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May 9, 2007
revised version

Tax on ´Earnings before Interest´ instead on ´Profit´: Fair, Simple and Competitive

A Conceivable Initiative of EU Member States for a Common Consolidated Corporate Tax Base

Paper presented at
European Parliament Committee on Economic and Monetary Affairs:
hearing on recent developments in direct taxation and the Lisbon Strategy
May 8, 2007, Brussels

Table of Content

0 Summary 2
1 The erosion of the traditional tax base ´Profit´ 3
2 Tax on ´Earnings before Interest´ instead on ´Profit´ 6
3 Tax on ´Earnings before Interest´ – international examples 8
4 Implementation by enhanced cooperation: ´EU action group´ 9
5 Results 10
6 Annex: Background Papers 11

0 Summary

Taxable profits have increasingly been converted into tax-free interest: There is a growing awareness in many EU Member States that business taxation exclusively on the basis of ´profit´ has negative consequences both for the revenue and – in the longer run – also for the stability of the economy: companies tend to increase financing from abroad. Instead of domestic profit they produce increasingly interest and license fees to be paid tax free to the international financial market, see fig. 1.

Example IKEA: IKEA Germany was (in 2003) financed without any equity entirely through loans of EUR 1.3 billion. 3% of its gross turnover of around EUR 2.3 billion was paid as a licence fee for the use of the trademark ´IKEA´. 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.

If the proposed **´Common Consolidated Corporate Tax Base´** would again be exclusively the residue ´profit´, a growing part of the capital returns would continue to be declared as interest, license fees and the like and transferred to non-EU-countries, see fig. 2: Non-EU-countries would gain at the expense of EU.

Tax rates - race to the bottom: 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 their tax base. To keep at least some tax revenue they are forced to follow the race to the bottom of their statutory tax rates, see fig. 3.

Tax on ´Earnings before Interest´ instead on ´Profit´: To counteract the described developments we propose to replace the traditional tax base ´profits´ by ´Earnings before Interest and Taxes (EBIT)´. It has three essential components:

- compensation for the use of equity – i.e. profit for the owners;
- compensation for the use of outside capital – i.e. interest paid to creditors and the interest contained in leasing rates;
- compensation for the use of outside rights and knowledge – i.e. royalties paid to patent holders etc..

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.

Implementation by enhanced cooperation: ´EU action group´: The implementation would be best achieved by an agreement between an ´action group´ of EU Member States based on enhanced cooperation. 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 common EU wide business taxation.

Result: Under this proposal all economic activities are taxed in the country where the compensation of capital is produced irrespective of the nominal tax residence of the enterprise or its parent company or the beneficiaries of the capital compensation. After all it is this country that needs the revenue to develop and maintain an infrastructure – from education to traffic systems, from water supply to public security and a fair legal system – as the necessary prerequisite for all economic activities in a country.

1 The erosion of the traditional tax base ´Profit´

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 returns derived from business activities:

- profits are the only part of capital returns that are taxed at the enterprise;
- interest and royalties, however, are taxed where the beneficiary is located.

When most investment and returns were domestic, this double system tax regime did not give rise to significant distortions. The globalization of production and trade, the liberalization of the international capital markets and the resulting ever increasing global flow of financial instruments have, however, resulted in a completely new situation.

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 fig. 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 wildly differing tax bases and rates.

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) capital	equity	loans	equity	loans	licences
from	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	at company and domestic shareholder	at domestic creditor	at company and domestic shareholder	goes largely untaxed abroad to international capital market	

The result is 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[1].

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 also – in the longer run – also for the stability of the economy: Largely dependent on the goodwill of their foreign creditors, companies become quite unstable in periods of economic crisis. On the other hand small and medium enterprises, not having access to such financial instruments, pay the full domestic taxes and are thus driven out of the market.

1.2 Example IKEA

IKEA Germany was (in 2003) financed – without any equity – entirely through loans of EUR 1.3 billion. 3% of its gross turnover of around EUR 2.3 billion was paid as a licence for the use of the trademark ´IKEA´. 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 are also deducted in Germany, but the resulting profits are neither taxable in Germany nor the EU. The result is that, despite being very profitable, IKEA Germany hardly pays any taxes neither in Germany nor in other EU Member States and pushes efficient family-owned furniture stores, which pay their domestic taxes of up to 40%, out of the market.

1.3 Corporate tax rates - 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 fig. 2.

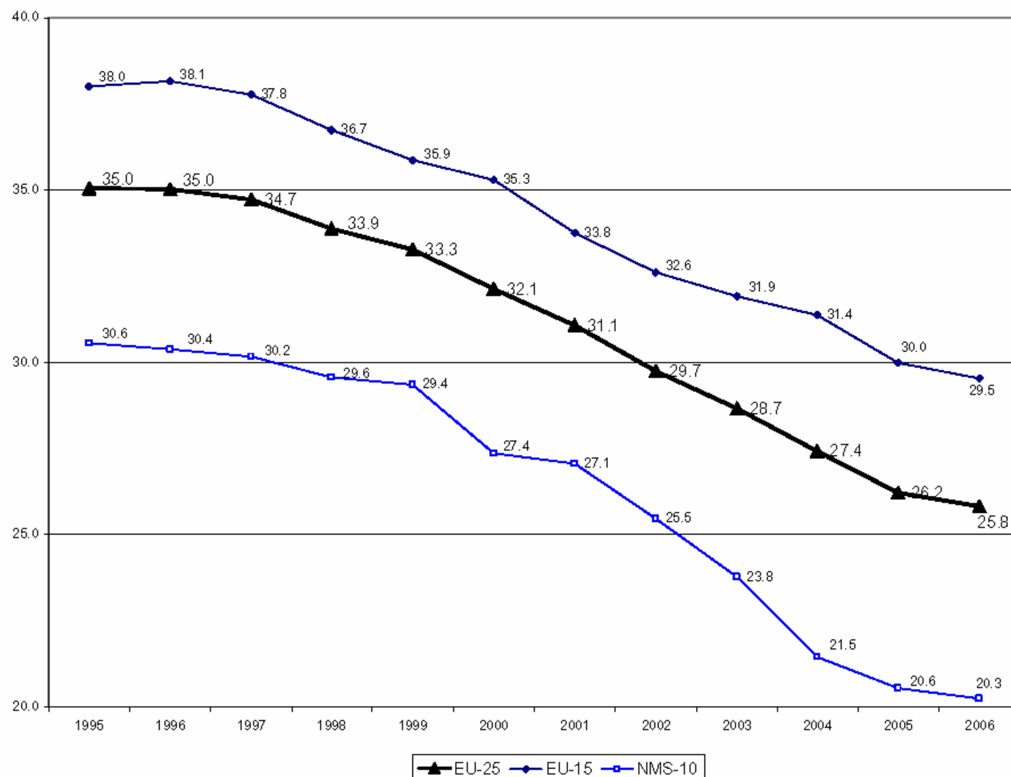
Germany, in 2006 still top runner with a rate of 40%, has decided to decrease its statutory tax rate on corporate income to 29% in 2008, Denmark will decrease from 28% to 22%, UK from 30% to 28% etc.. If these rate cuts continue the rates in the old EU Member States will soon come close to those of the new Member States thereby enforcing them to further cut rate well below 20%.

At the level of enterprises, there is also increasing tax discrimination against domestic and, in particular, small businesses that cannot ´internationalize´ their profits. An increasing number of states have established preferential tax regimes for international corporations (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

[1] See H. Huizinga (Tilburg Univ.) 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

illegally, for example, via incorrect transfer pricing methods, transformed into non-domestic income and thereby transferred to tax havens.

Fig. 2 : Development of top statutory tax rate on corporate income 1995-2006 in %



Source: Structures of the Taxation Systems in the European Union, EC, 2006, p. 35.

1.4 Questionable remedies

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

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 at best only reduce the harmful effects discussed. It appears that the statutory tax rate has little effect on the actual tax payments of large business. Evidently 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 total capital returns of a corporation. In other words, it is not primarily the height of the statutory tax rate, but mainly the width of the tax base for capital returns and its enforcement that determines revenue.

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 evade any one specific tax.

2 Tax on ´Earnings before Interest´ instead on ´Profit´

2.1 Including only ´Profit´ in the EU Consolidated Tax Base will be inadequate

If the proposed ´Common Consolidated Corporation Tax Base´[2] 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 in the future be transferred to non-EU-countries, see fig. 3: Non-EU-countries would gain at the expense of EU.

Fig. 3 : Non-EU-countries would gain at the expense of EU if Common Consolidated Corporate Tax Base is exclusively profit

	2015? **EU Common Consolidated Corporation Tax Base (CCCTB)**					
(1) 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 **inside EU** regardless whether the beneficiary is inside or outside EU		

2.2 A tax on all compensation of capital

To counteract the described developments we propose the replacement of the traditional tax base ´Profits´ by ´Compensation of Capital´. This tax base resembles the well known ´Earnings before Interest (EBIT)´. It consists of three essential components:

- compensation for the use of equity – i.e. profit for the owners;
- compensation for the use of outside capital – i.e. interest paid to creditors and the interest contained in leasing rates;
- compensation for the use of outside rights and knowledge[3] – i.e. royalties paid to patent holders etc..

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[2] Further progress during 2006 and next steps towards a proposal on the Common Consolidated Corporate Tax Base (CCCTB). COM(2007)223 final, May 4, 2007. For details see Annex: Background Papers, no. (1).

[3] This part of the compensation of capital is not included in the usual definition of ´Earnings before Interest´ (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.

2.3 Features of the proposed tax on ´Earnings before Interest´

Specifically, the proposed tax on ´Earnings before Interest´ 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.
- The tax is to be paid regardless of the tax residence of the beneficiaries of the different types of compensation of capital.
- The tax on ´Earnings before Interest´ could therefore reliably be collected with low compliance costs at the location of each enterprise.

Taxing the base ´Compensation of Capital´ does not cause any additional compliance cost for the companies, because earnings before interest, share of interest contained in leasing rates, license fees etc. are anyway established for 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 ´Earnings before Interest (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 could, therefore, be avoided.

1 # 3 Tax on ´Earnings before Interest´ – international examples

2 ## 3.1 The new US tax reform proposals

3 With regard to the arguments advanced it should be noted that the "Growth and
4 Investment Tax Plan" of the US President's Advisory Panel on Federal Tax Reform of
5 November 2005[4] resembles the authors' proposal in almost all respects, i.e.:

6 • the uniform taxation of all capital returns produced in the United States, i.e. interest
7 payments to creditors, licence fees and similar would not be deductible for tax
8 purposes;
9 • a low flat tax rate of 30% on this widened tax base; and
10 • the abolition of the "world income principle", which would end a form of tax evasion
11 that also affects Member States, such as Germany[5].

12 ## 3.2 The Italian regional tax IRAP

13 The Italian regional tax ´Imposta Regionale sulle Attività Produttive (IRAP)´ taxes all
14 values created within an enterprise at a rate of 4.25%. IRAP resembles the proposed
15 tax on ´Earnings before Interest´; in addition it taxes all compensation of employees. In
16 exchange for IRAP the former regional trade tax on profits with a tax rate of around 19%
17 and a payroll tax of around 9% for health insurance have been abolished: truly a very
18 successful transition to a tax system with a broad tax base and a low statutory tax rate.

19 IRAP has been considered by the European Court of Justice (ECJ). The ECJ has held
20 in its decision of 3 Oct 2006 that IRAP does not violate EC law[6].

21 ## 3.3 German business tax reform 2008

22 From 2008 Germany[7] will cut statutory corporate tax rates from 39% to 29% and
23 broaden the tax base: for corporate and trade tax interest can be deducted only up to
24 30% of ´Earnings before Interest´, with several escape clauses. 25% of the remaining
25 deductible interest has to be added to the trade tax base. Both new features resemble
26 the basic idea of the proposed tax on ´Earnings before Interest´.

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[4] 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/.

[5] 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.

[6] Case C-475/03, Banca popolare di Cremona coop. arl v. Agenzia Entrate Ufficio Cremona. Judgement od the Court (Grand Chamber) of 3 Oct 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.

[7] Entwurf eines Unternehmensteuerreformgesetzes 2008 (proposal for a reform of enterprise taxation), BT-Drs. 16/4841, 27.3.2007; decided finally in the German Bundestag in June 2007.

4 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.

4.1 ´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.”[8], explained the EC Director for Analyses and Tax Policies, M. Aujean and added, that the proposed Common Consolidated Corporate Tax Base (CCCTB) might not include all Member States. Already in March 2006, the EC Tax Commissioner L. Kovács proposed first steps towards the harmonization of the corporate income tax base concerning only an ´action group´ of Member States.[9] This means that the Commission is at least, in principle, in a position to accept such an ´action group´ procedure based on enhanced cooperation provided in the treaty.

4.2 No requirement for EU-wide tax harmonization

In principle, the proposed tax on ´Earnings before Interest´ 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 Member 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.

A member of the action group would, under the agreement, receive revenue from all capital compensation produced within that Member State. The member could continue

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[8] M. Aujean: European Commission launches comprehensive strategy to promote tax co-ordination in the EU, editorial to EC tax review, Kluwer Law International, issue 2/2007.

[9] "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.

to levy taxes on its own residents with respect to capital income obtained from action group countries as well as from third states according to the current residence principle.

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 in respect of those multinational transactions that take place within the action group states.

4.3 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 ´Earnings before Interest´ is enacted, the following developments could be predicted:

Investment in material assets 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 reduce the cost of labour, profits after taxes 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 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´ Member 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 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..

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[10]. 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 on ´Profit´ would yield a fair tax system with low 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´"[11].

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´.

6 Annex: Background Papers

(1) 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, May 4, 2007.
See also COM (2006) 823, 824, 825, 19 December 2006, COM (2005) 532, 25 November 2005.

(2) 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, 6.3.2007.

(3) Structures of the Taxation Systems in the European Union 1995-2004, Doc. TAXUD E4/2006/DOC/3201, European Commission, 2006.
http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_structures/Structures2006.pdf

(4) A. Rädler: Recent trends in European and international taxation. Intertax issue 8/9, 2004, p. 365-376.

The following publications by Jarass/Obermair are available at http://www.jarass.com, publications, taxes:

(5) Earnings Before Interest (EBIT) Instead of Profits as a Tax Base? Full Compensation for the Use of Capital as a Tax Base for Enterprises - a Possible Initiative for the Member States of the European Union? **European Taxation**, Official Journal of the Confédération Fiscal Européene, IBFD, Amsterdam, January 2007, p. 38-46.

(6) Tax on Compensation of Capital: A Conceivable EU Initiative. **Tax Notes International**, Vol. 41, No. 10, 13 March 2006, pp. 887-890.

(7) Enterprise Tax Reform 2008 (in German: Unternehmensteuerreform 2008). MV-Verlag, Münster, Germany, 2006.

[10] Similarly to "trade tax" or "business tax" already existing in several EU member states, see chapt. 3.2 and 3.3.

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