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RECENT DEVELOPMENTS IN EUROPEAN COMPANY LAW
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ELIMINATING TAX OBSTACLES FOR CROSS-BORDER OPERATIONS¹

JOHN CHOWN²

INTRODUCTION AND SUMMARY

This is the substance of a talk given at a two day conference on "Recent Developments in European Company Law" organised by the European Law Academy, Trier, Germany 15-16 February 2007. The others taking part were company lawyers, but I was asked, as an economist, to speak about tax obstacles to cross-border operations, and specifically to address some questions about why it had remained so difficult to create EU wide companies of the type that Americans take for granted, and why serious penalties on doing business across frontiers, within what was meant to be a single market, persisted for so long.

My paper suggests that the well-meaning efforts of the European Commission, and indeed of the European Court of Justice, aiming at "standardisation" may, paradoxically have hindered rather than helped true "harmonisation." Sensible measures to solve immediate problems had been put to one side with the implicit argument that once everyone has the same system all will be well. As every music lover knows, harmony is a much more powerful and subtle technique than unison!

The conference was billed to be on "Recent Developments" but, for reasons I explain, I took an historical approach, explaining why it was relevant. I discussed the complex problem of taxing company dividends and why, during the 1970s, many countries led by the French switched to an 'imputation system' by which shareholders were given a partial credit for the underlying tax paid by the company on the profit out of which dividends were paid. This was mainly to deal with the anomaly that interest was more favourably taxed than dividends, tempting companies into the excessive gearing, indirectly creating the "junk bond" scandal in the United States and generally distorting capital structures.

Unfortunately, these imputation systems created international problems (the main theme of my talk) and although there were other ways of resolving this issue, many countries simply backed away from imputation, inadvertently recreating the 'interest' problem which, it is now being argued, is giving unfair advantages to private equity transactions. This was the (unconvincing) excuse for the measures taken in 1997 by Gordon Brown which seriously damaged the previously favourable UK pension regime. Since my first draft of this paper, the issue actually became more topical: the problem is now being tackled by legislation before the German, Danish and Canadian Parliaments.

¹ The substance of this paper was published in Tax Notes International Volume 46 Number 6 May 7, 2007. There have been a few subsequent updates and amendments.

² Chown Dewhurst LLP, 51 Lafone Street, London SE1 2LX. Tel: +44 (0) 20 7403 0787; Fax: +44 (0) 20 7403 6693, E-mail: jchown@chowndewhurst.com, www.chowndewhurst.com



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Overall the paper gives an account of how and why so many different aspects of policy (including pensions and capital markets and corporate governance) interact with each other, often being the cause of the type of disaster which come under the heading of "The Law of Unintended Consequences". It covers a wider range of issues, such as cross-border mergers and relief for losses Controlled Foreign Corporation legislation, tax competition and the advantages and disadvantages of adopting a standard EU regime for calculating tax liabilities.

In my professional experience, I had found tax problems were a far greater obstacle to cross-border mergers and acquisitions than anything to do with company law and was fascinated to learn during the conference that company lawyers had been suffering similar problems for much the same reasons. It proved to be stimulating two days.

THE MIRRLEES STUDY – A PARTIAL FOLLOW-UP

Shortly after giving this talk I attended a two-day seminar organised by the Institute for Fiscal Studies (of which I was a co-founder) in Cambridge 12th to 14th April 2007 which covered some of the same ground. Thirty years ago, we (the Institute) had commissioned the Meade Report on the long-term future of UK taxation and to celebrate the anniversary we have initiated a follow up project chaired by Sir James Mirrlees. These seminars take place every two years but this was longer than usual and took the form of an in-depth discussion on the draft papers so far produced by members of the Mirrlees team, including of course himself. It was a fascinating gathering of tax policy specialists including some old friends from abroad that I had not seen for some time.

The most interesting papers from this point of view were International Capital Taxation by Rachel Griffith (Institute for Fiscal Studies), James Hines (University of Michigan) and Peter Birch Sorensen (University of Copenhagen); and Taxing corporate income Alan Auerbach (University of Michigan), Michael Devereux (Oxford Centre for Business Taxation and IFS) and Helen Simpson (IFS). These overlapped closely with my Trier paper and it was a good opportunity to go over the issues with members of my own profession. I hope to have more to say on the subject in the fairly near future.

These papers were preliminary drafts clearly marked "please do not quote" but as the work proceeds successive updated versions of them will be available and open for comment on the Mirrlees website: www.ifs.org.uk/mirrleesreview

THE KEY QUESTIONS

As an international tax practitioner who has advised major companies on their international operations, and as a tax policy adviser, I look at these issues rather differently from politicians, government officials and international organisations and these appear to be the key questions.

- Why are there serious fiscal penalties on companies operating across frontiers in the European Union which is meant to be a single market?
- Why did industry typically react to the larger scale appropriate to a larger market by promoting mergers between otherwise competing firms in a single country rather than by merging across frontiers?
- Why do (often surprising) countries such as India and Iceland prove to be big international investors?



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- The City of London is a leading financial centre and there are many examples of major international banks having more employees in their London office than in the head office back at home. Why then have so many City institutions (and UK companies generally) been acquired by foreign parents?

These major problems arise from apparently minor and subtle tax distortions, and it is interesting to ask how these have persisted. There are two partial answers. First the Commission had for a long time been confusing "harmonisation" with "standardisation", seeming to want to force countries into more or less identical tax systems and indeed seeming more concerned with an unrealistic long term objective of having a full Federal system of government with a single budget and a common tax system.³

The second reason is that some businessmen and politicians like the idea of creating "national champions" to compete in a larger market, often looking at the shadow of headline grabbing initiatives rather than the substance of the complex task of removing the technical obstacles to the stated goal of the free movement of capital and enterprise, as well as goods and services, across intra EU frontiers. Cross frontier mergers between companies would help them become large within the EU while not having an excessive market share in any particular country, and this would more in line with a healthy competition policy, and the ideal of a single market, than the "national champion" approach.

Although this paper discusses company taxation within the European Union and not (as such) personal or indirect taxes, I shall show that it is impossible to analyse the real problems of company tax without recognizing that companies are owned and managed by individuals, and that one needs to take an "holistic" approach to the overall tax burden on company profits. An earlier speaker had given a Continental definition of the status of a company, but I added a classic English one: a company is "an artificial creation of the Statute law which has no soul to be damned and no body to be kicked".⁴

In 1969, the European Commission published two Draft Directives (both of which I broadly supported at the time) the "Parent Subsidiary Directive" and the "Mergers Directive" the latter being directly relevant to the point I have just made. Both were adopted 23 years later, in 1993.

DOUBLE TAX AGREEMENTS

There are always problems when a company resident in one jurisdiction derives profits from another, as each country may in principle have a right to claim tax on the profits so generated. These have been largely (but never completely) solved by the network of bilateral double tax agreements which were pioneered by United Kingdom, actively promoted by the OECD, and taken up seriously and indeed enthusiastically by other countries even though they limit their taxing powers. The issues which needed to be addressed within the European Union were technically no more difficult, but the appropriate political will was lacking. The Commission seemed for many years to have no interest in practical solutions to practical problems, appearing to believe that this would distract attention from their "grand design" of a neat universal bureaucratic solution. Although one battleground between the Commission and the Parliament was on the question of harmonising rates and base, international practitioners have been more concerned with ensuring that independent tax systems can mesh together in such a way that there is no extra tax burden (and no opportunity for avoidance, sometimes referred to in

³The so-called pensions time bomb will have a far more dramatic impact on countries with the Bismarckian pay as you go system than those such as my own where there are substantial independent funds rather than mere government promises backing pension payments. We would expect countries such as France and Germany to be all in favour of a common single EU budget in the hope that they can export some of this problem to those of us who have been more prudent. You can hardly expect the British to share their enthusiasm.

⁴ Attributed (with variations) to Lord Thurlow (an English Judge) 1733-1806.



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our trade as “double non taxation”) just because business operates across frontiers. There are several reasons for wanting to harmonise company taxes, other than a naive desire for uniformity or administrative convenience.

A NEW APPROACH BY THE COMMISSION?

The turning point seems to have come when the EU was negotiating to bring in new (mainly former Communist) members which had adopted very business friendly tax regimes in the hope, typically not disappointed, of speeding their catch up with the rest of Europe, and does now seem that we are on the way to treating tax obstacles as serious but soluble technical issues.

The European Commission published in October 2001 a ‘communication’ entitled “Towards an Internal Market without Tax Obstacles”. This is far nearer to the “business” analysis than previous pronouncements: their aims are set out on their page 5 which says that “from an economic point of view company taxation in the internal market must

- contribute to the international competitiveness of EU businesses in line with the strategic goal established by the Lisbon European Council
- ensure that tax considerations distort as little as possible economic decisions by operators
- avoid unnecessary or unduly high compliance costs and tax obstacles to cross border economic activity
- not hinder the possibility of general tax competition while tackling all harmful or economically undesirable forms of tax competition.

(Taxpaying business and citizens can have different views from governments on the definition of “economically undesirable” tax competition.) The Communication says that “most of the differences between members can be accounted for by rates” (not altogether true) but specifically quotes, with approval, that “the level of taxation in this area is however a matter for Member States to decide in accordance with the principle of subsidiarity”. Seven obstacles listed can be summarised as follows:

- Intra group transfer pricing with high compliance costs and potential double taxation
- Cross border flows of income between associated companies may be subject to additional tax; the scope of the Parent/Subsidiary Directive is too narrow
- Cross border loss relief is not available and this can result in economic double taxation
- Cross border restructuring operations still involve high tax charges, notably capital gains taxes and transfer taxes. The scope of the Mergers Directive is too narrow.
- Conflicting taxing rights can still result in double taxation (I would add “and double non taxation”)
- “Certain tax systems contain a bias towards domestic investment. This is, for instance, the case for imputation systems granting specific tax credits only to domestic shareholders which are still operated by a number of member States.”



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- Fifteen different sets of tax rules involve substantial compliance costs and prevent companies treating the EU as a single market.

The Commission paper mentions two types of solution: “those targeted as particular obstacles, and those which in a comprehensive manner remedy all or most of the obstacles at a stroke”.

A PRACTITIONER’S VIEW

The Commission says it would like to ensure that corporate decisions, e.g on plant location, are not unduly distorted by differences in tax rates, base and systems but supporters of tax competition, including myself, take a more cautious view, and appear to have won, a (perhaps temporary) victory, thanks partly to the influence of the new Member States. Official Brussels does now seem to recognize the danger of imposing on new and relatively poor Member States the type of tax system appropriate for a mature one, and I'm delighted that they have allowed the Irish, the Slovaks and the Estonians (for instance) to build prosperous economies by adopting the type of business friendly tax systems which have actually succeeded in raising tax revenue. Yes, we must address the question of "unfair tax competition" but this is now being done in a sensible way and the protectionist instincts of some of the older Member States have, at least for the time being, been curbed.

The remaining questions fall from our point of view into two broad categories: The first and simplest is how to reduce the administrative burden, on small as well as large enterprises, of jurisdictional battles between different Revenue authorities. Section 5 of the Commission report looks at various ideas for providing a comprehensive tax base, an aspect I shall deal with later and briefly.

The second is more subtle: why are true trans-national EC mergers still impossible and why is the typical reaction to a larger market been for two national companies to merge, when public policy would suggest that cross-border alliances would be more appropriate in preserving competition and helping to create a genuine United Europe? Here, there are (at least) six major issues.

1. What was known in the UK as the "surplus ACT" (or elsewhere as the “equalisation tax”) problem by which there was a significant rise in the tax burden when a company has to draw on profits earned in a foreign country to meet its dividend. In this context the income source was "foreign" even if it was within the single market of the European Union, the inevitable situation of any EU company which earned more than half its profits outside its home base. This was the most critical, and most misunderstood, of the issues.
2. Ensuring that proper and full (but not excessive) relief from double taxation was given on dividends interest and royalties paid between parents and subsidiaries in different Member States.(This is closely related (1) above)
3. Ensuring that the tax reliefs and rollovers given on reconstructions mergers and demergers applied even when the companies concerned were resident in two different Member States.
4. Endeavouring to ensure that proper relief was given when a group of companies incurred losses in one Member State while earning profits in another.
5. Rationalising the treatment of Controlled Foreign Corporation legislation.
6. Dealing with the problem of redomiciliation: can (and should) companies be free to move their seat to another Member State?



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“SURPLUS ACT” THE MAIN INTERNATIONAL DISTORTION

We must now go back into some early, but very important, history. The most serious, and the most difficult to explain, of the distortions has its roots in attempts to deal with a domestic problem arising from the interrelationship of company and personal taxation. Companies as such are taxed on their profits but what happens when these profits are distributed to shareholders? In the early days of taxation (and indeed of companies) when tax rates were low, most countries simply taxed the dividend income as well. (For historical reasons, this hadn't been a problem in the United Kingdom and those of its once dependent territories whose tax systems were based on the UK model.) When tax rates rose, this double taxation became a problem, for two main reasons.

The most obvious was that it discouraged profit distributions and encouraged companies to retain cash even though they had no obvious internal opportunities to invest it. This was famously referred to by Edward Heath as encouraging "the survival of the fittest".

The more serious question, though, was the effect on company financing and the sharply different treatment of dividends which were (in most systems) treated as distributions paid out of already taxed profits and therefore doubly taxed, and interest treated as a deduction from taxable profits and taxed only once. Different countries had different approaches for dealing with this, and the Americans tackled it (and not very well) only recently. The Germans had for long had a "split rate" taxing retained profits at 51%, and distributed profits at a much lower rate of 15% - plus the personal tax. In 1965, the French achieved the same (domestic) effect by a "partial imputation" system by which shareholders were given a credit for some (but not all) of the underlying corporate tax. In the same year Jim Callaghan, the then British Finance Minister introduced a new system of corporate tax deliberately (but unthinkingly) creating the problem that everyone else had been seeking to avoid!⁵

In 1972, a new UK government determined to reverse this "reform" and initiated consultations on how to replace it. I wrote a pamphlet, and gave evidence strongly supporting the French system. This prevailed, we introduced an imputation system, and for many years this became increasingly adopted in other countries in Europe and elsewhere.

Unfortunately imputation systems, while solving two major problems, created two others. One, which we had foreseen, was an international problem which at first mainly affected the many UK multinational companies.⁶

There was a related problem (which I for one did not anticipate) on the implications for the taxation of company profits distributed to tax-exempt pension funds. There was a rather subtle algebraic effect by which the effective burden on distributed profits varied (in the UK) with the difference between the basic rate of income tax and the Corporation Tax rate. This only became apparent when Nigel Lawson and Norman Lamont, in otherwise very sensible reforms, reduced these rates and (by chance) narrowed the gap. They later took steps to restore the balance, but what they did was incorrectly used as a 'precedent' for what happened in 1997.

The combined effect of these two problems drove the world wide move away from imputation systems. Just before the change of government in 1997, some steps had, as noted, been taken and there

⁵ This actually marked the beginning of my serious career as tax policy adviser: I was part of the team advising the Conservative opposition in Parliament on this package of misconceived reforms and it led four of us to found the Institute for Fiscal Studies, hoping to make sure that future governments had access to competent independent advice.

⁶ Six of the largest set up a committee to lobby on this issue: I acted as their adviser.



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had been discussions on a more fundamental rethink. Gordon Brown rushed his fences and "solved" the international problem by his notorious raid on pension funds. It took the market about two years to recognise the implications of this but after that long term damage was done to the previously world beating pension arrangements in the UK.

From the point of view of today's discussions, the major problem encountered with European type imputation systems is that they discriminated seriously against cross border investment. Well-intended measures for the relief of domestic double taxation (integration) interacted with equally worthy arrangements for the relief of international double taxation resulting from cross frontier investment and in perverse and economically damaging ways. Specifically, although the countries of the European Union are dedicated to creating a single market and eliminating obstacles, including tax obstacles, to cross-frontier trade and investment it was for long impossible, without a serious tax penalty, to create a "European company" having its activities and shareholders spread across the whole of the EU in a way which would be taken for granted in the United States.

What was known in the UK as the 'surplus ACT problem' was referred to in Ireland as 'fiscal starvation' and in Continental Europe as the 'equalisation tax' problem. Effectively, what happens is this. Imputation credit is designed to give (a measure of) relief at the shareholder level for the tax paid on corporate profits. International tax credit relief is designed to prevent double taxation of profits earned and taxed in a country other than the country of residence of the parent. Both work well together (on the European model) if, but only if, the parent can pay its dividends out of domestic taxed profits, but if the company has to rely on foreign tax relieved profits, the imputation credit is effectively clawed back by the 'surplus ACT' (UK) or 'equalisation tax' (France, etc.) procedures. There was substantial unrelieved double taxation, and a very serious distortion of investment decisions.⁷

At first, this was a major public issue only in the United Kingdom as the home of many multi-national parent companies⁸, but it companies elsewhere within the E.U were now striving to invest across frontiers, and we, as professionals, were often asked to find an ideal location for holding companies where this problem would not arise. It was discussed from a European point of view at a seminar in Florence in 1993⁹, about the time that the countries most affected began to take individual measures designed to improve the competitive position of their holding companies. (This is yet another example, incidentally, where tax competition has done more to rationalise European tax laws than the long series of failed attempts at 'harmonisation'.)

There was no simple solution to the problem of 'surplus ACT' or equalisation tax in the UK or indeed elsewhere, as there is a straight conflict of view. From the point of view of the company and its shareholders tax is tax and relief should (surely) be the same, regardless of where the underlying corporate tax is paid. From the point of view of the Revenue authorities, it is unacceptable to have to refund (or, more debatably, even to credit) tax which they themselves have never collected in the first place. Imputation countries therefore imposed some form of "equalisation tax" to claw this back.

⁷The problem, in the UK, goes back a long way. See, for instance, "The Tax Treatment of Overseas Income - What Should be Done". John Chown and Dr Barry Bracewell-Milnes, Institute of Directors, December 1980. The point was also made in the Report of the Select Committee on Corporation Tax, HMSO, 20 October 1971. Evidence by Institute of Directors Taxation Committee (paras 745-809), by John Chown (paras 244-282) and by R T Esam of Shell (paras 283-345).

⁸The Dutch avoided it in a quite different way.

⁹"Corporate Tax on Distributions - Equalisation Tax", John Chown (UK), Dr Massimo Pagani (Italy), Graeme Cooper (Australia), Patrick de Fréminet (France), Dr Berndt Runge (Germany). Proceedings of a Seminar held in Florence, Italy, in 1993 during the 47th Congress of the International Fiscal Association, 3/8 October 1993 Kluwer.



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In 1982, Will Hopper, (then MEP) and I¹⁰ suggested a 'European' solution, involving a clearing house, to solve the more urgent Community problems, but this was not favoured by the Ruding Committee. One of the problems we obviously had to address in looking at the "surplus ACT" issue was equity between tax collectors, and the suggested "clearing house" would make sure that each member state collected an appropriate amount of the total tax take. The Commission resisted it on the grounds it was too complicated, although they are now looking at a similar clearing house approach to the problem of cross-border loss relief. (At the time they had looked at a similar measure for VAT¹¹ and found it would have been very expensive administratively). Our proposal, though, would have involved only a few major groups of companies.

An article in the Economist (February 24 2007) on "home bias" in the EU showed the largest multinationals in the EU earned almost two thirds of their profit outside their own country compared with half in 1997. This change can be accounted for by a solution having been found to the problem described above, but the solution, which varied from country to country, typically came at a price.¹²

DIVIDENDS AND INTEREST – SOME PARADOXES AND TOPICAL POINTS

This difference between the tax treatment of dividends and interest (a powerful tool in the armoury of numerate international tax planners) is a key problem which the imputation system mitigated while inadvertently creating international distortions just discussed. It has been recreated by the solutions found to these international problems.

The U.S and Canada

The problem has existed in non-EU countries, and while I do not want to discuss these in any detail may I make a couple of brief points? The United States was one of the last countries to persist with a so-called "classical" system of taxation with the full double taxation of both profits and dividends. This led to a great many artificial structures involving leveraged buyouts, junk bonds and private equity deals resulting in companies being bought and reorganised as subchapter S. corporations which are treated as transparent for tax purposes.

In 1992, there had been an abortive attempt to change the system which stimulated a great deal of academic and professional literature but nothing happened. More recently the present American government (not notorious for thinking before acting) introduced the change with virtually no consultation and very little analytical comment after the event.

In Canada, private enterprise took a hand and someone invented the concept of the "income trust" by which businesses were conducted by "trustees" on behalf of "beneficiaries" who could have marketable interests. Indeed at the last count about 150 income trusts were listed on Canadian stock

¹⁰"Company Tax Harmonisation in the European Economic Community." John Chown and William Hopper, MEP. Intertax, Munich August 1982. See also "Imputation systems - an overview." John Chown. Journal of Strategy in International Taxation, Volume 4, No 1, 1988, and "Company Tax Harmonisation in the European Community", John Chown. Institute of Directors, June 1989.

¹¹ When VAT was first introduced and I was the taxation correspondent of the Financial Times, I was asked by a publisher to see if we could bring out the first book on the subject, which we did by a matter of days. For years after that, the only VAT work we handled in my professional office was on "exempt" financial services where there were, and remain, conceptual issues. Otherwise, VAT seemed to require competent administration rather than sophisticated tax planning. This has changed since EU harmonisation, and we now have two people specialising in VAT planning: there are far more traps than before, while tax collectors are losing out seriously to crooks ripping them off with variants of the "carousel fraud" of a type impossible when VAT was a nationally administered tax.

¹² Many years ago, I suggested that reforming company tax was like laying linoleum. A bump in the surface could be beaten down only to re-emerge somewhere else.



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exchanges. There are changes now (early 2007) before the Canadian Parliament which take the form of a compromise actually improving the position of companies while bringing such trusts into line with the more normal structure.¹³ (Their March 2007 Budget also introduced a significant change in the deductibility of interest.)

Private Equity and Junk Bonds

Both the American and Canadian reforms were designed to deal with the distortions in the debt equity structure, which in turn was encouraging excessive leverage by companies, distorting industrial structures and giving an excuse for sort of corporate transactions where the only real beneficiaries were the financial intermediaries who earned fat fees. This is precisely what the imputation reforms of the 1970s were designed to correct, but as already explained most EU countries have backed away from imputation, in some cases actually re-creating the "interest" problem. Since I drafted this paper, there was an article in the Financial Times (February 8th 2007) saying that British Trade Unions were complaining that the more generous treatment of debt had been encouraging the type of "private equity" transactions of which they disapproved. The article also mentioned that British companies were paying £64 billion per annum of debt interest as compared with £40 billion of Corporation Tax payments. History does seem to go round in circles, but with different countries out of phase with each other. Apart from the Canadians, the German and Danish tax reforms being debated in early 2007 aim at narrowing this gap.

There is a more subtle point in the United Kingdom, which differs from most fellow member states both in having substantial independently funded pension schemes and in being the home of many multinational corporations. Many of problems created by imputation affected both. In 1997, Gordon Brown claimed to have "solved" the international problem that he did so by means of a stealth tax on pension funds which suddenly found themselves suffering much higher tax burden on UK dividends with no change in the treatment of interest or foreign dividends received. Apart from the direct cost this meant that rationally managed pension funds should be switching from equity securities into debt and corporate borrowers should be reacting by increasing their gearing.¹⁴ This did happen -eventually - but for 23 months the US and UK markets continued to move in parallel. When pension funds did begin dumping equities, the markets decoupled and for some years the UK market was relatively 20% lower than the American one. The UK market has now recovered but this it seems is not because pension funds have returned to the market because of the activities of private equity funds. The reason for such opportunities could be that the normal market place on the Stock Exchange has been distorted, partly by overregulation but also by Gordon Brown's ill-conceived measure.

A Fault in the Parent.Subsidiary Directive?

Oddly, one useful and adopted harmonising measure, the Parent/Subsidiary Directive (one of those delayed for 23 years), has a defect which actually helps companies to improve their tax position at the expense of governments. If a parent company in Country A has a subsidiary in Country B and finances it entirely with equity, Country B collects tax on the profits leaving little or nothing for Country A. If, however, the subsidiary is financed substantially by debt, then interest on this debt will be deductible from profits taxable in Country B which will not be allowed to impose withholding tax

¹³ There is excellent update and overview of this by Jack Bernstein, Tax Notes International January 15, 2007.

¹⁴ When the 1997 Finance Bill was going through Parliament, I met somebody at a party who was head of investment at a major merchant bank. When I told him that I was a tax specialist he said "my clients are no use to you: they are all pension funds and don't pay any tax" to which I replied "in that case why have I been spending so much time in the last two weeks talking to Ann Robinson [then head of the National Association of Pension Funds and a fellow economist well aware of the newly created problem] without either of us having time to discuss opera?" He had not realised that the budget changes would make a dramatic difference to the relative tax advantages of common stocks and bonds including convertible bonds



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leaving all the tax revenue to accrue to Country A. Which method of finance the group uses will depend on whether on Country A's tax rates are higher or lower than those of Country B. If Country A's tax rates are higher, equity finance will be used but if it then lowers its tax rate below that of Country B, companies will rush to reorganise to reverse the structure.

CROSS BORDER MERGERS

Most countries have for many years had legislation enabling companies to merge without precipitating an immediate charge to tax on unrealised gains at either company or shareholder level. The Mergers Directive sought to extend this concept to cross-border mergers BUT was opposed by Member States which did not want to encourage nasty "foreign" (even EU) companies to take over the national champions. "Co-determination", a German preoccupation not shared by others, was another issue and this Directive was also held up for 23 years. I was intrigued to learn from one of the speakers that a Mergers Directive dealing with the company law aspects had also languished in the limbo of draft, from 1984 to 2002.

Discussions on the subject within the European Union are sometimes confused by the difference of usage. In continental European countries the term "merger" is confined to a transaction on the one company disappears as such, its assets being absorbed into the surviving company. In the English-speaking countries the term is used for a wider range of transactions including those where two or more companies "merge" to form a common group creating or expanding on a parent subsidiary type structure. Companies and their advisers looking at "merger" (in this broad sense) proposals do not in my experience really concerned themselves whether there is to be a company acquisition leaving subsidiary intact or asset acquisition. That is technical detail to be left to the lawyers and tax advisers after agreement had been reached on the broad structure.

There was an article in tax notes international "Cross-Border Mergers in Europe: The Fall of the Last Barriers"¹⁵ the title of which suggests it contradicts my own article. Although very interesting, it is in fact confined to the narrower usage and is more relevant to the scope for using the European company type arrangements.

I could give a whole talk on this subject (indeed I would be delighted to help if somebody is prepared to write a PhD thesis on it), and a major topic for an international tax adviser is the choice of structure of international groups. Some countries (even if we look only at the EU) are natural favourites as a base for holding companies, while others seem to find that successful companies within their jurisdiction become natural targets of foreign predators. The lists change from time to time, either for accidental reasons (mainly but not exclusively tax), or because of deliberate policy decisions. Some countries have adjusted their tax systems to encourage outward expansion by their domestic companies while deterring predators. The European Commission would surely disapprove on principle, but it is not unknown for laws to be drafted in such a way that they do not notice!

CROSS BORDER LOSSES

The same problem applies to another complaint by the business sector which was the inability to obtain cross-border relief offsetting losses in one country against a profit in another. Again it is obviously unreasonable to expect a country to reduce its tax take from a company that is operating successfully elsewhere. This question was addressed in the Marks and Spencer case (far too complicated to discuss here) on which the ECJ have pronounced but which is still making its way through the UK courts who are trying to define with precision the exact scope of the ECJ's judgment

¹⁵ by Herve Bidaud and Jean-Marc Francheschi Volume 46 Number 5 April 30, 2007



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as it applies to the facts of the Marks & Spencer losses in Belgium, France and Germany. Although I sympathised with those pleading over the years for this kind of treatment, I could not see how we could reach an acceptable solution and did not give them any support. Recent discussions suggest a “clearing house” approach.

CONTROLLED FOREIGN CORPORATIONS

Early in my career, there were opportunities for parent companies to obtain blatant tax advantages by setting up subsidiaries in the tax countries. The scope was limited by "transfer pricing" rules and to some extent inhibited by exchange controls which still persisted in those days. In 1962, the Americans launched a fashion by introducing legislation by which the undistributed profits of such "Controlled Foreign Corporations" could be attributed to the domestic parent for tax purposes. Initially this was an understandable and necessary tax avoidance measure but it became a problem, distorting the competitiveness of international business.

This is not primarily a European Union problem, but these days a surprising number of companies have a choice about where they locate their parent company. In a transnational merger (of which I have had some experience), there is a choice of where to locate the ultimate parent which on occasions is not in the country of residence of either of the main participants. New high tech companies again can base themselves wherever it is convenient having regard to the nature of the operations and the residence respectively of the management and financial backers. (The likes of us frequently recommend that there is more scope for tax planning if the financial backers are not in the same country as the promoters.) One of the factors taken into account is whether or not the country concerned has "controlled foreign corporation" legislation because if it does not there is no way of clawing back the profits that can, subject to transfer pricing rules, be diverted to low tax jurisdictions. The ECJ has ruled (Cadbury Schweppes) that there is limited scope for imposing CFC rules on fellow members of the EU, and in practice this has complicated rather than simplified the rules with which we are dealing.

EXIT TAXES

In the De Lasteyrie decision in 2004 (followed in the N decision in 2006), the ECJ held that it was illegal for one Member State to charge tax on an individual changing residence to another country on the basis that he had disposed of and reacquired securities which had appreciated in value. It is also illegal for them to require the individual to furnish security against tax on the future realisation of the securities. It does appear that the Commission has taken the view that VAT provisions which apply to the change of residence of a company are also illegal, which could be a vital point for the “European Company”. This raises a number of questions: absent this decision there was a risk that someone changing residence might be subject to tax on the unrealised appreciation in the old country while being taxed on the whole gain in some future year in the new country. This double taxation might or might not have been prevented by double tax agreements depending on specific provisions in respect of laws and the timing of the various transactions. Although the decision could, on the assumption of identical tax systems, result in the new country collecting tax on the whole of the gain wherever accrued, there can now be a risk of "double non-taxation". The Commission hopes that Member State can collaborate to ensure a fair distribution of any tax eventually collected. At present, the UK government is taking the position that UK legislation already complies with the ECJ decisions but it seems clear that this position is insupportable.

ADMINISTRATIVE ISSUES



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We now come back to the other type of issue - simplifying administration. The idea of a standard European Union model tax code setting out the detailed rules might well make life simpler for true EU-wide companies (particularly for the EU subsidiaries of major non-EU parents) but although I looked at this years ago I never actively promoted this idea nor attempted to work out the details – this issue was, I thought, one for accountants, rather than economists. There could be two variants. The "soft" version would be optional and companies could apply it if they wished. A rather "harder" version would follow the American pattern of State taxation where although States are free to impose their own tax rates and base, most simply adopt the Federal base with a few specific exemptions and other amendments, at rates of their own choosing. This, if the details were right, could achieve significant administrative savings without distorting tax competition.¹⁶

The Common Consolidated Corporate Tax Base

The idea has now re-emerged under the name of the "Common Consolidated Corporate Tax Base" (CCCTB) but I have seen surprisingly little enthusiasm for it. An article in the Financial Times Friday, October 6, 2006 on corporate tax harmonisation in Europe quoted Laszlo Kovacs the EU Tax Commissioner, as seeking to create a CCCTB, denying any intention of harmonising tax rates and saying that the aim would be to simplify reporting and accounting for companies, particularly European owned companies operating throughout the European Union. Years ago, I wrote that "tax harmonisation" should not be a euphemism for standardisation but should simply mean making it easier for different fiscal systems to coexist. The particular issue was the taxation of profits crossing frontiers: the "surplus ACT" type problem, and maybe the message is getting across.

The Commission has wanted, for obvious reasons, to establish "*fonds propre*" raising money directly from taxpayers and any such arrangement could give them an opportunity to press for this. There is no real reason why the European Commission should not be properly funded by whatever means seems expedient, but this proposal must meet two tests.

First, there must be a proper system of financial control, adequate safeguards against fraud and corruption, and support for, rather than criticism of, auditors who see their duty as being to protect the interests of citizens as taxpayers rather than condoning the activities of their shiftier colleagues.¹⁷

Second, and perhaps more controversially, it must not threaten healthy tax competition, which has done more to bring the EU tax rates and systems into line at a civilised level than anything achieved by Directives.

The F.T interviewer quotes some of the new Member States, as saying that CCCTB could threaten their flat tax regimes by narrowing the base and forcing them to put up rates.¹⁸ On the positive side, she quotes Robert Thomas of Xerox as welcoming the proposal, being rightly concerned with the danger that we in the UK tend to assume that some initiative will not happen, fail to take action to steer it in the right direction, and are then surprised when it hits. She also quotes Chris Wales who had discussed this issue at a conference in Ravenna and who kindly sent me a copy of his paper. Surprisingly, since he was for some years Gordon Brown's Special Adviser on tax, he is more optimistic than I am in thinking that the rate of Corporation Tax in the EU will settle at around 15% on a broader base, and that the revenue would have to be made good from other sources. He is

¹⁶“Standardisers” need reminding that Federal States such as the United States, Germany, Switzerland, Australia and Canada permit a wide range of tax rates and rules.

¹⁷ Any EU “Constitution” needs to include a provision by which an individual Commissioner who treats such an auditor as a trouble maker rather than a guardian of the interest of citizens can be impeached

¹⁸ I'm a long-standing advocate of lower rate, broad-based taxes, and have a soft spot for flat taxes, but don't think they would work in the “old” E.U.



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disappointed that CCCTB is being treated as a priority issue believing that "companies are happy to live with high compliance costs provided the substance of the system itself delivers what they regard as the right result." He also thinks that the introduction would not really be effective in simplifying the system and would confuse everyone by making radical changes not in line with any country's customs and habits.

Transfer Pricing

An important and related point is transfer pricing. Most countries have for many years had rules to ensure that companies do not transfer the profits improperly to low tax jurisdictions by under-invoicing exports or over-invoicing imports on transactions with associated companies, but at first the legislation was only invoked on transactions with tax havens. In the 1960s the Americans began using the technique aggressively even on dealings with countries with similar tax rates and regimes in the hope of intimidating companies into allowing the US Internal Revenue Service to collect more than their fair share of the total tax take from international business. Other countries were forced to retaliate and the present situation, even within the EU, is that much of the transfer pricing work imposed on professionals is not directed against systematic tax take by their corporate clients but is really a battle for the tax like between two governments. This can have expensive consequences for the companies concerned both on administration and because by the time the dispute is resolved in favour of giving too much tax to one the countries, it may be too late to claim corresponding credit or other relief or make any adjustment in the other. This battle should really be fought directly between governments.

Another EU problem is that following a European Court of Justice case (Lankhorst-Hohorst) which held that it was illegal to discriminate against international transactions, countries have been forced to impose transfer pricing rules even on domestic transactions simply to protect themselves.

CONCLUSION

I am aware that this has been somewhat discursive and that I have covered a lot of different subjects. I hope that I will have shown you that tax policy is a very important aspect of ensuring that the European Union really can become a single market for the free movement of business enterprise. Arguably we have concentrated too much on the free movement of labour (a headline issue in the popular press) and we are still a very long way indeed from having a true single market particularly in financial services.

I have left even more unsaid, and if we were having a meeting of tax rather than company law specialists there would be enough issues within my terms of reference today for a highly technical two-day conference. Please treat this question seriously!



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APPENDIX

TAX COMPETITION

I am a believer in “tax competition” and (my specialist interest being in capital markets) recognize that for instance, the UK, France and Germany have broadly similar economies at comparable levels of development, but very different capital markets and business practices. All of these work well enough in their own countries but don’t export across frontiers.

In today’s world (and specifically within the single market of the EU) capital, enterprise and skilled labour face few obstacles to movement between countries and one factor in the choice of country will be whether it has transparent and honestly administered taxes and reasonable rates. Tax collectors in high-tax countries resent the loss of their tax base and have been seeking to stamp out what they regard as ‘unfair tax competition’; and to create a “tax collector’s cartel”, trying to bully other countries to adopt their own anti-economic practices.¹⁹ In contrast, some of us believe that tax competition, and the right of the over-taxed to move themselves and their capital elsewhere is a great defender of economic freedom, benefiting even those who do not intend to move. Successive Commissioners, in charge of competition policy have been assiduous in their efforts to check the development of cartels and other non-competitive practices. We need to apply the same enthusiasm to prevent governments conspiring to fix the prices (taxes) they impose on us, and ensuring that the citizen enjoys the benefit of competition in the “services” rendered by governments.

It is sometimes argued that, now that most EU members have achieved monetary union, unharmonised tax systems are the most significant remaining distortion to free and fair movement between Member States, and an eventual level playing field. This begs the central question, for economists, of how individual members of a Monetary Union can adapt to asymmetric shocks, given that they can no longer let the exchange rate take the strain, nor adjust interest rates to stimulate the economy or calm down “irrational exuberance”. This surely only leaves fiscal policy.

In the event tax competition has done far more than any Commission initiatives to bring EU tax practices more in line with each other. In the UK Chancellors Nigel Lawson and Norman Lamont lowered tax rates for both companies and individuals while broadening the tax base and these reforms (which actually increased the total tax take for reasons which surprised politicians but not economists) had to be copied elsewhere. More recently, some of the new EU members have done a splendid job in introducing sensible business friendly tax systems. The Germans led the way in removing capital gains tax penalties on company reorganisations.

¹⁹ Tax competition will not result in a race down to zero: theory suggests, and empirical evidence confirms, that tax rates can stabilise in the range 20-30% without damaging the economy or driving taxpayers away. There is a simple way of explaining this point. Revenue collected as a multiple of the tax rate (X) and the size of the tax base, while the disincentive effect of tax varies with marginal net of tax income (1-X). To take two extreme examples, reducing a tax rate from 90% to 80%, doubles the incentive but only reduces the return by 11% before taking account of the effects of the stimulus on the base. Public revenue, and private welfare, will both benefit. Reducing the tax rate from 20% to 10% would increase take home pay by 11% with a negligible incentive effect, but halves the revenue collected.