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# Future Tax System in the EU

## 1 Counteracting Harmful Tax Competition

The problem is made up of three effects that are closely related to each other:

- tax avoidance, often transformed into tax evasion, made possible through the use of global financial instruments and, in many cases, favoured by the rules of bank secrecy;
- the growing discrimination, in many countries, of tax residents and domestic business in comparison to tax foreigners and international business, which is due, among other factors, to:
- the so-called ´tax competition´, which, as practiced, should rather be called ´tax dumping´ or ´unfair tax practices´.

### Historical Roots of the Problem

Historical developments going back to the 1920s have led - more or less in all OECD countries and around the world - to the following system of taxation of income from business activities:

- Certain parts of operating surplus are taxed according to the principle: ´residence of producer´ (e.g. profit),
- other taxable parts of operating surplus are taxed according to the principle: ´residence of beneficiary´ (e.g. interest).

At a time when most investments and returns were domestic, this double system could not give rise to great distortions deriving from tax regimes varying largely from country to country. The globalisation of production and trade, the complete liberalisation of the international money market and hence the ever growing global flow of financial instruments has led to a completely new situation and created the phenomenon that is precisely described by the term 'harmful tax competition':

- A growing number of countries have established preferential tax regimes for international business (tax havens).
- A growing share of domestic surplus in the non-tax-havens is legally, e.g. via transfer to international holdings, or illegally, e.g. via untrue transfer pricing, transformed into non-domestic income and thus shifted to tax havens.
- The growing sector of financial services and of production of immaterial goods eludes a clear-cut definition of the country of production and thus altogether evades taxation according to ´residence of producer´. At the same time payments to the service provider that might be taxable can easily be shifted to a country with a preferential tax regime.

As a consequence we see on the level of countries the increasing erosion of the base ´business income´, on the level of enterprises a growing tax discrimination of domestic, in particular of small business, which cannot participate in the ´internationalisation´ of its gross income.

### Doubtful Remedies

An ever growing, increasingly difficult and non-transparent apparatus of national rules and regulations, of bi- or multinational agreements, supranational directives and international controls may, in our opinion, at best reduce these harmful effects. Certainly the Recommendations and

Guidelines set forth in the EU and OECD reports and proposal on Harmful Tax Competition will, if enforced, improve the situation; but, as also indicated in this report, new situations may require further and completely new solutions.

One drastic solution could be that governments relinquish all claims on business income as a tax base and shift taxation entirely towards individual income and property and towards indirect taxes. (De facto even though not yet de jure this is happening in some countries: in Germany the contribution of all taxes deriving from both individual and corporate capital to the total tax revenue has been decreased from 17 % to 10 % in the 1980 - 1996 period; in 2001 and 2002 the actually paid corporation tax has been decreased to close to zero.)

## 2 An Alternative: Taxation at the Site of Value Production

The alternative is a proposal that retains business income and -property as a tax base by means of a general tax at the Site of Value Production, irrespective of the tax residence of the beneficiary. The proposal which at least in principle is simple, transparent and easily controlled is that the two principles ´residence of producer´ and ´residence of beneficiary´ are replaced by a single principle ´taxation at the source´:

- All surplus produced (e.g. retained and distributed profit + interest, royalties etc.) shall be the tax base for an anonymously levied flat rate tax within the enterprise where it is physically produced, irrespective of the nominal tax residence of the corporation or its mother or the beneficiaries of the distribution (similar to ´enterprise tax´ or ´business tax´, already existing in several countries).The tax paid by the company should not be credited against the shareholder's personal tax liability (´no imputation´).
- All surplus distributed (e.g. dividends, interest, royalties etc.) could be subject to an additional flat rate withholding tax at the source which serves as an individualized prepayment of taxes on personal income. With respect to wages & salaries and some distribution of surplus this form of taxation is practiced successfully in most countries anyway.
- As a result there is at least one party in almost all conceivable economic transactions that has a dominant self-interest to declare fully and correctly in order to avoid an overvaluation and resulting over-taxation of his own income or wealth. Thus also the other party in a given transaction is easily controllable by a comparison of tax records.

Thus any provable result of an economic activity in a given country is subject to taxation in this country. (It is true that the temptation to reduce the provable taxable income within the country by means of untrue transfer pricing may be increased; observation of the OECD´s 1995 Guidelines on Transfer Pricing, c.f. Recommendation 6 concerning transfer pricing rules, becomes the more important.)

### The Role of Financial Instruments and Internet Trading of Immaterial Goods

Payments for financial services, including payments for derivatives and similar financial products which are increasingly used to replace the traditional financing through bank loans, should be treated like interest payments and hence be taxed at source, i.e. at the business entity using the service or instrument, unless the user can prove that the service does not represent a ´synthetic loan´.

Likewise payments for immaterial goods utilised in a given country should also be subject to the source tax in this country, unless the paying party can prove that the receiver of the payment is adequately taxed in his country of residence. Due to the self-interest of the paying party - cf. the section above - to declare these payments and the source tax on them correctly, complicated supranational control systems for the taxation of the trade with financial services and other immaterial goods can thus be avoided.

## 3 How to Achieve such Tax Policies

In principle the taxation-at-source-measures outlined above could be enacted through national legislation in any country that is suffering from the present unfair tax practices. However, in order to be efficient and to avoid new escapist strategies on the side of global business such legislation ought to be coordinated among a large group of important industrial nations, possibly under the auspices of supranational bodies such as EU and OECD.

The following outlines the principles how to achieve general taxation at the site of value production.

**An Initiative: Through Short Term Group Action**
**Towards Medium Term Harmonization of Capital Taxation**

97. The initiative would consist in the following agreement between a group of Member States: Within the action group all capital income is subject to a tax to be paid in that country where the corresponding production of goods and services takes place, provided the tax residence of the beneficiary of the income lies in one of the countries of the action group. This corresponds to the principle: taxation at the residence of production. It has to be examined whether or not an extension of this procedure to beneficiaries with tax residence in other EU Member States would constitute an override of the EC ´parent - subsidiary directive´ or of existing double taxation agreements. Problems may be smaller if the tax at source is levied in the form of an enterprise tax (´Gewerbesteuer´ and the like).

The action could be implemented in two steps:

In a first step a minimum tax is introduced; if income already thus taxed in the country of production is transferred to another action group country, it is taxed there as up to now. Minimum taxes on capital income, by the way, have since some time been proposed by experts to the EC.

In a second step the group members agree to a common tax at source to be levied only once and for all in that country where the income has been produced. A clearing procedure with mutual compensation of this tax within the action group could be introduced in order to avoid drastic changes of revenue in individual countries.

First consequence: A member of the action group will, according to the new agreement, receive revenues from all capital income produced within his country and distributed within the action group. He may continue to levy taxes on his own tax residents for capital income obtained in third countries according to the present residence principle (still valid for income from outside the action group).

Second consequence: Tax havens in third countries - including Member States - lose importance because capital income produced within countries of action group members is now in many cases taxed there. Example, assuming Germany and the Netherlands have joined the action group: A German daughter of a holding with headquarters in the Netherlands may continue to transfer interest and profits to the parent firm, but only after the tax due in Germany (something like 25 %) has been paid.

In the first step the Netherlands will continue to tax all holdings or parents that obtain payments from abroad at the present preferential rate (like a 10 % rate), including the transfers from Germany.

In the second step payments from action group countries that have already been taxed at source, in the example in Germany, may not be taxed a second time in another action group country like the Netherlands, but the Netherlands may claim compensations through the action group clearing procedure.

After some time the (minimum) rate agreed within the action group may be increased, intensifying the incentive for other Member States to participate.

98. Taxation of multinational enterprises: in this respect the existing and still growing problems are due to a number of factors: their flexibility regarding assignments of profits to individual subsidiaries in different countries, their use of hybrid financing, the difficulty to control the adequacy of transfer pricing and the treatment of royalties etc. At least for that portion of such multinational transactions that takes place within the action group of Member States, these problems will be considerably reduced.

99. Tax competition and competitivity of the action group countries:

Ceteris paribus capital goes to the place where the return after tax is the highest. After the action group agreement the following movements might be predicted:

- Real Investments: The proposed general (minimum) tax might reduce the yield after taxes for those investors presently using tax havens, at least in the first step. However, if the additional revenue is used appropriately, e.g. to decrease the cost of labour, the net profits, in particular in labour intensive sectors or for investors who have not made use of tax havens, may even increase.
- Financial investments and loans: Presently returns payed to tax foreigners are often treated better (e.g. interest net return ≈ gross return) than those paid to tax residents. A levelling of this difference within the action group is a step towards the Single Market. In addition the increased tax revenue might be used to reduce the general tax rate, increasing the net yield of investments of tax residents. Thus a reduced supply of third country financial investment would be compensated by an increased supply from action group countries, the average debtor´s interest rate may remain constant.
- Many so called ´foreign financial investments and loans´ in fact constitute domestic capital that is only managed abroad to avoid taxes. Uniform taxation of all capital income, wherever the beneficiary may reside, makes such costly financial constructions unattractive, thereby improving the overall competitivity of the countries of the action group.

100. Altogether the measures of the action group should be conceived in such a way that they constitute an automatism, a drive inherent in the system, that invites affiliation. The action group countries might even establish tax havens for the management of capital returns from third countries including Member States, thus creating an additional preference for these countries to join the agreement.

Once all or most Member States have joined the action group, the group agreement principle - any income (from labour and from capital in its many forms like profit, dividends, interest, value increases, royalties etc.) is taxed in the country where it is produced - could become common EU-principle."

For further explanation see also:

Harmful tax competition - an emerging global issue. OECD, Paris, 1998 (available at www.oecd.org).

US General Accounting Office: Potential Impact of Alternative Taxes on Taxpayers and Administrators. January 1998 (available at verfügbar unter www.gao.gov).

L. Jarass und G. M. Obermair: More Jobs, Less Tax Evasion, Cleaner Environment: Options for Compensating Reductions in the Taxation of Labour – Taxation of Other Factors of Production. Report to the European Commission, revised version Juni 1999
(available at http://www.jarass.com/atw-forschung.de/dat/pub/0699/MJv40p1.pdf).

L. Jarass und G. M. Obermair: Secrets of German Enterprise Taxation - An Analysis of all DAX30 Annual Reports 1996-2002 incl. Data of National Accounting (in German: Geheimnisse der Unternehmenssteuern - Steigende Dividenden, sinkendes Steueraufkommen. Eine Analyse der DAX30-Geschäftsberichte 1996-2002 unter Berücksichtigung der Volkswirtschaftlichen Gesamtrechnung). Metropolis-Verlag, Marburg, Germany, 2nd edition 2005.

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