiary of the distributed capital compensation, if the beneficiary is a tax resident, i.e. on received dividends, interest, royalties from Action Group states as well as from third states according to the current residence principle.

3.4. Tax competition and the competitiveness of the Action Group states

Capital goes to where the after tax return is the highest. Accordingly, once the Action Group agreement on a tax on EBIT is enacted, the following developments could be predicted.

Investment in tangibles like buildings and machinery: the tax on EBIT could reduce the yield after tax for those investors presently using tax havens, at least initially. If, however, the additional revenue were used appropriately, for example to increase the allowed depreciation rates or to reduce the cost of labour, profits after taxes could increase, for instance in labour-intensive sectors and certainly for investors that have not made use of tax havens.

Financial investments and loans: currently, returns on investments and loans paid to non-residents are often treated more favourably than those paid to tax residents. The removal of this discrimination would be a step towards the EU Single Market. Resulting tax revenue could be used to reduce the statutory tax rates, thereby increasing the net yield of investments in Action Group states.

Foreign financial investments and loans managed abroad to avoid taxes: the uniform taxation of all capital income, wherever the beneficiary resides, would make such costly financial constructions unattractive, thereby improving the overall competitiveness of the states in the Action Group.

Taken together the measures of the Action Group states should be enacted in such a way that the measures include an automatic element, i.e. a force inherent in the system that encourages affiliation. The Action Group states could even establish 'tax havens' for the management of capital returns from third states, including EU Member States, thereby creating an additional reason for these states to join the Action Group. Finally, once all or most of the Member States had joined the Action Group, the group agreement principle could become a common EU principle.

Appropriate transition periods and respective transition rules should be implemented to enable all business to adapt to the new tax base by reducing debt financing, special rules for small enterprises etc.

3.5. Results

Taxing earnings before interest instead of profit would tax the results of all economic activities – profit, interest and royalties – in the state of production, irrespective of the tax residence of the enterprise, its parent company or the beneficiaries.[13] This would be justifiable, as it is this state that requires the revenue to develop and maintain an infrastructure, from education to traffic systems and from water supplies to public security and a fair legal system that are the necessary prerequisites for all economic activities in a country.

A tax on earnings before interest instead of profit would make the tax system fairer with lower compliance cost thereby increasing the competitiveness of EU economy. The broadening of the tax base would allow a reduction of statutory tax rates without loss of revenue. This is in accordance with the guiding EU principles for the proposed consolidated common corporation tax base: 'uniformity and simplification' and 'the new tax base should be "broad" rather than "narrow"'.[14]

The authors recommend an analysis of the change of the effective tax burden for the STOXX companies due to the proposed tax on earnings before interest.

[13] Similarly to 'trade tax' or 'business tax' already existing in several EU Member States, see chapter 3.2 and 3.3.

[14] Further progress during 2006 and next steps towards a proposal on the CCCTB. COM(2007) 223 final, 4 May 2007, p. 6, para. 7. For details see Annex: Background Papers, no. (1).

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