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Earnings Before Interest (EBIT) Instead of Profits as a Tax Base?¹

Full Compensation for the Use of Capital as a Tax Base for Enterprises - a Possible Initiative for the Member States of the European Union?

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¹ Parts of this article first appeared in an article written by the authors, Lorenz Jarass and Gustav M. Obermair, entitled "Tax on Compensation of Capital: A Conceivable EU Initiative", published in *Tax Notes International*, Vol. 41, No. 10, 13 March 2006, pp. 887-890; see www.jarass.com, publications, taxes

1. Capital Income Tax Base Erosion in Germany: A Threat to Economic Stability?

1.1. Introductory remarks

Since 2000 the effective² tax burden (the "implicit tax rate") on capital income in Germany has fallen from 28% to an all-time low of approximately 21%³ in 2005 (half the statutory tax rate of around 40%). This is, except for Greece, by far the lowest compared to the average of the 15 Member States of the European Union before 1 May 2004 (hereinafter: the EU15) of over 25%. The authors, therefore, argue that it is apparent that tax policies in Germany have failed to react adequately to the globalization of economies and the full liberalization of the EU financial market.

The decline of revenue from capital taxation in Germany has resulted in significant deficits, less investment in public infrastructure and economically damaging increases in the rates of other taxes, for example, in 2007, the German standard VAT rate rises from 16% to 19%. Enterprises that operate globally have also increasingly transferred the financing of their German subsidiaries from equity to, at least in form, foreign credits. Instead of taxable profits these enterprise, therefore, declare domestic earnings as interest that is transferred abroad free of German taxation. This trend discriminates against small and medium-sized enterprises (SMEs), which have less access to such financial instruments.

As a consequence of these tax strategies, the authors argue that Germany has lower employment and less domestic purchasing power. This, in turn, gives rise to a further reduction in revenue from the wage tax, social security contributions and consumption taxes. The result is a vicious downward spiral.

Will the governing bodies in Germany be able to resist the pressure from large businesses and reduce harmful tax competition in the European Union so as to prevent the further impoverishment of public institutions? In this respect, a widening of the tax base to include all capital compensation would, in the authors' opinion, be helpful.

With regard to this, it should be noted that the German government has declared its intention to amend the German enterprise tax system in 2008 and presented key points in respect of such a reform⁴ on 12 July 2006, i.e. a reduction in the statutory corporate income tax rate from 25% to 12.5% (thereby, including the "solidarity surcharge" and trade tax, reducing the overall statutory corporate tax rate from 39% to 29%) and significant tax restrictions in respect of debt financing.

² The term "effective tax rate" is used by Devereux and Griffith (M.P. Devereux and R. Griffith, "The Taxation of Discrete Investment Choices - Revision 2", Working Paper No. W98/16 (London: Institute for Fiscal Studies, 1999)) in respect of a tax rate based on model calculations. As Devereux and Griffith use the word "effective", many believe that this is an estimate of an effective tax burden, which is not the case.

³ *Structures of the Taxation systems in the European Union, Data 1995-2004* (Luxembourg: Eurostat, 2006), p. 85, available at http://ec.europa.eu/taxation_customs/taxation/gen_info/economic_analysis/tax_structures/index_en.htm.

⁴ *Eckpunkte zur Unternehmensteuerreform, Beschluss des deutschen Bundeskabinetts vom 12.7.2006*, available at www.bundesfinanzministerium.de/cln_02/nn_54/sid_CCDF3D9BF41288E0C481E4D98B537E30/nsc_true/DE/Aktuelles/Pressemitteilungen/2006/07/20060712__PM0088.html.

1.2. The assignment of taxes to production factors

The authors refer to several previous reports⁵ that have made use of an assignment of taxes to production factors for a quantitative assessment of the trends described in 1.1. Since 1998, this method has also been used by the Commission.⁶ The assignment is as follows:

- Taxes and contributions on labour income are regarded by employers as part of gross labour costs. These comprise all the items that are regularly withheld by employers and paid to the tax authorities, i.e. the wage tax (corrected for tax refunds), and employers' and employees' compulsory social security contributions. The amount derived from tax and social security statistics divided by "compensation of employees" from the relevant national accounts is the effective tax and social security contribution burden on labour.
- The taxes assigned to production factor capital are mixed. They comprise all individual income taxes less the taxes withheld on wages, the income tax of unincorporated businesses, corporate income tax and, if relevant, regional or communal trade taxes. Property and wealth taxes should primarily be assigned not to capital income, but, rather, to capital stock. EU statistics, however, include these, although listed separately, in the general category of "taxes on capital". In this article, these taxes are shown in the upper shaded column in Figure 1 (see 1.3.). The German National Accounts provide the data in respect of capital income, which are divided into three classes, i.e. incorporated businesses, households, including the self-employed, and government. The total income of these classes is referred to as "capital income" in this article. Accordingly, the effective tax burden on capital is the quotient of "taxes on capital income" divided by "capital income". Incorporated businesses comprise both corporations subject to corporate income tax and partnerships liable to income tax. The respective disaggregations in Figures 1 and 2 are based on German trade tax statistics.⁷

1.3. Disaggregation of capital income and its taxation

Figures 1 and 2 provide details of capital income and disaggregation and the development of these factors since 1998.

The taxes on capital income in Figure 1 are analysed as specified in tax statistics as follows:⁸

- the lower black column: corporate income tax and the respective trade tax (in Germany, *Körperschaftsteuer* and *Gewerbsteuer*);
- the middle white column: income taxes and the respective trade tax (in Germany *Einkommensteuer* and *Gewerbsteuer*); and
- the upper shaded column: the taxes on property and wealth (included so as to permit a comparison with the aggregated EU data).

⁵ See, for example, L. Jarass and G.M. Obermair, "More Jobs, Less Tax Evasion, Cleaner Environment", commissioned by the European Commission, DG XXI, June 1999, available at www.jarass.com.

⁶ See note 3.

⁷ Compare L. Jarass and G.M. Obermair, *Geheimnisse der Unternehmenssteuern*, 2nd edition (Marburg: Metropolis, 2005), Chapter 2.

⁸ All amounts include the 5.5% German "solidarity surcharge" on both income tax and corporate income tax.

The capital income tax base in Figure 2 is disaggregated into:

- the lower black column: the profits of corporations (in Germany, *Aktiengesellschaft* (AG) and *Gesellschaft mit beschränkter Haftung* (GmbH)); and
- the middle and upper white columns: the income of (limited) partnerships (in Germany, *Kommanditgesellschaft* (KG), *Offene Handelsgesellschaft* (OHG), etc.), and the self-employed and private households, respectively.

Figure 1: Taxes on capital income - Germany

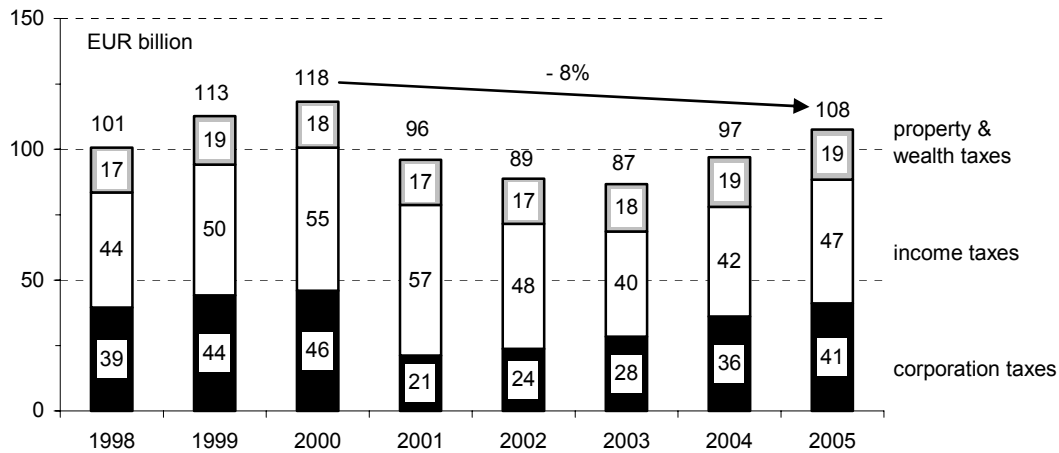
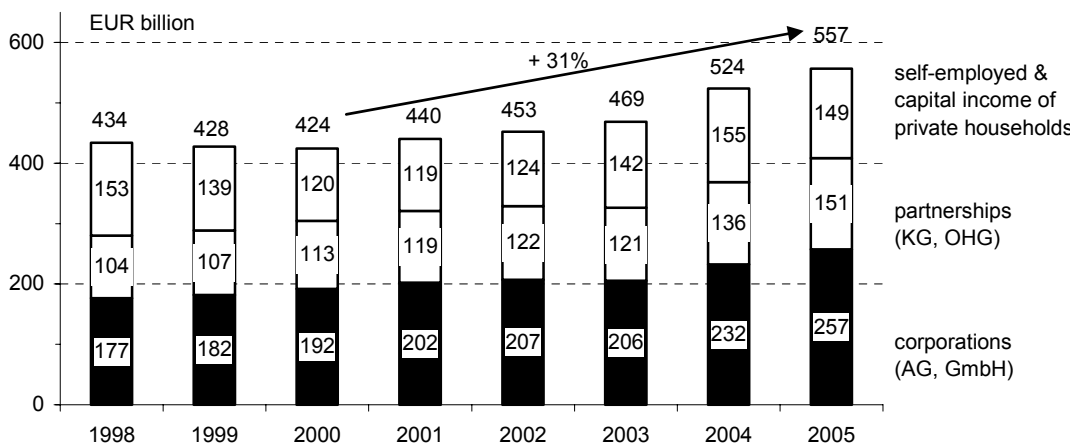


Figure 2: Capital income - Germany



For comparison, Figures 3 and 4 set out the corresponding amounts for the production factor labour.

Figure 3: Taxes and contributions on labour - Germany

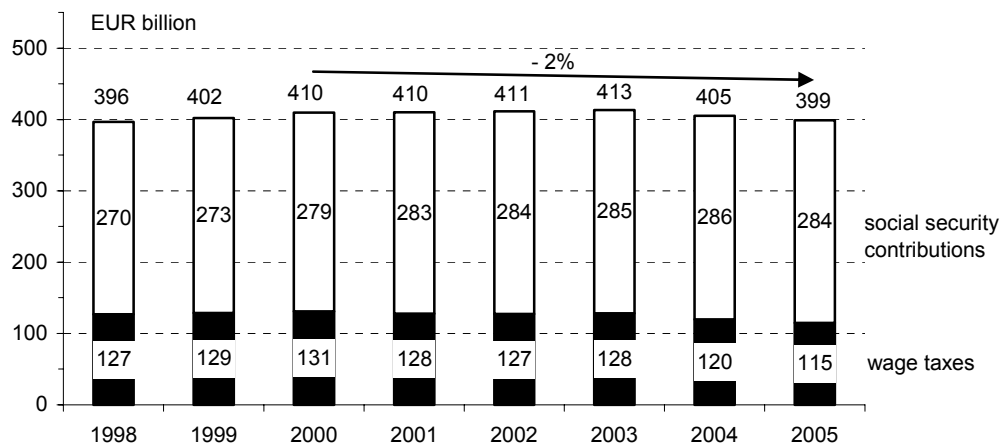
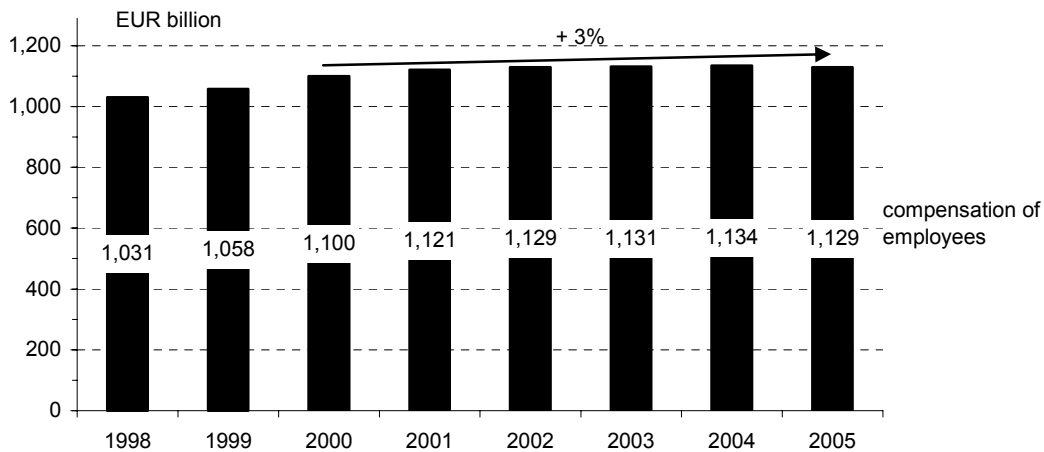


Figure 4: Labour remuneration - Germany



1.4. A significant change in the direct tax burden

The data from the German National Accounts and the official tax statistics in Figures 1, 2, 3 and 4 (see 1.3.) reveal the significant change in the distribution of the burden of direct taxation from capital to labour over the past 25 years. This trend has, in fact, accelerated since 2000, as indicated by the arrows above the columns in Figures 1, 2, 3 and 4. That is, whilst in the period 2000 to 2005, capital income *increased* by 31%, in the same period, the tax paid on capital *fell* by 8%. In contrast, labour income and levies on labour have remained almost constant in this period. In other words:

- Around 1980, the burden of taxes and contributions on the production factor labour amounted to 33% of gross labour income. The total tax burden on capital income at that time was also 33%.⁹
- By 2005, the tax burden on labour had increased by one tenth to 36% of labour income, whereas the tax burden on capital income had been significantly reduced to 19% (i.e. 108/557, see Figures 1 and 2) or around half of what it had been 25 years before.¹⁰ The first significant

⁹ Including 6 percentage points in respect of property taxes.

¹⁰ Including property taxes that have been reduced from 6 to 3 percentage points.

reduction to around 22% occurred in the period 1980 to 1990. Following a brief increase to 28% in 2000, since 2001 the tax burden on capital income has fallen to its present level of 19%.

- In absolute terms, the total of taxes on capital were more than one third of those on labour before 1980. This has fallen to around one quarter in 2004/05, but not because capital income reduced in comparison to gross labour income during that period, as, on the contrary, the ratio of capital income to gross labour income increased from one third in 1980 to one half in 2005.
- Comparable data for the EU15 for 2003/04¹¹ reveal that the tax burden on capital including property taxes was, except for Greece, by far the lowest in Germany with an effective tax burden of around 21% against the EU15 average of over 25%. The tax burden on labour in Germany was significantly in excess the EU15 average, but the growth of labour costs of 1.4% annually between 1995 and 2001 was one third of the EU15 average. At 0.8% annually, the growth in employment in Germany was by far the lowest in the European Union, even in the period 1995 to 2001. Since then, German employment has contracted, i.e. the number of jobs has fallen, with unemployment increasing from 4 million in 2000 to almost 5 million in 2005.
- From the employment perspective, the authors, therefore, argue that the claimed positive effect of reduced business and enterprise taxation has apparently not been a success.

This comparison, in the authors' view, does not support the widely held view, based on a scenario of relatively closed national economies, that stagnating wages, high and rising profits and low business taxation create employment.

1.5. Profits, tax payments and dividends of corporations

In this section, the authors focus, under the heading of corporations, on those enterprises that are subject to corporate income tax.¹² The following Table sets out the total profits of these corporations over time in row (1), their tax payments in row (2) and the dividends distributed to shareholders in row (3).

Table 1: German corporations – profits, income taxes and dividends

	EUR billion	1998	1999	2000	2001	2002	2003	2004	2005
(1)	profits	177	182	192	202	207	206	232	257
(2)	tax payment	39	44	46	21	24	28	36	41
(2a)	effective tax burden = 2/1	22%	24%	24%	10%	11%	14%	15%	16%
(2b)	statutory tax rate (corporate + trade tax)	54%	50%	50%	39%	39%	39%	39%	39%
(2c)	profits taxed = 2 / 2b	73	88	92	55	61	73	93	106
(2d)	share of profits taxed = 2c / 1	0,41	0,49	0,48	0,27	0,29	0,36	0,40	0,41
(3)	dividends	83	97	108	120	114	110	113	132
(3a)	dividends / tax payments = 3/2	2,1	2,2	2,3	5,7	4,8	3,9	3,1	3,2

The profit data reveals, in contrast to the widely held view, nearly continuous growth in profits at an average annual rate of more than 5%. Indeed, for industry, i.e. excluding the banking and insurance sector, profits have increased by more than 7% annually.

¹¹ See note 3.

¹² In Germany, primarily AGs and GmbHs.

It should also be noted that tax payments, shown in row (2), reveal a significant reduction in 2001, followed by a modest increase until 2005 when they returned to the 1998 level. Specifically, compare 1998 and 2005. Profits have increased by approximately one half, but tax revenue is around the same. The static tax revenue from corporations, therefore, runs counter to their growing profits. In this respect, the reduction in the statutory tax rate from 50% to 39% in 2001¹³ only accounts for part of this. To a greater extent, this is due to other aspects of the German tax laws and the various reforms described in 2. The effective tax burden on corporations (row (2a)) has always been well below the statutory rate in force (row 2b), which was 50% or over until 2000 and has been 39% since 2001. The effective tax burden of 16% on corporate income in 2005 is, therefore, considerably less than one half of the statutory tax rate.

On the assumption that (illegal) tax evasion is not significant for corporations, another explanation is required for the discrepancy between the statutory tax rate and the effective tax burden. In the authors' opinion, it appears that corporate profits as recorded in the German National Accounts and the taxable profits declared to the tax authorities have become almost decoupled. An example of this is the case of BMW. For two consecutive years the CEO has proclaimed "the most successful year in the history of the company" to shareholders. In these years, however, the municipalities in which the BMW production facilities and administration are located did not receive any trade tax from BMW "as profits were counterbalanced by significant losses".

A consideration of dividends (rows (3) and (3a)) corroborates this decoupling theory. Specifically, dividends in the period 2002 to 2004 were approximately one and a half times those of 1998, whilst the tax paid in this period (row (2)) remained below the 1998 level.

A simple example reveals the discrepancy between distributed profits and profits. Assume that a company's profits before taxes are 100 with a tax rate of 33%. In this scenario, 67 remains for reinvestment or distribution. Accordingly, even if the company decided to distribute the entire amount to the shareholders every year, the dividends would be exactly double the tax payment. Row (3a) in the Table appears to confirm this simple result up to 2000, except that the statutory tax rate (including trade tax) for corporations was then over 50% and the maximum theoretical distributable profits should, therefore, have been approximately equal to the tax paid. In the last five years, with a statutory tax rate of 39% and, as a result, a maximum theoretical distributable dividend of around one-and-a-half times the tax paid, dividends paid have, however, amounted to three or more times the tax paid.

This, the authors' view, confirms the previous conclusions, shown in row (2d). For German corporations, a degree of (legal) tax avoidance has become possible, whereby the profits declared to the tax authorities is only one third or less of the profits available for distribution and reinvestment despite a reduction in the statutory tax rate from 54% in 1998 to 39% since 2001. The results are well known, i.e. Germany's non-compliance with the stability rules of the Maastricht Treaty, a sharp reduction in public investment, in particular, at the municipal level, the continuing weakness of domestic demand, and increasing unemployment, and, therefore, a further reduction in revenue and social contributions. In other words, the vicious downward spiral referred to in 1.1.

¹³ The corporate income tax rate was reduced from 40% to 25%, but the trade tax rate of around 17% (deductible for corporate income tax purposes) has remained unchanged.

2. Government Tax Policy: The Danger to the Public Finances

2.1. Introductory remarks

Traditional tax laws are intended to operate in relatively closed national economies. For a long time and until quite recently, national governments and legislators paid little attention to the effect of globalization on national fiscal policy and on tax revenue. Only when the liberalization of the international capital market and the opening up of the internal EU frontiers had already occurred did a number of previously neglected and, indeed, negligibly small lacunas in tax laws appear to become significant loopholes in respect of (legal) tax avoidance. This is particularly true with regard to large businesses operating internationally and their tax departments that outnumber and often outwit national tax authorities.

In Germany, Conservative governments were apparently unwilling to close these loopholes. On the contrary, the Kohl government, which was in power until 1998, created a number of additional ones. In 1998, there was some expectation that the new Schröder government would address this situation. Indeed, Lafontaine, the then radical First Minister of Finance, did move in this direction (see the increased tax payments in the period 1998 to 2000 in Figure 1 in 1.3.), only to be replaced after one year by Eichel, a more moderate individual, who ended this trend.

Since the end of 1998, the Commission for Business Tax Reform in Germany had proposed consistent recommendations to make taxation simpler and more systematic, and to reduce the statutory rates and alleviate some burdens, whilst, at the same time, retaining total revenue as approximately constant. Many problems have, however, arisen regarding the proposed reform. Specifically, the reform has apparently become more favourable to large businesses than even the more business-oriented advisers had recommended, measures to compensate for tax reductions have not been enacted, and a law to close fiscal loopholes¹⁴ was, under pressure from the business community, rendered meaningless and, indeed, counterproductive in the parliament.

2.2. The primary reasons for declining tax revenue

In this section, the authors consider some of the old and new legal tax strategies that, in their opinion, have contributed most to the decline of public revenue in Germany. These are:

- *Group taxation that is more and more used for tax avoidance*: the concept of a "corporation", as is generally defined, i.e. as a juristic person acting independently from others, is, in the authors' opinion, arbitrarily violated if all the separate corporations that are subsidiaries of a parent company, such as the more than 100 subsidiaries of *Siemens AG*, can aggregate their profits and losses and pay taxes only on the balance, if any. In this way, even the most profitable subsidiaries hardly pay any tax. If government does not permit 100 independent small businesses, for example in Berlin, to aggregate their results and pay tax only on what eventually remains, why should it allow this with regard to large businesses? In view of the recent ruling in the *Marks & Spencer*¹⁵ case by the European Court of Justice (ECJ), this problem may become even more urgent. Specifically, if national group taxation is not limited in the near future,

¹⁴ *Steuervergünstigungsabbaugesetz*, 2 December 2002 (*Drucksache des Deutschen Bundestages* No. 15/119).

¹⁵ ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*.

irrespective of the domestic or foreign tax residence of the individual company, non-discrimination rules could make the taxation of large businesses meaningless in the now 27 Member States of the European Union.

- *Losses carried forward within a company that are not time limited and only since 2004 limited to 60% of annual profits*: this is a provision that has arguably made high-risk speculations safer, as, in the case of failure, the treasury, and, therefore, ultimately the general taxpayer, must bear (part of) the cost, but, in the case of success, only limited taxes are paid. For example, at the beginning of 2003, the DAX30 corporations had accumulated total losses carried forward of EUR 100 billion, which was approximately three times their average annual reported profits. From 2003 to 2005, these companies reported EUR 184 billion profits to their shareholders, but the losses carried only fell to EUR 94 billion at the end of 2005.¹⁶
- *Two one-off effects of the 2001 reform¹⁷ from which revenue is only slowly recovering*: these are the complete tax exemption for the proceeds from the sale of holdings and a tax refund of EUR 1 for every EUR 6 paid to the shareholders out of reserves built up from profits that were previously taxed at a higher rate, a privilege granted after a threat to sue government for "violation of private property". No individual taxpayer can obtain such refunds due to the reduction in the highest income tax rate from 53% in 1999 to 42% in 2005.
- *Increasingly tax-driven replacement of self-financing by outside financing through foreign creditors*: interest on borrowings paid to creditors and licence fees paid to licensors located abroad are not taxed in Germany, despite the fact that the value is produced in Germany. Only a trade tax of approximately 4% is levied on this interest, which is one of the reasons why large businesses dislike this tax. It is here that unfair tax competition within the European Union is also apparent. By granting preferential tax regimes to foreign holdings and credit institutions, a growing number of Member States encourage these entities to establish their tax residence outside the Member State in which value is produced. This results in the "erosion of the base", which for some years has been criticized by the Commission. Mutual impoverishment makes each Member State in the end poorer. The transaction costs of these strategies also make the strategies inaccessible for SMEs. This can be regarded as a form of unfair competition between regional enterprises and international entities.
- *Last but not least, since 1999 a tax deduction for expenditure in respect of investments abroad has been available, despite the fact that the eventual profits are not liable to tax in Germany*: this clearly violates one of the principles of the German Income Tax Law (*Einkommensteuergesetz*), Sec. 3c of which states that "expenditures connected with income that is tax exempt in Germany are not deductible" (authors' unofficial translation).¹⁸ The exception to this rule, as far as the cost of foreign investments is concerned, was only introduced in 1999 under pressure from large businesses, with, in the authors' view, adverse effects for employment in Germany. Most of the expenditure, planning and administration costs and all the debt interest of a foreign subsidiary in

¹⁶ These losses carried times the statutory tax rate are reported as active deferred taxes, which reduces the tax expense in the statement of income, thereby increasing reported profits net of tax. See L. Jarass and G.M. Obermair, *Unternehmenssteuerreform 2008 - Kosten und Nutzen der Reformvorschläge* (Münster: MV-Wissenschaft, 2006), p. 119, Table 11.0.

¹⁷ See note 14.

¹⁸ This general rule is applied extensively with regard to wage earners. Specifically, compulsory social security contributions, which are certainly connected to income, are tax deductible only up to a specified limit.

respect of the transfer of many jobs to low-wage and low statutory tax states can now be set off against the profits realized in Germany. Only the costs of wages, depreciation and material must be deducted in the low-tax state, in which the profits are taxed. The profits after this low taxation can, then, be transferred back to Germany, where a final tax of 2% is levied.

Consequently, in the authors' opinion, German wage earners are subsidizing the export of their own jobs.

If the mobility of large businesses makes taxation difficult, one extreme solution would be for governments to abolish business income taxation and transfer taxation entirely to individual income, property and consumption. As shown in 1.3., de facto even if not yet de jure, this has already occurred to a large extent in states like Germany, where, in 2004 and 2005, corporate income tax raised approximately the same amount of revenue as the tobacco tax.

There are, however, good reasons to retain the range and variety of tax bases as wide as possible and to tax these bases evenly at relatively low rates. Specifically, this keeps revenue more stable with regard to economic fluctuations and makes the evasion of any one specific tax, given the high, related transaction costs, less attractive.

2.3. The erosion of the business income tax base

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

- certain aspects of the compensation for capital, for example, profits, are taxed according to the principle of "the residence of the producer"; and
- other aspects of the compensation for capital, for example, interest, are taxed according to the principle of "the residence of the beneficiary".

When most investment and returns were domestic, this double system did not give rise to significant distortions derived from tax regimes that varied widely from state to state. The globalization of production and trade, the liberalization of the international money markets and, therefore, the ever increasing global flow of financial instruments have, however, resulted in a completely new situation, and created the phenomenon that is described as "harmful tax competition". In other words:

- A increasing number of states have established preferential tax regimes for international businesses (tax havens).
- A growing share of the domestic surplus in non-tax haven jurisdictions is legally, for example, via transfers to international holdings, or arguably illegally, for example, via incorrect transfer pricing methods, transformed into non-domestic income and thereby transferred to tax havens.
- The growing sectors of financial services and the production of intangible assets elude a clear definition of the state 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.

Consequently, a number of states are experiencing the increasing erosion of the business income tax base. At the level of enterprises, there is also increasing tax discrimination against domestic and, in particular, small, businesses that cannot "internationalize" their profits.

As a consequence of the different tax rates in Europe, any enterprise undertaking activities in two or more states has opportunities for transnational profit shifting. This results in 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 conduct much of their activities.¹⁹

Consider the following example. The German subsidiary of the multinational furniture and house ware group IKEA had, in 2003, zero equity in Germany, financed entirely through credits amounting to a debt of EUR 1.3 billion. Three percent of its gross turnover of around EUR 2.3 billion is paid as a licence fee²⁰ for the use of the IKEA trademark. Both the interest for the credits and the licence fees are legally deducted as costs in Germany and transferred finally to Switzerland, thereby escaping almost all taxation in Germany. Expenses for financing the ongoing expansion into Eastern Europe and Russia are also deducted in Germany, but the resulting profits are not taxable in Germany. Following the recent ECJ decision in the *Marks & Spencer* case, IKEA could even be able to deduct all the liquidation costs of ultimately failed investment in the Eastern European Member States. The result is that, despite being very profitable, IKEA Germany hardly pays any tax in Germany and, in the authors' view, pushes efficient German family-owned furniture stores, which pay their domestic taxes of up to 40%, out of the market.

2.4. Questionable remedies

An ever growing, increasingly difficult to operate and non-transparent, apparatus of national rules and regulations, bi- or multinational agreements, supranational directives and international controls can only, in the authors' opinion, at best reduce the harmful effects discussed in 2.1. to 2.3. As revealed in the Table (see 1.5.) and the related comments, it appears that the statutory tax rate has little effect on the tax payments of large businesses. Accordingly, it is not 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 profits of a corporation. In other words, it is not primarily the statutory tax rate, but mainly the tax base for capital income and its enforcement that determines revenue.

It should also be noted that:

*The European Commission believes that the only systematic way to address the underlying tax obstacles ... is to provide companies with a consolidated corporate tax base for their EU-wide activities.*²¹

In addition, there is a growing awareness in many Member States that business taxation solely on the basis of taxable profits has negative consequences both for revenue and, in the longer term, for the stability of the economy. Driven by a tax avoidance mentality, companies, in particular, the subsidiaries of multinationals, tend to use mostly outside financing from abroad as described in the example of IKEA (see 2.3.). Instead of domestic profits, these entities primarily produce interest that is transferred abroad tax free, which eventually finds its way to a tax haven harbouring the institution that is the final beneficiary. SMEs, which cannot use these instruments, pay the full domestic taxes and are, therefore, rendered uncompetitive.

¹⁹ See H. Huizinga and L. Laeven, *International Profit Shifting within European Multinationals* (Tilburg University/World Bank: 5/2005).

²⁰ For some time referred to as a management fee.

²¹ "A Common Consolidated EU Tax base", Commission Non-Paper, 7 July 2004, available at http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm.

3. An overdue change to the capital income tax base?

3.1. Introductory remarks

The erosion of the tax base capital, in respect of which the Commission has long warned, could be reversed by national tax policy without any requirement for EU-wide tax harmonization by substituting "all compensation for capital", which is a clearly defined and easily measurable quantity, for the tax base "profits". Specifically, the authors argue that, as revealed in 2., the taxable profit tax base is more and more subject to tax strategies, which, in many cases, can reduce the base to a small fraction of the actual earnings.

In this respect, total capital compensation essentially consists of the following three components:

- (1) compensation for the use of equity, i.e. profits paid to the owners;
- (2) compensation for the use of outside capital, i.e. interest paid to creditors; and
- (3) compensation for the use of outside rights and knowledge, i.e. licence fees paid to patent holders, etc.

3.2. A tax on all compensation for capital

As a solution to various problems discussed, the authors propose a general tax on all compensation for capital (hereinafter: CCT). Specifically, CCT would have the following features:

- a common tax base for all compensation in respect of capital, for example, with regard to interest paid to creditors, both domestic and foreign, licence fees, royalties, etc. and the remaining profits;
- a tax rate that could differ between states;
- a basis of taxation that would exist irrespective of the formal tax residence of the beneficiaries of all capital compensation; and
- the collection of tax at the location of the enterprise where the capital compensation is produced.

Regardless of the tax residence of the beneficiaries, CCT could reliably be collected with low compliance costs at the location of each enterprise. 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.

Under this proposal, the results of all economic activities would be taxed in the state of production, irrespective of the tax residence of the enterprise, its parent company or the beneficiaries of the distributed surplus.²² 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 economic growth.

²² Similarly to the "trade tax" or "business tax" that already existing in several states.

3.3. Financial instruments and internet trading in intangible assets

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. in the hands 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 could, therefore, be avoided.

3.4. The new US tax reform proposals

With regard to the arguments advanced in 3.1. to 3.3., it should be noted that the "Growth and Investment Tax Plan" of the US President's Advisory Panel on Federal Tax Reform of November 2005²³ resembles the authors' proposal in almost all respects, i.e.:

- the uniform taxation of all capital returns produced in the United States, i.e. interest payments to creditors, licence fees and similar would not be deductible for tax purposes;
- a low flat tax rate of 30% on this widened tax base; and
- the abolition of the "world income principle", which would end a form of tax evasion that also affects Member States, such as Germany (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 taxable in that state).

3.5. Short-term action and medium-term harmonization of capital taxation

In principle, the "taxation-at-source" measures described in 3.2. could be enacted 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 businesses, the introduction of such legislation should, however, be coordinated amongst a larger group of important industrial nations, possibly under the auspices of supranational bodies, such as the European Union or the OECD. The measures that could result in the general taxation of capital compensation at the location of the production of value are outlined below.

In this respect, it should be noted that, in March 2006, the Commission's Tax Commissioner, Mr. Kovács, proposed the first steps in the harmonization of the corporate income tax base in respect of an "action group" of Member States.²⁴ This means that the Commission is at least, *in principle*, in a position to proceed with such an "action group" procedure.

²³ 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/.

²⁴ "If unanimity will not be achieved, the Commission will examine the possibility of resorting to the enhanced cooperation mechanism.", Commissioner Kovács, "The European Commission's business taxation agenda", Oxford, 23 March 2006, p. 6., available at

http://ec.europa.eu/taxation_customs/resources/documents/common/about/speeches/OXFORD_speech.pdf. See also Commissioner Kovács, "The Common Consolidated Corporate Tax Base", Brussels, 5 April 2006, available at http://ec.europa.eu/taxation_customs/resources/documents/common/about/speeches/speech_CCCTB_050406.pdf.

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 occurred. This would correspond to the principle of taxation in the residence state of production. Group members also would agree to tax all compensation in respect of capital, which would be levied only in the state in which the compensation was produced.

A member of the action group would, under the agreement, receive revenue from all capital compensation produced within that state. The member could continue to levy taxes on its own residents in respect of capital income obtained in third states according to the current residence principle. 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 in respect of 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 in respect of those multinational transactions that took place within the action group states.

It must be emphasized that CCT 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. CCT would, therefore, not be caught by the prohibition in Art. 33 of the Sixth VAT Directive.^{25,26}

3.6. 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 had been concluded, the following developments could be predicted:

- *Real investment*: CCT 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 reduce the cost of labour, net profits could increase, in particular, 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 tax foreigners are often treated more favourably than those paid to tax residents. The removal of this difference within the action group would be a step towards the finalization of the Single Market in the European Union. Any additional tax revenue could also be used to reduce the general 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

²⁵ Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax : uniform basis of assessment.

²⁶ The Italian *imposta regionale sulle attività produttive* (IRAP), which taxes all value added at the enterprise, has been considered by the ECJ. See, ECJ, 3 October 2006, Case C-475/03, *Banca popolare di Cremona coop. arl v. Agenzia Entrate Ufficio Cremona*.

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 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.

4. Conclusions

In this article, the authors have argued that the erosion of the capital income tax base in Germany is a threat to economic stability. Specifically, this has given rise to a vicious downward spiral of lower employment and less domestic purchasing power, which, in turn, reduces tax revenue. An analysis of the change in the tax burden, in the authors' view, does not support the widely held view that stagnating wages, high and rising profits and low business taxation create employment. In this respect, government policy has had an adverse effect, especially, in the light of the liberalization of the international capital market and the erosion of the business tax base. As a solution to this problem, the authors propose

- a general tax on all compensation for capital (CCT), not only on profits,
- that would have a common tax base,
- different tax rates between states,
- a basis of taxation that would exist regardless of residence and
- tax collected where the capital compensation is produced.

The authors conclude by proposing that CCT should be introduced by an action group of states so as to increase its effectiveness.