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Tax on Compensation of Capital: A Conceivable EU Initiative

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There is a growing awareness in many EU member states that business taxation solely on the basis of taxable profits has negative consequences both for the revenue and — in the longer run — also for the stability of the economy. Driven by the tax avoidance mentality, companies tend to use mostly outside financing from abroad. Instead of domestic profit, they produce mostly interest to be paid tax-free to the creditors abroad. Small and medium-size enterprises, not able to use these instruments, pay the full domestic taxes and are thus driven out of the market.

We propose a general tax on compensation of capital (CCT), the base of which consists of three essential components:

- compensation for the use of equity: profit for the owners;
- compensation for the use of outside capital: interest paid to creditors; and
- compensation for the use of outside rights and knowledge: license fees paid to patent holders, etc.

The tax is to be collected at the enterprise where the compensation of capital is produced. The tax rate may differ between countries.

Compensation of employees (wages and salaries) continues to be taxed only under the personal income tax regime as practiced successfully in most countries.

Thus, the results of all economic activities are taxed in the country of production irrespective of the nominal tax residence of the enterprise or its parent company or the beneficiaries of the capital compensation (similar to trade tax or business tax already existing in several countries). After all, it is this country that needs the revenue to develop and maintain an infrastructure — from education to traffic systems and from water supply to public security and a fair legal system — as the necessary prerequisite of any economic results.

Implementation could be taken up as part of the recent "EU Action Group" proposal for a common tax base of EU Tax Commissioner László Kovács. To enact these measures in an efficient way and to counteract new escapist strategies on the side of global business, it would be best to achieve an agreement on this type of business taxation among a group of EU member states that suffer most from the current tax practices.

The obvious advantages for both governments and business in these countries — increased revenue resulting in improved infrastructure and in decreasing tax rates — 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.

It must be emphasized that the proposed CCT is an enterprise tax to be collected by the country of production. Its tax base has nothing to do with the well-known VAT, which is essentially a sales tax collected in the country of consumption.

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 compensation of capital (profit) are taxed according to the residence of the producer; and
- other parts of compensation of capital (interest) are taxed according to the residence of the beneficiary.

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. Indeed, traditional tax laws were written to act in relatively closed national economies. For a long time, and until quite recently, national governments and legislators paid little attention to the impact of the impending globalization on national fiscal policy and on the actual tax revenue. Only with the liberalization of international capital markets and the opening of the internal European frontiers did a number of previously neglected gaps in tax laws open up to become tremendous loopholes for legal tax avoidance — particularly in the hands of large multinational corporations and their tax divisions, which outnumber and often outwit national tax offices.

Present Situation: Erosion of the Tax Base

The globalization of production and trade, the complete liberalization of the international money market, and hence, the ever-growing global flow of financial instruments have 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 nondomestic 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, and on the level of enterprises a growing tax discrimination of domestic — in particular, small — businesses that cannot participate in the internationalization of their gross income.

Due to rather different tax rates within Europe, any enterprise conducting activities in two or more countries has opportunities for transnational profit shifting. This leads to a substantial redistribution of national corporate tax revenues. Some European states appear to gain extra revenues from intra-European profit shifting by multinationals at the expense of those countries like Germany where the same enterprises still conduct a large part of their actual industrial production (cf. International Profit Shifting within European Multinationals, Huizinga/Laeven (World Bank), 5/2005).

Example: The German subsidiary of the multinational furniture and houseware group IKEA had in 2003 zero equity in Germany and was financed entirely through credits amounting to a debt of €1.3 billion. Three percent of its gross turnover of around €2.3 billion is paid as license fee for the use of the trademark "IKEA." Both interest for the credits and license fees are legally deducted as cost in Germany and transferred finally to Switzerland, thereby escaping almost any taxation. The finance costs of the expansion to East Europe and Russia are deducted in Germany, whereas the resulting profits are tax-free in Germany. Due to the recent ECJ decision on *Marks & Spencer* they will also be allowed to deduct all liquidation cost of an eventual failed investment in EU Eastern Europe. Result: Although being very profitable, IKEA-Germany hardly pays taxes and pushes efficient family-owned furniture stores out of the market that have to pay their due domestic taxes of up to 40 percent.

Doubtful Remedies

An ever-growing, increasingly difficult, and nontransparent apparatus of national rules and regulations, of bilateral or multinational agreements, supranational directives, and international controls may, in our opinion, at best reduce these harmful effects.

If the volatility of big business makes taxation so difficult, one drastic solution could be that governments relinquish all claims on business income as a tax base and shift taxation entirely toward 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.

Compensation of Capital

"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" (A Common Consolidated EU Tax Base, Commission Non-Paper, July 7, 2004). There is a growing awareness in many EU member states that business taxation solely on the basis of taxable profits has negative consequences both for the revenue and — in the longer run — also for the stability of the economy. Driven by the tax avoidance mentality, companies, in particular subsidiaries of multinationals, tend to use mostly outside financing from abroad as described in the IKEA example. Instead of domestic profit, they produce mostly interest that is transferred abroad tax-free and eventually finds its way to a tax haven harboring the institution that is the final beneficiary. Small and medium-size enterprises, not able to use these instruments, pay the full domestic taxes and are thus driven out of the market.

Total compensation of capital consists essentially of three components:

- compensation for the use of equity: profit to owners;
- compensation for the use of outside capital: interest to debtors; and
- compensation for the use of outside rights and knowledge: license fees to patent holders, etc.

We propose a general tax on compensation of capital, irrespective of the tax residence of the beneficiary:

- common tax base: all compensation of capital, e.g., interest paid to creditors, both domestic and foreign, paid license fees, paid royalties, etc., as well as the remaining profit;
- tax rate: may differ between countries; and
- collection of tax: at the enterprise where the compensation of capital is produced.

Compensation of employees (wages and salaries) continues to be taxed only under the personal income tax regime as practiced successfully in most countries.

Thus, the results of all economic activities are taxed in the country of production irrespective of the nominal tax residence of the enterprise or its parent company or the beneficiaries of distributed surplus (similar to a trade tax or business tax already existing in several countries). After all, it is this country that needs the revenue to develop and maintain an infrastructure — from education to traffic systems, and from water supply to public security and a fair legal system — as the necessary prerequisite of any economic results.

Financial Instruments and Internet Trading

Payments for financial services, including payments for derivatives and similar financial products that 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. Likewise, payments for immaterial goods utilized in a given country should also be subject to the source tax in this country. Complicated supranational control systems for the taxation of the trade with financial services and other immaterial goods can thus be avoided.

Tax Reform in the USA

The Growth and Investment Tax Plan of the U.S. President's Advisory Panel on Federal Tax Reform of November 2005 resembles our proposal in almost all respects:

- Uniform taxation of all capital returns produced in the United States, i.e., interest payments to creditors, license fees, and the like shall no longer be deductible for tax purposes.
- A flat rate of 30 percent on this broadened tax base.
- Abolition of the world income principle; this would end a type of tax evasion that affects also EU countries like Germany. The deductibility of worldwide costs — even though only a vanishing fraction of the proceeds obtained abroad — is actually taxed in the home country.

Toward Harmonization

In principle the taxation-at-source measures outlined above could be enacted through national legislation in any country that is suffering from the current 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 the EU and the OECD. The following outlines the measures that could lead to a general taxation of capital compensation at the site of value production.

The initiative would consist in the following agreement among a group of member states: Within the action group all capital compensation is subject to a tax to be paid in that country where the corresponding production of goods and services takes place. This corresponds to the principle of taxation at the residence of production. The group members agree to a tax on all compensations of capital, to be levied only once in the country where the compensation has been produced.

A member state of the action group will, according to the new agreement, receive revenues from all capital compensation (interest paid, license fees paid, and remaining profits) produced within its country. It may continue to levy taxes on its own tax residents for capital income obtained in third countries according to the current residence principle. Tax havens outside the action group lose importance because all capital compensation produced within action group countries are now taxed there.

The growing problems with the taxation of multinational enterprises 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.

Tax Competition

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 tax might reduce the yield after taxes for those investors currently using tax havens, at least in the first step. However, if the additional revenue is used appropriately, e.g., to decrease the cost of labor, the net profits may even increase, particularly in labor intensive sectors and certainly for investors who have not made use of tax havens.
- Financial investments and loans: Currently returns paid to tax foreigners are often treated more favorably than those paid to tax residents. A leveling of this difference within the action group is a step toward the single market. In addition, the increased tax revenue might be used to reduce the general tax rate, increasing the net yield of investments from action group countries.
- 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 competitiveness of the countries of the action group.

Altogether the measures of the action group should be enacted 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 could become common EU principle.

EU Compatibility

It has to be examined whether the proposed tax on compensation of capital would constitute an override of the EC interest and royalties directive or of existing double taxation agreements. Problems may be smaller if the tax is levied in the form of an enterprise tax (*Gewerbesteuer* and the like).

The Italian regional trade tax (IRAP) is a combined tax on compensation of capital and on compensation of employees. A bank representing the interests of Italian industry recently went to the European Court of Justice to abolish the IRAP, with the argument that its tax base is too close to the VAT and thus violates the prerogative of the EU on value added taxation.

It must be emphasized that the CCT proposal is an enterprise tax to be collected by the country of production. Its tax base has nothing to do with the well-known VAT, which is essentially a sales tax and collected in the country of consumption.

For background information, also see:

- "The Great Tax Shift in Germany, 2006" (available at http://www.jarass.com, Publications, Taxes, B. papers).
- "Secrets of German Enterprise Taxation — Using DAX30 Annual Reports 1996-2002 and of National Accounting Data" (in German: *Geheimnisse der Unternehmenssteuern*). Metropolis-Verlag, Germany, 2nd edition, 2005.
- "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 June 1999 (available at http://www.jarass.com, Publications, Taxes, A. books and extensive reports). ◆