RECENT DEVELOPMENTS

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European Company Taxation: The Ruding Committee Report Gives Harmonization Efforts a New Impetus

I. Introduction

A. Background

One of the main reasons for the Europeans to establish a Common Market was the prospect of substantial economic progress in all Member States. A raising of the standard of living can only be achieved, however, under economic conditions where resources are allocated freely to their most productive use. Thus, the Treaty Establishing the European Economic Community (EEC) describes the Common Market as "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured."[1] The authors of the Treaty were well aware that in a market within which competition was being distorted, an efficient allocation of resources would not be possible. Article 3(f) of the EEC

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1. *See* Treaty Establishing the European Economic Community, Mar. 25, 1957, 298 U.N.T.S. 11 (1958), *as amended by* Single European Act, 1987 O.J. (L 169) 1 (effective July 1, 1987) [hereinafter EEC Treaty or Treaty of Rome] art. 8(a). Article 8(a) was inserted in the Treaty by the 1986 Single European Act, designed to accelerate the process of European integration by aiming at the completion of the internal market by the end of 1992.

Treaty consequently calls for "the establishment of a system ensuring that competition shall not be distorted in the Common Market."

According to conventional economic analysis, competition can be distorted not only by protectionist trade policies, government subsidies, public procurement policies, and market imperfections, but also by discriminatory taxes. The distorting effect of discriminatory taxes is explicitly recognized in the EEC Treaty for taxes on transactions in goods, that is, indirect taxes.[2] Direct taxes, especially taxes on corporate income, are said to have a similar effect as corporate taxation may influence decisions on the location, financing, or legal form of investment. Nevertheless, the possibility of distortions resulting from direct taxation is not expressly mentioned in the EEC Treaty.

To attain the objectives set out in the EEC Treaty, article 3(h) provides for "the approximation of the laws of the Member States to the extent required for the proper functioning of the common market." Given the sometimes discriminatory character of taxation and the declared necessity to remove the barriers to economic integration, the establishment of a single internal market may have profound implications for tax policy in Europe. Nevertheless, the EEC Treaty does not explicitly refer to a possible harmonization of direct taxes, whereas harmonization of indirect taxes is specifically provided for in article 99 of the Treaty.[3]

B. Indirect Taxes

Not surprisingly, the most progress thus far in the EEC's tax harmonization efforts has been made in the field of indirect taxation. Considerable progress has been made in harmonizing the Value-Added Tax (VAT). The VAT was introduced in the EEC in 1967 by Council Directive 67/227/EEC.[4] This Directive requires Member States to replace turnover taxes with a common system of VAT. Although all Member States have applied the VAT since 1987, some still existing differences in national VAT systems remained to be overcome. One area where an adjustment seemed necessary was the number and level of VAT rates that varied from country to country.[5] The Member States rejected a proposal by the Commission in 1987 limiting the number of tax rates to not more than two, a standard rate within the range of 14 to 20 percent and a reduced rate between 4 and 9 per cent. In June 1991, however, the Member States reached an agreement. As of January 1, 1993,

2. EEC Treaty, *supra* note 1, arts. 95-97 & 99.

3. EEC Treaty, *supra* note 1, art. 99 reads as follows: "The Commission shall consider how the legislation of the various Member States concerning turnover taxes, excise duties and other forms of indirect taxation, including countervailing measures applicable to trade between Member States, can be harmonized in the interest of the common market."

4. *See* Council Directive 67/227 of Apr. 11, 1967, O.J. (71) 1301.

5. The standard VAT rates varied from 12% in Luxemburg to 25% in Ireland. The reduced VAT rate, applicable to basic necessities such as transactions relating to food, energy, pharmaceutical products, and books ranged from 0% to 10%. Some countries like Italy even had up to eight different VAT rates.

the EEC countries have applied a standard VAT rate of at least 15 percent (without a ceiling), with one or two optional reduced rates (minimum 5 percent) on certain defined goods and services.[6]

The Member States also agreed on retaining the country of destination principle, which implies that the goods are exported free of VAT from the country of origin and that the right to tax the goods is left to the country of their destination. But without border controls, which disappeared with the realization of the internal market at the end of 1992, the destination principle is difficult to operate and may facilitate tax fraud. Therefore, the EEC will probably maintain the destination tax system only during a limited transitional period until a final VAT system is implemented at the end of 1996.

To date, the EEC has achieved no harmonization in excise taxes on mineral oils, alcohol, and tobacco. Excise taxes vary widely from Member State to Member State in number and system as well as in tax rates. Several proposals by the EEC Commission that sought to solve some of these issues have received only a cool reception by the Member States. The EEC undoubtedly faces a difficult task in accomplishing harmonization of excise taxes among its Member States.

C. Direct Taxes

As mentioned above, none of the EEC Treaty's articles provide specifically for a harmonization of direct taxation. Only article 220 of the Treaty of Rome refers implicitly to direct taxes by stating that Member States should enter into negotiations with a view to securing the abolition of double taxation within the Community. While the provision expresses a desire to abolish international double taxation, the legal obligation imposed on Member States to attain this objective is rather weak. The Treaty provides for no sanctions if Member States do not negotiate. Nevertheless, the EEC countries have created over the years a nearly complete network of bilateral double tax treaties that comprises sixty-six conventions between twelve Member States.[7] For two reasons, however, these bilateral treaties fail to remove the obstacles to an internal market to a satisfactory degree. First, while they help to reduce double taxation, double tax treaties do not achieve complete abolition of double taxation. Secondly, double tax treaties do not provide a uniform solution for triangular and multilateral relations among Member States.

A possible solution for the harmonization of direct taxes is article 100 of the Treaty of Rome. According to article 100, "the Council shall, acting unanimously

6. Some argued that a rate band without any ceiling could lead to wide gaps between the national VAT rates, thus creating distortions of competition. But the supporters of the present accord refer to the situation in the United States where significant differences in the level of state sales taxes do not appear to give rise to major distortions in trade.

7. Nine additional double tax treaties have to be concluded until the system envisaged by art. 220 of the EEC Treaty is completed. *See* Commission of the European Communities: Guidelines on Company Taxation, SEC(90)601 final [hereinafter Guidelines].

on a proposal from the Commission, issue directives for the approximation of such provisions . . . as directly affect the establishment or functioning of the common market." Thus, the only condition for its application is that the respective legal provisions of the Member States have an immediate impact on the Common Market. As national direct tax systems are assumed to have such immediate consequences, article 100 of the EEC Treaty would seem to be a solid and ready legal foundation upon which harmonization of direct taxes can be based.

It should also be noted that the Member States' tax laws are to comply with the fundamental freedoms of the EEC Treaty. Specifically, the Member States' tax laws must not restrict the free movement of capital[8] and the freedom of establishment[9] within the Community. Tax laws restricting the allocation of capital investment or the location of a new branch or subsidiary violate the EEC Treaty and, consequently, must be abolished.

Although article 100 would appear to be an attractive basis for the harmonization of direct taxes, its procedural rules make it difficult to do so. Above all, the requirement of a unanimous decision by the Council in fiscal matters constitutes a major obstacle to the harmonization of direct taxes. This requirement leaves little more than the initiative to the Commission because proposals on direct taxation can be obstructed even by the smallest Member State.

Despite its weak legal foundation in the Treaty of Rome, the harmonization of corporate taxation has been discussed within the EEC since the early 1960s. The Neumark Report (1963)[10] and the Tempel Report (1971)[11] pointed out the need for harmonization measures on a Community level to the Commission and recommended a uniform corporation tax system in all Member States. The Neumark Report proposed a split-rate system, similar to Germany's system in force at that time, to reduce double taxation on dividends, with a lower tax rate on dividend distributions than on retained earnings. The Tempel Report advocated the classical

8. EEC Treaty, *supra* note 1, art. 67, requires the Member States to ensure the free movement of capital only to the extent necessary to ensure the proper functioning of the internal market. Moreover, according to art. 73(b) of the EEC Treaty, *supra* note 1, as amended by the Maastricht Accord, restrictions of the movement of capital are prohibited. *See* [Proposed] Treaty on European Union (Council of European Communities and Commission of the European Communities, European Communities ed., 1992) [hereinafter Maastricht Accord].

9. EEC Treaty, *supra* note 1, arts. 52, 58. Article 52 of the EEC Treaty, *supra* note 1, gives companies the right of free establishment in all Member States. The setting up of agencies, branches, or subsidiaries must not be restricted by tax provisions. *See* Case 81/87, The Queen & H.M. Treasury & Commissioners of Inland Revenue *ex parte* Daily Mail and General Trust PLC, 1988 E.C.R. 5505, Common Mkt. Rep. (CCH) ¶ 14,510 (1988); and Werner F. Ebke & Markus Gockel, *European Corporate Law*, 24 INT'L LAW. 239 (1990).

10. An unofficial translation of the Report into the English language was published by HUGH THURSTON, THE EEC REPORTS ON TAX HARMONIZATION (1963).

11. ARNOLD JAN VAN DEN TEMPEL, STUDIES, COMPLETION—APPROXIMATION OF LEGISLATION SERIES NO. 15 (1970).

unintegrated corporate tax system[12] throughout the Community. This system still applies in Belgium, Luxembourg, and the Netherlands. A Commission proposal in 1975 aiming at the harmonization of the corporate tax structure and the corporate tax rate met strong opposition by the European Parliament. For the delegates, a full and real harmonization could not be achieved without harmonizing the tax base, an element that the draft directive of the Commission did not include. The Commission's plans to draft a proposal that would also embrace the corporate tax base were never realized.

After the issue of corporate tax harmonization had been debated for nearly thirty years without leading to results, the Commission presented a new concept. In a communication of April 20, 1990, the Commission withdrew its 1975 proposal and announced that it had abandoned the idea of comprehensive corporate tax harmonization.[13] The Commission stated that harmonization efforts should concentrate on those aspects of company taxation that may lead to double taxation and thus obstruct cross-border activities of enterprises within the EEC. The new approach emphasized, in accordance with the principle of subsidiarity,[14] the coordination and approximation of tax policies rather than a systematic harmonization. To underline its seriousness and to give an impetus to the new strategy, the Commission published in the communication a list of priority measures designed to eliminate the principal forms of double taxation. It did not take long for the Commission's initiative to come to fruition. On July 20, 1990, the Council unanimously adopted three proposals of the Commission's priority list. For the first time in the history of the EEC the Member States agreed on measures in the field of direct taxation at a Community level.

Of the adopted proposals, the most important is the Parent-Subsidiary Directive,[15] which was submitted in draft form by the Commission as early as 1969. This Directive is designed to eliminate double taxation of profits distributed in the form of dividends by a subsidiary in one Member State to its parent company established in another Member State. The Directive provides for the Member State of the subsidiary to abolish any withholding tax and for the Member State of the parent company to exempt the dividends or to impute the tax paid to the

12. Under the classical system, little or no relief is provided for economic double taxation. Distributed dividends are fully taxed twice, once at the corporate level and again at the shareholders' level.

13. *See* Guidelines, *supra* note 7, at 605.

14. The principle of subsidiarity, as defined in the Treaty of Maastricht, *supra* note 8, requires that "in areas where the Community does not have exclusive competence, . . . it [the Community] should only act when and to the extent that the objectives cannot be achieved to a sufficient extent by the Member States. . . . No Community measure should exceed what is strictly necessary to achieve the objectives of the Treaty." Once adopted by the Member States, this provision of the Maastricht Accord will be introduced into the EEC Treaty, *supra* note 1, as art. 3(b).

15. *See* Council Directive 90/435 of July 23, 1990, on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries in Different Member States, 1990 O.J. (L 225) 6.

Member State of the subsidiary against its own tax. The Mergers Directive,[16] the preliminary version of which dates back to 1969, provides for any capital gains arising from a merger, a division or contribution of assets, or an exchange of shares, to be taxed not at the time of the operation in question, but only when capital gains have been realized. The EEC Commission's third proposal, the Arbitration Convention,[17] aims at eliminating, within a specific period of time, double taxation resulting from adjustments in transfer-pricing.[18] In order to become effective, the Convention needs to be ratified by all Member States.

Encouraged by the Council's relatively fast acceptance of the proposed measures, the Commission submitted two new proposals[19] designed to abolish other forms of double taxation. The first draft directive is intended to abolish withholding taxes on interest and royalty payments between subsidiaries and parent companies established in different Member States. The second draft directive provides for the deductibility of losses incurred by a foreign permanent establishment or a subsidiary from the parent company's losses. Since the two proposals meet the needs of companies, the Commission attached great importance to these draft directives and urged the Council to adopt them in 1992.[20]

II. The Ruding Report

A. The Ruding Committee's Mandate

To gain a better understanding of what long-term measures are necessary in the field of company taxation once the internal market has been established, the

16. *See* Council Directive 90/434 of July 23, 1990, on the Common System of Taxation of Mergers, Divisions and Contributions of Assets Taking Place Between Companies from Different Member States, 1990 O.J. (L 225) 1.

17. *See* Convention 90/436 of August 20, 1990, on the Elimination of Double Taxation in Connection with the Adjustments of Profits of Associated Enterprises, 1990 O.J. (L 225) 10.

18. The deadline for the Parent-Subsidiary Directive and the Mergers Directive to be implemented into national law was December 31, 1991. At that time, out of twelve Member States only two Member States with respect to the Parent-Subsidiary Directive, and one Member State with respect to the Mergers Directive, had passed the required national legislation to implement the Directive. As a general rule, a directive exerts effects only if it has been implemented by the national legislative bodies. Despite this delay, the Directives will still have the desired results. Under certain circumstances, provisions of directives have direct force, so that companies concerned may invoke direct rights against those Member States that have not passed the implementation laws yet. For details, see Trevor C. Hartley, The Foundations of European Community Law 200-11 (2d ed. 1988). The Commission's harmonization efforts are less successful as far as the Arbitration Convention is concerned. At the end of 1992 none of the Member States had ratified it.

19. *See* Proposal for a Council Directive on a Common System of Taxation Applicable to Interest and Royalty Payments made between Parent Companies and Subsidiaries in Different Member States, 1991 O.J. (C 53) 26; Proposal for a Council Directive Concerning Arrangements for the Taking into Account by Enterprises of the Losses of their Permanent Establishments and Subsidiaries Situated in Other Member States, 1991 O.J. (C 53) 30. For further details concerning these two proposals, see Howard M. Liebman, *European Tax Law*, 26 Int'l Law. 215, 222-24 (1992).

20. Despite the Commission's urgent call for further harmonization, neither the draft directive on foreign losses nor the draft directive on withholding taxes on interest and royalty payments achieved the unanimous approval from the EC Council in 1992.

Commission charged a committee of independent experts with the task of inquiring into this question. The Committee was formed in December 1990 under the chairmanship of Mr. Onno Ruding, a former Dutch finance minister.[21] The Committee met eleven times between January 1991 and February 1992 and submitted its report to the Commission on March 18, 1992.[22] On the basis of its mandate, the Committee inquired into the following questions:

a. Do differences in taxation among Member States cause major distortions in the internal market, particularly with respect to investment decisions and competition? Special attention is focused on those distortions considered to be discriminatory with respect to enterprises and shareholders of other Member States.
b. In so far as such distortions arise, are they likely to be eliminated simply through the interplay of market forces and tax competition between Member States, or is action at the Community level required?
c. What specific measures are required at the Community level to mitigate these distortions?[23]

B. Principal Tax Differences between EEC Member States

The Committee concluded that the principal differences in the taxation of business income between Member States relate to the nature of the corporation tax system, the statutory tax rates, and the tax bases of the Member States. Furthermore, the tax treatments of cross-border income flows differ. These differences concern not only the imposition of withholding taxes but also the methods and extent of relief for double taxation in the hands of the recipient.

In the European Community, the corporate tax systems range from a classical system[24] in Belgium, Luxembourg, and the Netherlands to the full imputation system[25] in France, Germany, and Italy. Some Member States provide shareholder relief from double taxation by levying reduced personal tax rates on dividends. Corporate tax rates differ considerably among Member States. They range from 10 percent in Ireland, for certain industries, to a rate of 50 percent in Germany.[26]

Further differences among the Member States result from differences in depreciation rules, the tax treatment of losses and capital gains, and the definition of

21. The other members were: Donal de Buitleir (Ireland); Jean-Louis Descours (France); Lorenzo Gascon (Spain); Carlo Gatto (Italy); Ken Messere (Great Britain); Albert Rädler (Germany); Franz Vanistendael (Belgium).

22. Report of the Committee of Independent Experts on Company Taxation (Commission, European Communities ed., 1992) [hereinafter Ruding Report].

23. *See* Ruding Report, *supra* note 22, at 24.

24. *See supra* note 12.

25. A system whereby a tax credit is given to shareholders under the personal income tax for the amount of corporation taxes actually paid on profits distributed as dividends.

26. If local taxes are included, the overall corporate tax rate on retained earnings in Germany is as high as 57.5%.

business expenses. While the rules of financial accounting have been harmonized in the European Community, tax accounting principles thus far vary from Member State to Member State. In Germany[27] and other Member States, for example, financial accounting principles are also, as a general rule, relevant for tax accounting purposes, subject to certain exceptions provided for by the tax laws.

C. Impact of Tax Differences between EEC Member States

According to an empirical survey launched by the Committee, the tax differences among the EEC Member States have a major impact on investment location decisions of multinational companies. They result in distortions in competition that impair economic efficiency. Financial activities in particular are affected by tax considerations. While many other important determinants factor into an investment location decision, tax induced distortions in competition will most likely lead to a misallocation of resources within the Community. In order to improve the Community's overall competitiveness relative to countries like the United States or Japan, those fiscal distortions need to be eliminated.

D. Conclusions and Recommendations

1. *The Ruding Committee's Approach*

The Ruding Committee points out that, even though during the past decade there has been some convergence of business taxation within the EEC,[28] wide differences continue to exist. Some of these differences impede the completion of the internal market. Thus, the key question is whether the harmonization of national corporate taxation can be achieved by the competition between different tax systems or whether measures at the Community level will be necessary. The Ruding Committee concluded that such differences are unlikely to be reduced much further through independent action by Member States and that distortions can only be removed by measures agreed to at the Community level.

Other considerations support focusing Community harmonization on the minimum requirements necessary to remove discrimination and major distortions. These considerations include but are not limited to the need to allow Member States as much flexibility as possible to collect revenue through direct taxes, the linkage between corporate tax and personal income tax, and the principle of subsidiarity.[29] Furthermore, the need for unanimity on tax matters requires a pragmatic approach.

27. German Income Tax Statute of Sept. 7, 1990, § 5(1), 1990 Bundesgesetzblatt, Teil I [BGBl. I] 1898.

28. According to the Ruding Committee, the convergence in corporate tax rates results from the growing desire of some Member States to establish more neutral tax regimes from a domestic standpoint, rather than from tax competition among EEC Member States or EEC Member State and non-EEC countries.

29. *See supra* note 14.

For these reasons, the Ruding Committee based its recommendations on the view that, at this stage of the Community's development, action at the Community level should concentrate on the following priorities:

a. removing those discriminatory and distortionary features of countries' tax arrangements that impede cross-border business investment and shareholding;
b. setting a minimum level for the statutory corporation tax rate and common rules for a minimum tax base, so as to limit excessive tax competition between Member States intended to attract mobile investment or taxable profits of multinational firms, either of which tend to erode the tax base in the Community as a whole; and
c. encouraging the maximum transparency of any tax incentives granted by Member States to promote investment.[30]

The recommendations made by the Ruding Committee within the framework of these priorities are divided into two categories: the elimination of the double taxation of cross-border income flows and the harmonization of corporate taxes. Additionally, the Committee presents, in Annex 10 A of its Report, two proposals for a common EEC corporate tax system.

The Committee has included in its recommendations a schedule for their implementation. Each proposal is classified as falling within one of three phases according to the urgency of its implemention. Phase I recommendations ought to be implemented by the end of 1994. Preparatory work on Phase II recommendations should begin immediately with a view to implementation during the second phase of the Economic and Monetary Union.[31] The implementation of Phase III recommendations is envisaged concurrently with full economic and monetary union.[32]

2. *Elimination of Double Taxation of Cross-Border Income Flows*

Even though considerable progress in the area of double taxation has been made by the adoption and subsequent implementation of the Parent-Subsidiary Directive,[33] room for improvement still exists. To ensure the removal of fiscal obstacles to companies that operate in more than one Member State, the Ruding Committee recommends extension of the scope of the Parent-Subsidiary Directive to cover all companies subject to corporate tax irrespective of their legal form (Phase I). The directive should be subsequently extended to all other enterprises subject to income taxation (Phase II).

With respect to dividends received by individual shareholders the Committee

30. *See* Ruding Report, *supra* note 22, at 202.
31. According to art. 109(e)(1) of the EEC Treaty, *supra* note 1, as amended by the Maastricht Accord, *supra* note 8, the second stage towards the Economic and Monetary Union is to begin on January 1, 1994.
32. The third stage of the Economic and Monetary Union will start no later than January 1, 1999. *See* EEC Treaty, *supra* note 1, art. 109(j)(4), as amended by the Maastricht Accord, *supra* note 8.
33. *See supra* note 15.

recommends a uniform withholding tax of 30 percent. This withholding tax would be waived provided that the shareholder submits proof of his or her status as an EC resident taxpayer (Phase II).

The Committee also urges the Member States to adopt, as soon as possible, the two pending directives dealing with withholding taxes on cross-border interest and royalty payments and with the Community-wide compensation of losses of permanent establishments and subsidiaries[34] (Phase I). To eliminate double taxation arising from transfer pricing disputes, the Committee recommends that the Member States ratify the Arbitration Convention[35] and establish appropriate rules concerning transfer pricing adjustments by Member States (Phase I).

Furthermore, the Ruding Committee discussed the issue of the interjurisdictional allocation of the corporate tax base, also a possible source of double taxation. The experts examined whether lessons could be drawn from the experience of other multi-jurisdictional states such as Canada, Switzerland, and the United States in this field of taxation.[36] Although the Committee acknowledged that the separate accounting method, currently used by most European states to allocate the income of multinational companies, was not always easy to implement in practice, it saw no need for introducing a system of formula allocation within the EEC in the near future. According to the Committee, the introduction of a formula allocation method "might be reconsidered when a much higher level of integration between Member States is achieved, in particular, when group treatment has been introduced for enterprises located in different Member States."[37]

In regard to bilateral double tax treaties between Member States, the Committee recommends improvement of existing treaties. Additionally, the Committee suggests that the EC Commission define a common policy on double tax treaties in respect to Member States as well as third countries (Phase I).

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34. *See supra* note 19.

35. *See supra* note 17.

36. In the United States, for instance, states use a formula to allocate the income of multistate enterprises to the various tax jurisdictions (the "unitary-method"). After determining the total income of the company subject to allocation to the various states within which the company operates, this method apportions the income by a formula (usually based on payroll, property, and sales) to each state.

The European states, on the other hand, prefer the separate accounting method to allocate the income of companies that engage in business activities in more than one Member State. The separate accounting method associates each item of revenue and direct expense to its source state. To prevent companies from manipulating the taxable base (by, say, assigning an inflated amount of income to low tax states and leaving little income for higher tax states), the transfer-prices of intercompany transactions or transactions between members of the same group are adjusted under the arm's-length principle. That is, the prices are calculated as if the transactions took place between unrelated third parties. For a more detailed exposition of the unitary tax method, see, for example, Henry J. Lischer, *Income Taxation by the States of the United States: Unitary Apportionment of the Income of Multijurisdictional Businesses, in* EUROPEAN INTEGRATION IN THE WORLD ECONOMY 143 (Hans-Jürgen Vosgerau ed., 1992).

37. *See* Ruding Report, *supra* note 22, at 130.

3. *Corporate Taxes*

The three components of corporate taxes upon which the Committee focused, were the statutory tax rate, the tax base, and the tax system.[38]

a. Tax Rate and Tax Base

In order to face the risks of serious erosion of corporate tax revenues by unrestricted competition between Member States, the Committee recommends that a minimum corporation tax rate of 30 percent be introduced (Phase I). This rate should apply to both retained and distributed profits. Since the Ruding Committee believes that competition between Member States will not result in decreasing tax rates and that wide differences between these rates distort the functioning of the internal market, the Committee also proposes a maximum corporation tax rate of 40 percent[39] (Phase II).

Harmonization of corporate tax rates, however, makes little sense without some degree of harmonization of the tax base. Therefore, the Committee suggests that the rules for determining the tax base be approximated without delay (Phase I). Though it makes some specific recommendations, the Committee proposes that the technical problems should be examined by another group of independent experts.

b. Corporate Tax System

The different tax treatment of domestic and foreign-source income is related to the different corporate tax systems within the Community. Given the current level of integration, Member States are unlikely to be willing to introduce a common corporate tax system. The Ruding Committee therefore proposes that the Member States at least mitigate discrimination resulting from the different tax treatment.

Thus, the Ruding Committee suggests that Member States that currently provide relief for dividends paid out of domestic-source income to domestic shareholders (whether individual or corporate) either in the form of an imputation credit or as a reduced rate of personal tax be required to extend similar treatment to dividends paid out of profits originating from other Member States (Phase I). This suggestion encompasses a proposal that corporate shareholders be allowed to offset foreign corporation taxes against domestic imputation taxes[40] and that individual shareholders be given equal tax treatment irrespective of the source of

38. The term "tax system" is used to describe the manner and the extent to which tax relief is provided to shareholders in respect of corporation taxes levied on profits distributed as dividends.

39. Local taxes on corporate income, such as the German municipal trade tax (*Gewerbeertragsteuer*), should be included in the statutory tax rate within the range of 30% to 40%.

40. The term "imputation tax" is used to describe the mechanism by which Member States which operate an imputation tax system ensure that any dividend distribution which carries a tax credit has been subject to domestic tax at the corporate level. It includes *précompte* (France), *Ausschüttungsbelastung* (Germany), *imposta di congualio* (Italy), and advance corporation tax (Ireland and the United Kingdom).

dividends. This solution would be in accordance with the principle of source country entitlement since the shareholder's country of residence bears the cost of tax relief.

The Committee admits that the implementation of this recommendation cannot remove all possible distortions. Additionally, for example, Member State *A* which provides some kind of tax relief for its residents' domestic dividend income, would probably be unwilling to grant the same tax exemption for foreign dividends when the source country *B* does not provide its residents any tax relief and consequently does not provide tax relief for dividends paid by a state *A* company.[41] This conduct, however, would be in accordance with the Committee's proposal since it merely requires the Member States to treat foreign dividend income like domestic dividend income. This example shows that distortions do not arise only from the way dividend income is being treated in the country of shareholders' residence, but also from the differences in the source country's corporation tax system.

Accordingly, the Ruding Committee suggests that the Community should make further efforts to achieve a more harmonized corporate tax system within the Community. Such a common corporate tax system, as a long-term objective, should be neutral with respect to the competition between different forms of business associations (incorporated versus nonincorporated businesses), between different methods of financing (debt versus equity finance), and between distributed and retained profits. Furthermore, the neutrality of investments in domestic shares and in foreign shares should be warranted. The Ruding Committee points out, however, the difficulty in determining an appropriate corporate tax system that will completely satisfy all criteria.[42]

The Ruding Committee discusses different approaches to a common corporate tax system.[43] The Committee states that neither a classical corporate tax system nor an imputation system meets the requirement of tax neutrality in competition. The Committee also reviewed the recent proposals of the U.S. Treasury on this issue.[44] However, these proposals were considered unacceptable since they would not allow Member States to tax dividend income according to the personal overall situation of the shareholder.

A majority of the Committee favors a system that provides some relief from double taxation of dividends at the level of the individual shareholder and full exemption for corporate shareholders. The proposed system provides definite taxation of all corporate earnings in the source country and reduced taxation of dividend income in the individual shareholder's country of residence. The source

41. *See* Brigitte Knobbe-Keuk, *The Ruding Committee Report—An Impressive Vision of European Company Taxation for the Year 2000*, EC T.R. 22, 32 (1992).

42. *See* Ruding Report, *supra* note 22, at 441.

43. *See id.* Annex 10A; at 439-60.

44. *See* DEP'T OF THE TREASURY, INTEGRATION OF THE INDIVIDUAL AND CORPORATE TAX SYSTEMS (Jan. 1992).

country is entitled to the corporate tax revenue because it bears the cost of the infrastructure and environment whereas the shareholder's residence country can tax its residents at a reduced rate and according to their ability to pay.

III. Conclusion

The Ruding Report provides a fresh impetus for action in the field of European company taxation by opening the floor for a Community-wide debate of this issue. The Ruding Report deals with the elimination of double taxation of cross-border income flows and the harmonization of corporate taxation. With respect to the elimination of double taxation of cross-border transactions, the Report basically proposes to improve and extend directives that have already been adopted. The harmonization of corporate taxation is a more sensitive issue, however. A further comprehensive harmonization of corporate taxation, including tax systems, tax rates, and tax base, is an ambitious project. Such a project requires the Member States to give up a considerable part of their fiscal sovereignty. For this reason, the Ruding Committee provided a less strict approach that gives preference to coordination and mutual adjustment of policies rather than systematic harmonization or even the introduction of a single European corporate tax system. The EC Commission reacted rather reluctantly to some of these proposals.[45] In the Commission's view, one should not be carried away by a desire for harmonization that would not be consistent with the principle of subsidiarity and the respective responsibilities of the Member States and the Community.

That European integration is difficult became apparent once again in the Danish and French referenda on the Maastricht Treaty,[46] which demonstrates that the political environment for a further harmonization of company taxation could hardly be more hostile. Nevertheless, to maintain the advantages of a unified market for goods, services, and capital, the Member States must overcome current hesitations.

Obviously, the increasing integration will inevitably result, to a certain degree, in a loss of national sovereignty and a transfer of powers from the Member States to the Community. This development will, however, be warranted by the economic advantages of integration. Since most of the above-mentioned issues will, if resolved, not only remove obstacles to cross-border activities within the EEC, but also improve the competitive position of European business relative to non-EC-based companies, the Ruding Committee's recommendations should be implemented as soon as possible.

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45. *See* Commission of the European Communities SEC(92)1118 final; *see also* Union of Industries of the European Communities (UNICE), *Position on the Recommendations for Harmonisation in the Area of Company Taxes as Made by the Ruding Committee*, (1992) INTERTAX 518-23.

46. In Denmark and in France only a small majority voted for the ratification of the Treaty of Maastricht.