NYLS Journal of International and Comparative Law

Volume 13 | Number 1

Article 3

1992

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I. INTRODUCTION

> *It is absolutely essential that companies operating in two or more EC countries should not be penalized in tax terms and thus placed at a disadvantage compared with companies whose activities are confined to national territory.*[1]

On June 11, 1990, the Finance Ministers of the Member States of the European Communities[2] agreed unanimously on a package of three proposals concerning corporate taxation.[3] These measures deal with (1)

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* This article takes account of developments up to October 31, 1992.

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1. *Single Market Increasingly Becoming a Reality for Firms*, EC PRESS RELEASE, (Brussels Press), Nov. 28, 1990, at 1 (citing EC Commissioner Christiane Scrivener) [hereinafter *Single Market Reality*].

2. Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Portugal, Spain, the Netherlands, and the United Kingdom are the current Member States of the European Community ("EC"). The plural "European Communities" refers to the following: the European Economic Community ("EEC"), the European Community for Coal and Steel ("ECCS"), and the European Atomic Energy Community ("EURATOM"). TREATY ESTABLISHING A SINGLE COUNCIL AND A SINGLE COMMISSION OF THE EUROPEAN COMMUNITIES, Apr. 8, 1965, 4 ILM 776 (1965) [hereinafter MERGER TREATY].

3. *Agreement on Three Directives for the Harmonization of Direct Taxation*, WORLD TAX NEWS, June 1990, at 21 [hereinafter *Agreement on Three Directives*]; *EC Finance Ministers Adopt Directives to Eliminate Risks of Double Taxation*, Daily Tax Rep. (BNA) No. 143, at

the taxation of cross-border mergers and reorganizations; (2) the taxation of cross-border payments of dividends between subsidiaries and their parent companies; and (3) transfer pricing disputes. The main aim of this new legislation is to eliminate all forms of double taxation incurred by EC corporations setting up in other Member States. This double taxation is due to the frequent overlap of taxing jurisdictions.

> At the present time, there are twelve tax territories in the Community, each with its own tax system. Companies operating in two or more Member States are taxed by each of the national tax administrations concerned. Although a number of bilateral double taxation agreements have, in some cases, helped to reduce the extent of these obstacles to transfrontier activities, they leave much to be desired when it comes to satisfying the requirements of the internal market.[4] This is because they do not cover all bilateral relations between Member States, do not completely abolish double taxation . . . and entail considerable administrative complications for companies.[5]

The formal vote on this new EC legislation took place on June 11, 1990, when the Finance Ministers approved the entire package after twenty-one years of debate.[6] This is the first EC legislation on direct taxation, apart from a 1979 directive which merely dealt with mutual assistance between tax authorities.[7] In that sense, this agreement is a

G-3 (July 25, 1990) [hereinafter *EC Finance Ministers Adopt Directives*]; *Council Reaches Long-Awaited Agreement on Corporate Taxation*, Common Mkt. Rep. (CCH) ¶ 95,505 (1991) [hereinafter *Council Reaches Agreement*]; *EC Tax Commissioner Sets Priorities*, 169 J. ACCT. 25, 26 (1990); Howard M. Liebman & Fussell M. Patten, *TPI Country Survey: European Community*, 17 TAX PLANNING INT'L REV. 28 (1990); *Removing Tax Barriers — New Measures to Encourage Cross-Border Co-Operation*, ERNST & YOUNG EC BRIEF 1 (Aug. 1990); John J. Goldsworth, *EC Ministers Agree on Direct Tax Measures, at Last!*, 2 TAX NOTES INT'L 665 (1990); *see also* 1 EUROPE 1992: LAW & STRATEGY 10-12 (1990).

4. This term is synonymous to the popular term "common market" and to the term "single market." According to the EEC Treaty, this market "shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaty." TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [EEC TREATY] art. 8a §2, 298 U.N.T.S. 3, 11.

5. *Single Market Reality*, *supra* note 1, at 2.

6. *EC Council Approves Package of Directives to Eliminate Risks of Double Taxation*, Daily Tax Rep. (BNA) No. 114, at G-1 (June 13, 1990) [hereinafter *EC Council Approves Package*]; *Finance Ministers Give Nod to Corporate Tax Package*, 1992—*The External Impact of European Unification*, (BNA) No. 9, at 6 (July 27, 1990).

7. The Council Directive concerning mutual assistance by the competent authorities of

"historic decision."[8] Until recently, the harmonization[9] of indirect taxes (value-added tax ("VAT"), customs duties, and excise duties)[10] was proceeding at a much faster pace than the harmonization of direct taxes (corporate taxes, capital taxes, and income taxes).[11] Originally, the EC gave priority to indirect taxes because "there was no way that two major tax projects could be conducted at the same time."[12] The Member States needed financial stability and were therefore unable to adjust their income at both the direct and the indirect tax levels.[13]

This important breakthrough results from the momentum of the 1992 program.[14] Since taxation is very sensitive to national demands, the EC Council has often encountered resistance when trying to legislate in the tax area.[15] For instance, Germany, since 1984, has blocked the adoption of

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Member States in the field of direct taxation and value-added tax is published in 1979 O.J. (L 331) 22, 28. "[This] directive . . . added little to the powers the Member States already possessed under double tax treaties with other Member States." *Progress Towards European Community Tax Harmonization*, WORLD TAX NEWS, Dec. 1990, at 1. For a short history of the harmonization of direct taxation in the EC, see MARK BREALEY & CONNOR QUIGLEY, COMPLETING THE INTERNAL MARKET OF THE EUROPEAN COMMUNITY, 1992 HANDBOOK 221 (1989).

8. *A Companies' Europe*, EC PRESS RELEASE, (Brussels Press), June 12, 1990, at 1.

9. In article 100 of the EEC TREATY the term "approximation" is used. EEC TREATY, *supra* note 4, art. 100. However, this article will use the terms "approximation," "standardization," and "harmonization" interchangeably.

10. For an explanation of the situation of indirect taxation in the EC, see GEERT LOWAGIE & PATRICK KELLEY, *Value-Added Tax in the European Community After 1992*, 4 Tax Notes Int'l 1047 (1992); Terra, *VAT in the EEC: The Place of Supply*, 26 COMMON MKT. L. REV. 449, 455 (1989); Michel V. M. Van Beek, *Indirect Taxation and 1992*, 9 NW. J. OF INT'L L. & BUS. 552, 552 (1989); Donald W. Parker, *The Value-Added Tax in the European Economic Community*, 11 B.C. INT'L & COMP. L. REV. 155, 155 (1988); *VAT Proposal Cleared for Signature at EC Finance Ministers Meeting*, Daily Tax Rep. (BNA) No. 223, at G-4 (Dec. 4, 1990). For recent developments, see *EC Finance Ministers Adopt Directives Harmonizing VAT, Excise Duty Rates*, Daily Tax Rep.(BNA) No. 204, at G-2 (1992).

11. Peter Cussons et al., *European Community Direct Tax Measures*, 17 TAX PLANNING INT'L REV. 11, 14 (1990); *see also Progress Toward European Community Tax Harmonization*, *supra* note 7, at 1.

12. Kathleen Matthews, *Expect U.S. Tax Treaty with EC, Commission Official Tells Conference*, 49 TAX NOTES 507, 508 (1990) (statement of Mr. Michel Petite, a staff member of the economics and taxation cabinet of the EC in Brussels, Belgium, speaking on October 16, 1990, at the Conference on Taxation, Trade and Investment in the European Community).

13. *Id.*

14. *See* Completing the Internal Market: White Paper from the Commission to the European Council, COM (85)310 final at 3, *reprinted in* 2 INT'L & COMP. L. Q. 97 (1990).

15. "Tax is one of the [EC's] great battlegrounds. [It is] . . . an area where national governments guard their tax-setting prerogatives so jealously and where each can wield a veto to block any [EC] action." David Buchan, *New Iron Lady Ventures onto EC's Tax-Setting*

the new tax legislation due to a dispute with the Netherlands.[16] The EC Member States' tax sensitivity is conspicuously reflected in the Single European Act ("SEA"), which requires unanimity for the adoption of tax measures, but allows a qualified majority for most other decisions.[17] Because of the unanimity requirement and Germany's opposition, it took many years of negotiations to attain agreement.[18] As a matter of fact, the oldest proposals had been on the table since 1969.[19]

The new legislation consists of[20] the Council Directive on the common system of taxation applicable to mergers, divisions, transfers of assets, and exchanges of shares concerning companies of different Member States (the "Merger Directive");[21] the Council Directive on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (the "Parent-Subsidiary Directive");[22] and the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (the "Transfer Pricing Convention").[23]

These three tax measures will be complemented by two directives announced by the EC Commission (the "Commission")[24] in April,

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Battleground, FIN. TIMES, Apr. 17, 1989, at 6; *see* Michael Maskall & Peter Cussons, *European Trends in Direct Taxation Towards 1992: Survey of Tax Considerations as Applied to European Corporations*, 16 TAX PLANNING INT'L REV. 3, 10 (1989).

16. *See infra* Chapter III. B.

17. EEC TREATY, *supra* note 4, art. 18; *see* David Williams, *Taxation in the European Community: 1992—And Then What?*, 16 TAX PLANNING INT'L REV. 21, 21 (1989).

18. *Council Reaches Agreement*, *supra* note 3.

19. These are the Commission proposals of January 16, 1969, on a common tax system for mergers, divisions, and contributions of assets occurring between companies of different Member States and on a common tax system for parent companies and subsidiaries of different Member States. 1969 O.J. (C 39) 1. The proposal on the elimination of double taxation in connection with the adjustment of transfers of profits between associated enterprises (arbitration procedure) dates from November 29, 1976. 1976 O.J. (C 301) 4. However, these proposals were updated by the Commission in May 1989. *See* John J. Goldsworth, *Update on EC Directives on Harmonizing Direct Taxes*, 2 TAX NOTES INT'L 912, 912 (1990).

20. CLIFFORD CHANCE, THE CCH GUIDE TO 1993, CHANGES IN EEC LAW 22-29 (2d ed. 1990).

21. Council Directive 90/434, 1990 O.J. (L 225) 1 [hereinafter Merger Directive]. For a summary of this Directive, see Cussons et al., *supra* note 11, at 20.

22. Council Directive 90/435, 1990 O.J. (L 225) 6 [hereinafter Parent-Subsidiary Directive]. For a summary of this Directive, see Cussons et al., *supra* note 11, at 20.

23. Convention 90/436, 1990 O.J. (L 225) 10 [hereinafter Transfer Pricing Convention]. For a summary of this Convention, see Cussons et al., *supra* note 11, at 18; *see also* Eric Osterweil & Caoive M. Collins, *New Convention for Transfer Pricing Dispute Arbitration*, INT'L TAX REP., Dec. 1990, at 1.

24. The functional difference between the Commission and the Council in the legislative

1990,[25] and which were proposed on November 28, 1990, by EC Commissioner Christiane Scrivener, who is responsible for taxation and the customs union.[26] The two proposed directives are (1) the Council Directive on the abolition of withholding tax on interest and royalty payments made between parent companies and subsidiaries in different Member States (the "Interest and Royalties Directive")[27] and (2) the Council Directive on the arrangements for the taking into account by undertakings of the losses of their permanent establishments and subsidiaries situated in other Member States (the "Carry-Over of Losses Directive").[28]

These five measures should remove all substantial problems of double taxation and should allow European companies to take full advantage of the single market.[29] Indeed, the general objective of the new legislation is "to ensure that enterprises which operate in several Member States do not receive less favorable treatment in fiscal terms than . . . enterprises which confine themselves to a single country."[30] Through the elimination of the existing tax disincentives "for companies to invest across borders because the tax treatment is more attractive for investment made within one country," the Commission seeks to encourage "the process of industrial restructuring needed in order for the [EC] to face up to the competitive challenge of the internal market."[31]

The Merger Directive and the Parent-Subsidiary Directive expressly state that "Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with [these Directives] not later than 1 January 1992."[32] EC Commissioner Scrivener has stressed

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process within the EC is that "the Commission proposes, the Council disposes." *See* EEC TREATY, arts. 145-63, *amended by* the MERGER TREATY. On the legislative process in tax matters, *see Price Waterhouse Outlines EC Tax Legislative Process*, 4 Tax Notes Int'l 1140 (1992).

25. *Council Reaches Agreement*, *supra* note 3.

26. *EC Tax Commissioner Introduces Two Proposals to Remove Tax Barriers*, Daily Tax Rep. (BNA) No. 232, at G-3 (Dec. 3, 1990) [hereinafter *Two Proposals*]; Kathleen Matthews, *European Commission Introduces Two New Corporate Tax Directives*, 3 TAX NOTES INT'L 16, 16 (1991).

27. Cussons et al., *supra* note 11, at 16.

28. *See generally* EC PRESS RELEASE, (Brussels Press), Nov. 28, 1990 [hereinafter EC PRESS RELEASE NOV. 28, 1990]; Cussons et al., *supra* note 11, at 15-16.

29. Cussons et al., *supra* note 11, at 15-16; *Commission Takes New Approach to Company Taxation*, 655 Common Mkt. Rep. (CCH) 1 (1990) [hereinafter *Commission Takes New Approach*].

30. *Council Reaches Agreement*, *supra* note 3.

31. *Two Proposals*, *supra* note 26, at G-3.

32. Directives contain the goals and deadlines to be achieved, while their implementation

the importance of having this legislation in place before the 1992 deadline.[33] Several Member States have started the implementation process ahead of time, while others have not been able to meet the deadline Scrivener set.[34] The Transfer Pricing Convention, on the other hand, is a multilateral convention and requires ratification by the twelve national legislatures.[35] This process will take at least a year;[36] in fact, by mid 1992, only two states had ratified it.[37] The Convention will enter into force on the first day of the third month following that in which the last Member State deposits its instrument of ratification.[38] Concerning the proposed Interest and Royalties Directive and the Carry-Over of Losses Directive, EC Commissioner Scrivener "hopes to get approval of [these] proposals in time for them to be transposed into national legislation by [January 1, 1993]."[39] As of October 31, 1992, the Directives had not been adopted, and thus his deadline cannot be met. It is hoped that the Interest and Royalties Directive will be approved under the British presidency of the EC Council of Ministers, which concludes at the end of 1992.[40] No major opposition is expected to this Directive, which is a mere extension of the Parent-Subsidiary Directive.[41] The Carry-Over of

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is left to the discretion of each Member State. Merger Directive, *supra* note 21, art. 12(1); Parent-Subsidiary Directive, *supra* note 22, art. 8(1).

33. *Commission Takes New Approach*, *supra* note 29, at 2.

34. *See*, e.g., *Britain Preparing to Implement EC Taxation Directives, Will Affect U.S. Firms*, Daily Tax Rep. (BNA) No. 66, at G-1 (Apr. 5, 1991); Patrick L. Kelly, *Belgian Legislation Needed to Implement New EC Directives Reviewed*, 2 TAX NOTES INT'L 1028, 1029 (1990); Christine Guillerm-Kirk, *France Must Make Only Minor Changes to Implement New Directives*, 2 TAX NOTES INT'L 1034, 1034 (1990); Alex Morris, *Spain Adopts Implementing Legislation for EC Mergers Directive*, 4 TAX NOTES INT'L 747 (1992) and Patrick Kelley, *Belgium Completes Implementation of EC Parent/Subsidiary Directive*, 4 TAX NOTES INT'L 7 (1992).

35. Transfer Pricing Convention, *supra* note 23, arts. 17-18. The instruments of ratification must be deposited at the office of the Secretary-General of the EC Council.

36. *EC Finance Ministers Adopt Directives*, *supra* note 3.

37. *Scrivener Proposes Communication on Corporate Tax Harmonization*, Daily Tax Rep. (BNA) No. 133, at G-2 (1992).

38. Transfer Pricing Convention, *supra* note 23, arts. 18.

39. Two Proposals, *supra* note 26, at G-3.

40. *Eliminating Corporate Double Taxation is Post-1992 EC Priority, Official Says*, Daily Tax Rep. (BNA) No. 209, at G-1 (1992); *EC Wants to End Double Taxation by End of Year, Scrivener Says*, Daily Tax Rep. (BNA) No. 197, at G-1, G-2 (1992).

41. John Turro, *Commission Readies Vote on Proposed Interest and Royalty Directive—Loss Directive Not Considered Front-Burner Issue*, 3 TAX NOTES INT'L 617 (1991). EC Commissioner Scrivener expressed hope that the Directive will be adopted at the November 23, 1992, meeting of the Council of Ministers. *EC Wants to End Double Taxation by End of*

Losses Directive is more controversial[42] and its adoption is likely to take more time.[43] Since the EC Council adopted the Parent-Subsidiary Directive, no major opposition is likely to these two proposals, which are merely an extension of that Directive.[44]

With this new legislation, the EC has abandoned its plan to set a uniform rate of corporate taxation across the twelve Member States.[45] This would be very difficult to achieve in view of each Member State's "unique method of generating revenues from both direct and indirect taxing methods."[46] Instead, the EC Commission intends to take a "new approach," based on "mutual recognition and coordination between the Member States, the main aim of which is to remove the spectre of double taxation."[47] According to EC Commissioner Scrivener:

> [I]n the time leading up to 1993, Community action should concentrate on the measures essential for completing the internal market . . . . [A]lthough harmonization will still have a role to play in certain cases, priority [should] be given to mutual

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Year, Scrivener Says, Daily Tax Rep. (BNA) No. 197, at G-1, G-2 (1992).

42. This is due in part to the fact that "[t]he domestic legislation of three member states—Belgium, Greece, and Italy—currently does not allow loss relief between parents and subsidiaries." John Turro, *supra* note 41.

43. *Eliminating Corporate Double Taxation is Post-1992 EC Priority Official Says,* Daily Tax Rep. (BNA) No. 209, at G-1 (1992).

44. *See infra* chapters V and VI.

45. Company Taxation and Withholding on Dividends, Common Mkt. Rep. (CCH) ¶ 3217.10 (1975). This plan was put forward originally in a proposed Directive of 23 July 1975 on the harmonization of systems of company taxation and of withholding taxes on dividends. 1975 O.J. (C 253) 18. The Commission officially withdrew this draft directive on April 18, 1990. Under the Commission's 1975 proposal, "each Member State would apply a single rate of corporation tax to the distributed or undistributed profits of enterprises. This rate could not be less than 45% nor more than 55% and would be considered the normal rate. Exceptions would be made if a Member State [had] economic, regional, or social reasons for applying a different rate. In those cases the Commission [had] to be consulted." *See Two-Part Corporate Tax Plan Emphasizes Rate Convergence, 1992—The External Impact of European Unification*, (BNA) No. 4, at 5 (Apr. 20, 1990) [hereinafter *Corporate Tax Plan*]; A chart illustrating the existing diversity of direct corporate taxes is reprinted in Cussons et al., *supra* note 11, at 22. For a summary of each Member State's direct tax system, see Thomas H. Gibson & Meryl A. Rains, *Europe 1992 Removing Fiscal Barriers: The Unlikely Spectre of Tax Harmonization,* 13 HASTINGS INT'L & COMP. L. REV. 531, 536-84 (1990).

46. Gibson & Rains, *supra* note 45, at 532.

47. *Commission Takes New Approach*, *supra* note 29, at 655; *see* Liebman, *supra* note 3, at 29.

recognition and the approximation of national laws in meeting the needs that arise as the internal market is further developed.[48]

The new approach has, consequently, important consequences for the post-1993 objectives.[49]

Although the Commission has dropped the idea of a single corporate tax rate, it is still concerned about "the effects on the single market of disparities in the burden of taxation on companies across the Community. To this end it [has set] up a committee of experts to look into the effects on the single market of these different rates."[50] Two key issues will be addressed by this committee: "whether the differences in corporate taxation distort or influence investment decisions, and whether market forces and competition among national fiscal systems will suffice to eliminate these differences or [whether] Community legislation will be necessary."[51] Furthermore, this committee will have to address a number of questions:[52] (1) whether any action, at the EC level, should concentrate on one or more elements of corporate taxation—namely, the different corporate taxation systems, the differences in tax treatment associated with the legal status of companies, and the tax base or the tax rate; (2) whether any measures envisaged lead to harmonization, approximation, or the establishment of a framework for national legislation; and (3) if measures need to be taken to evaluate the effect on Community objectives such as cohesion, environmental protection, and the fair treatment of small and medium sized firms. "In the light of the results of this study, the committee will decide what, if any, further proposals should be brought forward."[53] This committee met for the first time on January 21, 1991.[54] The committee reported on the progress of its work to EC Commissioner Scrivener in July, 1991.[55] On March 18,

48. John Goldsworth, *EEC Commission Adopts New Approach to Company Taxation*, 2 TAX NOTES INT'L 550, 551 (1990); *see* Howard M. Liebman, *Interview with Mme. Christiane Scrivener*, 17 TAX PLANNING INT'L REV. 3, 3 (1990).

49. It is said that "[t]he Commission's new approach is in keeping with the principle of 'subsidiary,' a new word in the language of Eurospeak . . . ." which suggests, when used in connection with the new approach on taxation, that "rigid harmonization may not be required." Goldsworth, *supra* note 48, at 550; *see Single Market Reality*, *supra* note 1, at 1.

50. *Commission Takes New Approach*, *supra* note 29 at 2.

51. *Corporate Tax Plan*, *supra* note 45, at 5.

52. *See* Cussons et al., *supra* note 11, at 16; Goldsworth, *supra* note 48, at 551.

53. Cussons et al., *supra* note 11, at 16.

54. *Expert Committee Discusses Corporate Taxation in the Single Market*, 674 Common Mkt. Rep. (CCH) 1 (1991).

55. *Id.* at 2.

1992, the committee presented its report, the so-called Ruding Report on Corporate Taxation, named after the committee's Chairman, former Dutch Finance Minister Onno Ruding.[56] On June 24, 1992, EC Commissioner Scrivener in turn issued a first reaction to the Ruding Report in the format of guidelines on planned EC Commission measures in the post-1992 single market.[57] Commissioner Scrivener also plans "to launch a comprehensive process of consultation with Member States before formulating proposals for legislation . . . ."[58]

It should be noted that many tax matters among EC Member States will continue to be governed by the network of bilateral-double-taxation treaties. This network is very extensive, but not complete.[59] In this respect, "it is tempting to speculate that in due course the Commission may propose a single multilateral treaty governing all relationships among EC members to replace the current bilateral network. This will probably not be possible until a greater degree of harmonization of national tax systems has taken place."[60] The newly adopted tax measures bring this harmonization closer.

II. THE MERGER DIRECTIVE

A. Purpose

The Merger Directive[61] aims to remove artificial obstacles to mergers and reorganizations[62] of corporations, that is, obstacles created

56. *Scrivener Proposes Communication on Corporate Tax Harmonization*, Daily Tax Rep. (BNA) No. 123, at G-2 (1992). For the full text of the Ruding Report, see 4 TAX NOTES INT'L 731 (1992) and Jens Blumenberg & Richard Minor, *Ruding Committee Report Unveiled—New Measures Proposed for Company Taxes in the EC*, 4 TAX NOTES INT'L 563 (1992).

57. *Scrivener Proposes Communication on Corporate Tax Harmonization*, Daily Tax Rep. (BNA) No.123, at G-2 (1992).

58. John Goldsworth, *EC Commission Review Ruding Committee Report, Suggests Member State Consultation*, 5 TAX NOTES INT'L 177 (1992).

59. Cussons et al., *supra* note 11, at 22.

60. *Id.* at 16-17. "A natural result of a [such a single] treaty would be to the EC act as negotiator for treaties with the rest of the world." In this respect there are some expectations that the EC will negotiate a double taxation treaty with the U.S. in the near future. Others, however, do not believe that this will be the case. *See* Matthews, *supra* note 12, at 507.

61. Merger Directive, *supra* note 21, at 1. *See generally* Johnathan S. Schwarz, *New Strategies for Cross-Border Mergers, Acquisitions, and Reorganizations*, 2 J. INT'L TAX. 51 (1991); Eric Tomsett, *The Directive on Cross-Border Mergers*, WORLD TAX NEWS, Dec. 1990, at 2.

62. The term reorganization, for the purposes of this article, includes divisions, transfers

mainly by taxation and corporate law. In so doing, the Directive will facilitate desirable mergers and reorganizations, i.e., those which increase companies' productivity and improve their competitive position.[63] "[Such an increase and improvement] has always been the Commission's basic concern in its approach to company taxation."[64] If the internal market is to operate effectively, it is necessary for EC enterprises to attain a size that improves their competitive position in the world market.[65] Until the full implementation of the Merger Directive, the main obstacle to corporate growth is the tax cost of mergers and reorganizations.[66] This is because many countries' tax systems simply discourage mergers and reorganizations "by treating transfers of assets and shareholdings as if they were made at market values and taxing the corresponding gains arising [from the transfer]."[67] As a result, primary concern of the Merger Directive was the removal of the tax cost of cross-border mergers and reorganizations, along with safeguarding the interests of the country of the acquired company.[68]

B. Content[69]

The core of the Merger Directive consists of a general tax deferment for the entire capital gain on liquidations resulting from a merger[70] or a

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of assets, and exchanges of shares.

63. *Tax Treatment of Mergers, Split-ups and Transfers of Assets,* Common Mkt. Rep. (CCH) ¶ 3213.01 (1991) [hereinafter *Tax Treatment*].

64. A Companies' Europe, *supra* note 8, at 1-2.

65. *Id.* at 1.

66. *Tax Treatment, supra* note 63, ¶ 3213.01.

67. Tomsett, *supra* note 61, at 2.

68. Merger Directive, *supra* note 21, at 1.

69. For a discussion of all the issues involved, see generally *Tax Treatment, supra* note 63. *See generally Corporate Taxation Measures Published,* 665 Common Mkt. Rep. (CCH) 1 (1990).

70. A "merger" is defined as:

> an operation whereby one or more companies, on being dissolved without going into liquidation, transfer all their assets and liabilities to another existing company in exchange for the issue to their shareholders of securities representing the capital of that other company, and, if applicable, a cash payment not exceeding 10% of the nominal value, or, in the absence of a nominal value, of the accounting par value of those securities, two or more companies, on being dissolved without going into liquidation, transfer all their assets and liabilities to a company that they form, in exchange for the issue to their shareholders of securities representing the capital of that new company, and, if applicable, a cash payment not exceeding 10% of the nominal value, or in the absence of a nominal value, of the accounting par value

division.[71] This system has the advantage of being simple to apply.[72] As a matter of fact, it is already in effect in most of the Member States,[73] but for budgetary reasons most countries limit its application to national operations.[74] Inherent in the fact that this system has not been applied throughout the entire Community, however, is

> the danger that mergers might always go in the same direction, to the detriment of the countries with the most liberal tax policies . . . . [I]f . . . one Member State is less stringent in taxing capital gains in international mergers than another State, mergers would flow in the direction of the former State and would result in losses of revenue. This would be incompatible with the principles of tax neutrality and competition policy.[75]

Under the new system, therefore, the tax on capital gains[76] will be deferred until the acquiring company[77] actually realizes these gains.[78]

> of those securities, a company, on being dissolved without going into liquidation, transfers all its assets and liabilities to the company holding all the securities representing its capital.

Merger Directive, *supra* note 21, at art. 2(a). For examples, see Tomsett, *supra* note 61, at 2-3.

71. A "division" is defined as:

> an operation whereby a company on being dissolved without going into liquidation, transfers all its assets and liabilities to two or more existing or new companies, in exchange for the pro rata issue to its shareholders of securities representing the capital of the companies receiving the assets and liabilities, and, if applicable, a cash payment not exceeding 10%

of the nominal or par value of those securities. Merger Directive, *supra* note 21, art. 2(b). For an example, see Tomsett, *supra* note 61, at 3.

72. *Tax Treatment*, *supra* note 63, ¶ 3213.12.

73. Tomsett, *supra* note 61 at 2; *see EC Council Approves Package*, *supra* note 6, at G-1. "But under the existing situation, most national fiscal rules equate a cross-border fusion, division or contribution of assets as a total or partial liquidation of the company putting in the assets." *Id.*

74. "The provisions often exclude cross-border transactions, to prevent the use of mergers and reorganizations to move profits and capital gains outside the tax jurisdiction of the country in which they arise." Tomsett, *supra* note 61, at 2.

75. *Tax Treatment*, *supra* note 63, ¶ 3213.03.

76. These gains result from the difference between the real value of the assets and liabilities transferred and their value for tax purposes. *Tax Treatment*, *supra* note 63, ¶ 3213.12.

77. For the definition of the terms transferring company, receiving company, acquired company, acquiring company, and branch of activity, see Merger Directive, *supra* note 21, art.2(e)-(i).

78. Merger Directive, *supra* note 21, art. 4(1); *see Tax Treatment*, *supra* note 63, ¶

This means that, under article 4 of the Directive, no tax is imposed on capital gains at the time of the merger or the reorganization. For example, in the case of a firm bringing with it into a fusion land, factories, and buildings that appear on its balance sheet at below the current market level, the tax authorities would not tax the capital gains until the land, factory, and buildings were in fact sold.[79] The Directive only applies to mergers and reorganizations in which companies from at least two EC Member States are involved.[80] Furthermore, the Directive "does not apply to the stamp or transfer duties that may arise on these transactions . . . . In some countries . . . this could involve substantial liabilities."[81]

To prevent tax evasion and to safeguard the taxing rights of the acquired company's country

> the Member States shall make the application of [the tax deferment] conditional upon the receiving company's computing any new depreciation and any gains or losses in respect of the assets and liabilities transferred according to the rules that would have applied to the transferring company or companies if the merger or division had not taken place.[82]

In order to remove all tax impediments to cross-border mergers and divisions, the Directive also prescribes favorable tax treatment of reserves and provisions, losses, and cross-holdings of interests.[83] First, the receiving company's permanent establishment, situated in the Member State of the transferring company, may carry over provisions and reserves with the same tax exemptions that may have been granted to the transferring company.[84] Likewise, to the extent that the Member State would apply provisions allowing the receiving company to take over the

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3213.12; *Corporate Taxation Measures Published*, *supra* note 69, at 1.

79. This is the same system that currently applies to such activities, which take place at a purely national level, according to the conclusions issued by the Council. *EC Council Approves Package*, *supra* note 6, at G-1.

80. Merger Directive, *supra* note 21, art. 1. For an account of the impact of the Directive can have on United States companies, see Karina Haum & David Tillinghast, *A Primer on the Impact of the EC Directive on Mergers and Divisions on U.S. Companies with Interests in Europe*, 3 TAX NOTES INT'L 575 (1991).

81. Tomsett, *supra* note 61, at 2, 4.

82. Merger Directive, *supra* note 21, art. 4(2).

83. *See id.* art. 5-7.

84. *Id.* art. 5.

losses of the transferring company which had not yet been exhausted for tax purposes, it shall extend those provisions to cover the take-over of such losses by the receiving company's permanent establishments situated within its territory.[85] Finally, if the receiving company owns capital stock of the transferring company, any gains accruing to the receiving company on the cancellation of that stockholding is exempt from taxation.[86] In addition, "the Directive also provides that where the shareholders of the transferring company receive securities in the acquiring company, that allotment of securities should not in itself give rise to taxation of the shareholders."[87] This provision applies to mergers, divisions, and exchanges of shares.[88]

Article 10(1) concerns the special case of a transfer of a permanent establishment. When a permanent establishment, which is situated in a Member State other than that of the transferring company, is transferred in a merger, a division, or a transfer of assets the latter state shall renounce any right to tax that permanent establishment.[89]

Title III of the Directive concerns the transfer of assets.[90] This title, which consists of article 9 only, makes the provisions of article 4 (taxation of capital gains deferred until actual realization), article 5 (treatment of provisions and reserves), and article 6 (take over of losses not yet

85. *Id.* art. 6.

86. *Id.* art. 7.

87. *Id.* art. 8; *Corporate Taxation Measures Published*, *supra* note 69, at 1.

88. An "exchange of shares" is defined as:

> an operation whereby a company acquires a holding in the capital of another company such that it obtains a majority of the voting rights in that company in exchange for the issue to the shareholders of the latter company, in exchange for their securities, of securities representing the capital of the former company, and, if applicable, a cash payment not exceeding 10% of the nominal value or, in the absence of a nominal value, of the accounting par value of the securities issued in exchange.

Merger Directive, *supra* note 21, art. 2(d).

89. For an example, see Tomsett, *supra* note 61, at 2, 5. Article 10(1) continues: "the [s]tate of the transferring company may," however, "reinstate in the taxable profits of that company such losses of the permanent establishment as may previously have been set off against the taxable profits of the company in that State and which have not been recovered." Merger Directive, *supra* note 21, art. 10(1). Article 10(2) contains an exception in the event the Member State of the transferring company levies taxes on the company's world-wide profits. *Id.* art. 10(2). For further information on this exception, see *Tax Treatment*, *supra* note 63, ¶ 3213.25; Tomsett, *supra* note 61, at 2, 5.

90. A "transfer of assets" is defined as "an operation whereby a company transfers without being dissolved all or one or more branches of its activity to another company in exchange for the transfer of securities representing the capital of the company receiving the transfer." Merger Directive, *supra* note 21, art 2(c). For an example, see Tomsett, *supra* note 61, at 2-3.

provisions and reserves), and article 6 (take over of losses not yet exhausted for tax purposes) applicable to transfers of assets. In addition, article 10 (the transfer of a permanent establishment) also applies to a transfer of assets.[91]

The Merger Directive contains three "escape clauses"[92] or "anti-avoidance provisions."[93] Member States can refuse to apply the benefits of the Merger Directive if a particular operation's principal objective is tax evasion or tax avoidance[94] or a particular operation results in a company that no longer fulfills the national requirements for employee participation in the management of the company.[95] Furthermore, the Merger Directive does not apply to companies in an EC Member State which are considered under a double-tax treaty between that Member State and a country outside the EC to be resident, for tax purposes, in the non-EC Member State.[96]

> This provision is designed to prevent such dually resident companies from taking advantage of the directive when the tax treaty in question provides for them to be taxed outside the EC so that profits and gains that might otherwise have been taxed in an EC country would escape tax in the EC.[97]

Important criticism has been voiced against this Directive stressing its lack of relevance for most situations:[98]

> Although new tax laws to implement the reliefs provided by the directive will be useful and indeed very welcome in some cases, a careful examination of the definitions of mergers, divisions,

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91. Merger Directive, *supra* note 21, art. 20.

92. *Corporate Taxation Measures Published*, *supra* note 69, at 1.

93. Tomsett, *supra* note 61, at 2, 6.

94. The Directive continues: "[T]he fact that one of the operations . . . is not carried out for valid commercial reasons such as the restructuring or rationalization of the activities of the companies participating in the operation may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives." Merger Directive, *supra* note 21, art. 11(1)(a).

95. *Id.* art. 11(1)(b). According to article 11(2), article 11(1)(b) shall only apply as long as no Community legislation containing equivalent rules on representation of employees on company organs are applicable to the companies covered by this Directive. *Id.* art. 11(2).

96. *Id.* art. 3(b).

97. Tomsett, *supra* note 61, at 2, 6.

98. *Id.* at 4.

> cover many of the procedures that multinational groups are likely to plan to follow. The directive's provisions generally cover situations in which a company in one EC member state transfers its business to a company in another EC member state that then carries on the business as a branch (permanent establishment) in the first country . . . . In practice, however, . . . [m]ost corporate groups operating in Europe prefer . . . to maintain a separate subsidiary . . . in each country in which their business is located.[99]

Member States are required to implement this Directive by January 1, 1992[100] (except for Portugal which may delay the application of the provisions concerning transfers of assets and exchanges of shares until January 1, 1993).[101]

III. THE PARENT-SUBSIDIARY DIRECTIVE[102]

A. Purpose[103]

As explained above, the competitive strength of EC companies has to be increased to guarantee the proper functioning of the common market. An effective way to realize this is through the formation of corporate groups consisting of parent companies and subsidiaries of different Member States. Acquiring stock in related companies producing a conglomerate controlled by one parent company is a common structure at the international level. From a legal standpoint, no tax problem arises when one company acquires an interest in another company. Subsequently, however, the subsidiary's previously taxed profits are taxed again when they are distributed to its parent. This is a major disadvantage to a parent-subsidiary corporate structure set up in different EC Member

99. Tomsett further argues that this Directive would, however, become useful on the creation of European companies. *See id.* at 4, 6.

100. Merger Directive, *supra* note 21, art. 12(1).

101. *Id.* art. 12(2).

102. Parent-Subsidiary Directive, *supra* note 22, at 6. *See generally* Fraus Vanistenolael, *The Implication of the Parent-Subsidiary Directive in the EC—Comment on Some Unresolved Questions*, 5 TAX NOTES INT'L 599 (1992); Jonathan S. Schwarz, *24 EC Directives Cover Cross-Border Income Flows*, 2 J. INT'L TAX. 180 (1991); Tomsett, *The Directive on Parent/Subsidiary Taxation*, WORLD TAX NEWS, Dec. 1990, at 7.

103. The following section is based on *Taxation of Parent Companies and Subsidiaries*, Common Mkt. Rep. (CCH) ¶ 3215.01 (1991).

States.[104] The national tax provisions governing the relations between parent companies and subsidiaries of the same Member State are generally more advantageous than those applicable to parent companies and subsidiaries of different Member States.[105] This clearly penalizes those companies setting up subsidiaries in other EC Member States. The Parent-Subsidiary Directive aims at the removal of these hampering and restricting tax provisions.

B. Content

Article 4 of the Parent-Subsidiary Directive addresses the problems encountered with respect to double taxation of profit distributions.[106] The Member States can adopt either of two possible solutions. When a parent company, by virtue of its association with its subsidiary, receives distributed profits, the state of the parent company must either "refrain from taxing such profits, or tax such profits while authorizing the parent company to deduct from the amount of tax due that fraction of the corporation tax paid by the subsidiary which relates to those profits."[107] This choice constitutes the core of the Parent-Subsidiary Directive. This rule, however, does not apply to distributions in a liquidation.[108]

Some Member States already apply the system set forth in article 4.[109] The Parent-Subsidiary Directive, however, extends the system throughout the Community.[110]

> Because of the differences between the national provisions and the differences between the various tax treaties, the tax burden on dividends distributed by a subsidiary to its parent company would vary depending on the source of the dividend. This could deflect capital movements in the form of acquisitions of holdings and lead to distortions of competition because companies might, for

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104. Parent-Subsidiary Directive, *supra* note 22, at 6.

105. *Corporate Taxation Measures Published*, *supra* note 69, at 1-2.

106. Article 1 specifies that the Directive applies "to distributions of profits received by companies of that State which come from their subsidiaries of other Member States" and "to distributions of profits by companies of that State to companies of other Member States of which they are subsidiaries." Parent-Subsidiary Directive, *supra* note 22, art. 1.

107. *Id.* art. 4.

108. *Id.* art. 4(1).

109. The United Kingdom, Denmark, France, and the Netherlands are examples. Tomsett, *supra* note 102, at 7, 9; *Taxation of Parent Companies and Subsidiaries*, *supra* note 103, ¶ 3215.11.

110. *Taxation of Parent Companies and Subsidiaries*, *supra* note 103, ¶ 3215.01.

> tax reasons, be induced to acquire holdings in companies of one country rather than another.[111]

Some states, however, limit the tax exemption to ninety or ninety-five percent of the dividends received. "The remaining . . . [five or ten percent] is considered a management cost of the holding already deducted from the taxable profit of the parent company."[112] Therefore, each Member State has the option

> of providing that any charges relating to the holding and any losses resulting from the distributions of the profits of the subsidiary may not be deducted from the taxable profits of the parent company. Where the management costs relating to the holding in such a case are fixed as a flat rate, the fixed amount may not exceed 5% of the [distributed profits].[113]

The definition of parent companies and subsidiaries is an important issue. In attempting to define these terms, two problems have arisen. First, there is a need to establish a minimum shareholding requirement, and second, a minimum holding period.[114] For purposes of this Directive only, the status of a parent company is attributed to a company of a Member State that has a minimum holding of twenty-five percent of the capital of a company of another Member State.[115] This implies that a minority shareholder can qualify under the Directive as a parent company.[116] Through bilateral agreements, Member States may replace the criterion of a twenty-five percent holding of the capital with that of a holding of twenty-five percent of the voting rights.[117] Also, Member States have the option of not conferring the status of "parent company" to entities that fail to own and maintain the minimum shareholding for an uninterrupted period of at least two years.[118] It is very important to

111. *Id.*

112. *Id.* ¶ 3215.11.

113. Parent-Subsidiary Directive, *supra* note 22, art. 4(2).

114. *Taxation of Parent Companies and Subsidiaries*, *supra* note 103, ¶ 3215.09.

115. Parent-Subsidiary Directive, *supra* note 22, art. 3(1)(a).

116. Matthews, *supra* note 12, at 508.

117. Parent-Subsidiary Directive, *supra* note 22, art. 3(2).

118. *Id.*

notice that the Directive also applies to EC corporations owned by shareholders outside the EC.[119]

The council realized that "it was furthermore necessary, in order to ensure fiscal neutrality, that the profits which a subsidiary distributes to its parent company be exempt from withholding tax."[120]

> In general, depending on the country, there are two ways of ensuring that dividends are taxed only once: Under one system, a subsidiary is not subject to withholding on dividends distributed to its parent, but the parent must withhold tax when it distributes the dividends received to its shareholders. The other system is the reverse of the first. Both methods have the same result where the dividend is redistributed by the parent company, but not where the dividend is allocated to reserves. In the first case, the parent company may retain the full amount, while in the second case, the amount is reduced by the tax withheld at the source. Withholding at the subsidiary level penalizes parent companies whose own business activities do not produce sufficient profits for self-financing. The other method, i.e., not withholding taxes at the subsidiary level, eliminates this drawback by achieving absolute tax neutrality in the allocation by the parent company of the dividends received from its subsidiaries: the parent company is always treated as though it had realized the profit directly itself and not through subsidiaries. Where parent and subsidiary are in different countries, tax is almost always withheld when the subsidiary distributes profits to its parent. This results in double taxation if the State of the parent company provides for exemption of the subsidiary's profits, i.e., for a second withholding when the parent company redistributes the dividends. The first withholding then becomes the final tax. That is why the Commission considered it essential that tax not be withheld at the subsidiary level [cite omitted]. This solution is all the more justified because withholding at the source normally represents an advance payment of tax and there is no cause to collect it where the recipient's income is tax-exempt.[121]

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119. Tomsett, *supra* note 102, 7, 9-10.

120. Parent-Subsidiary Directive, *supra* note 22, at 6.

121. *Taxation of Parent Companies and Subsidiaries*, *supra* note 103, ¶ 3215.13.

Except for the United Kingdom and Ireland,[122] the provisions of this Directive prohibiting dividend withholding taxes are of considerable significance since substantial withholding taxes presently are imposed on most dividends between subsidiaries and parent companies within the EC.[123] Even though double-taxation treaties among Member States often reduce the rates of withholding taxes substantially, rates from five to fifteen percent typically apply to dividends paid by a subsidiary to its parent in another Member State.[124]

Additionally, the Directive prohibits "Member States from withholding tax, as some do at present, at the source on foreign dividends received by their companies.[125] Without this prohibition, the . . . exemption at the subsidiary level would become meaningless. These States [are], however, . . . [able] to withhold tax when the dividends are redistributed by the parent company."[126]

This Directive has to be implemented by January 1, 1992,[127] but exceptions[128] apply to Greece,[129] Germany,[130] and Portugal.[131] First, under article 5(2), Greece does not have to comply with this

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122. Tomsett, *supra* note 102, at 7-8.

> The new directive will not, however, change the position of profits distributed by companies resident in the United Kingdom or in the Republic of Ireland to parent companies in other member states. This is because the United Kingdom and Ireland do not impose any dividend withholding taxes. The advance corporation taxes imposed in those two countries on the distribution of dividends are not withholding taxes; indeed, [under article 7(1)] the directive specifically excludes such taxes from its application. Similarly excluded is the French equalization tax.

Id.

123. *See* INTERNATIONAL TAX HANDBOOK 1990, at 625-32 (Horwath International 1990); Maskall & Cussons, *supra* note 15, at 3, 18.

124. Tomsett, *supra* note 102, at 7.

125. Parent-Subsidiary Directive, *supra* note 22, art. 6.

126. *Taxation of Parent Companies and Subsidiaries*, *supra* note 103, ¶ 3215.17. Under article 7(1) the term "'withholding tax' [does] not cover "an advance payment or prepayment . . . of corporation tax to the Member State of the subsidiary which is made in connection with a distribution of profits to its parent company." Parent-Subsidiary Directive, *supra* note 22, art. 7(1).

127. Parent-Subsidiary Directive, *supra* note 22, art. 8(1).

128. *See generally Ministers Approve Three Directives to Eliminate Risk of Double Taxation, 1992-The External Impact of European Unification*, Daily Tax Rep. (BNA) No. 6, at G-1.

129. *See* Parent-Subsidiary Directive, *supra* note 22, art. 5(2).

130. *See id.* art. 5(3); *see Agreement on Three Directives*, *supra* note 3, at 21; *Taxation of Parent Companies and Subsidiaries*, *supra* note 103, ¶ 3215.15.

131. Parent-Subsidiary Directive, *supra* note 22, art. 5(4).

Directive for an indefinite period. As long as Greece does not levy corporate taxes on distributed profits, it may continue to levy a withholding tax on profits distributed to parent companies of other Member States.[132] Second, Germany is allowed, under article 5(3), to impose a "compensatory withholding tax of five percent on profits distributed by its subsidiary companies," for a transitional period up to 1996, "as long as it charges corporation tax on distributed profits at a rate of at least 11 [percentage] points lower than the rate applicable to retained profits."[133] As mentioned above, Germany had blocked the adoption of the three-point taxation package since 1984 because of a dispute with the Netherlands concerning the Parent-Subsidiary Directive and specifically regarding what level of withholding tax Germany could charge a subsidiary during a transition period.[134] In order to obtain Germany's approval of the package, the Finance Ministers of the EC Member States agreed to this exception with respect to Germany.[135] Thirdly, due to the structure of the Portuguese economy, "in which most of the transnational companies are subsidiaries and not parents, implementation of the [Parent-Subsidiary] [D]irective [would] entail a major loss of revenue for [that] country."[136] As a result, under article 5(4), Portugal "may levy a withholding tax on profits distributed by its subsidiaries to parent companies of other Member States" for an eight-year period, with a possibility of extending this exception beyond that date.[137] The rate of

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132. Greece has a unique corporate tax system within the EC in that it allows dividend distributions to be deducted from taxable income in computing corporate income tax but then imposes a heavy withholding tax on the dividend distributions at rates comparable to the corporate income tax. Accordingly, the dividend withholding tax effectively represents the corporate income tax on distributed profits.

Tomsett, *supra* note 102, at 7-8.

133. Germany has an unusual corporate tax system in that there is a substantial difference between the tax rate of corporate income tax charged on distributed profits (36%) and the rate charged on undistributed profits (50%). Traditionally, Germany has tended to maintain high rates of dividend withholding taxes under its double tax treaties on dividends paid by a German subsidiary to a foreign parent company. These high rates are intended to discourage foreign parent companies from stripping the maximum possible profits out of their German subsidiary companies in order to maximize the proportion of profits that enjoy the lower rate of corporate income tax. Tomsett, *supra* note 102, at 7-8.

134. For a complete release of this dispute, see *Germany Remains Principal Obstacle to EC Company Tax Package*, WORLD TAX REP., Apr. 1989, at 83 [hereinafter *Germany Remains Principal Obstacle*].

135. *EC Council Approves Package*, *supra* note 6.

136. *Id.*

137. The Directive provides that "[b]efore the end of the eight year the Council shall decide

the Portuguese withholding tax, however, may not exceed fifteen percent initially and ten percent ultimately, "subject to the existing bilateral agreements concluded between Portugal and a Member State."[138]

Finally, a question is raised about what the function of EC holding companies will be when this Directive is implemented:

> Initially it may seem as if the role of holding companies within the EC will be much reduced, as the favorable double tax treaties of countries such as the Netherlands and Denmark will from 1 January 1992 no longer be important for minimizing withholding taxes on dividend flows within the EC. After that date, the parent/subsidiary directive should result in the minimum dividend withholding tax rates being applied to such dividend flows, provided that the parent has a participation of at least 25% in its subsidiary company. Holding companies may nonetheless still be of use when they are located in countries that provide protection from tax on capital gains arising from future disposal of subsidiary and associated companies. Indeed, in combination with the parent/subsidiary directive, such holding company structures may, in appropriate circumstances, provide a more favorable overall tax position than was available previously.[139]

IV. The Transfer Pricing Convention[140]

A. Purpose

This Convention is designed to avoid corporate double taxation arising from transfers of profits between associated enterprises. Until it comes into effect, difficulties can arise when one Member State, under its inter-company transfer pricing rules, increases the taxable profits of an enterprise. This leads to double taxation if the country of the other enterprise involved does not reduce that enterprise's taxable income

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unanimously, on a proposal from the Commission, on a possible extension of [this deviation to comply with this Directive]." Parent-Subsidiary Directive, *supra* note 22, art. 5.

138. *Id.* 5(4).

139. Tomsett, *supra* note 102, at 7, 10.

140. Transfer Pricing Convention, *supra* note 23, at 19. *See generally* Johnathan S. Schwarz, *Transfer Pricing European Style*, 2 J. INT'L TAX. 120 (1991); John Turro, *EC Arbitration Treaty to Provide Solution to Transfer Pricing Disputes*, 3 TAX NOTES INT'L 479 (1991); Thommes, *The Arbitration Procedure Convention*, WORLD TAX NEWS, Dec. 1990, at 10.

correspondingly.[141] Until now, these adjustments could only be made on the basis of bilateral-double-taxation treaties.[142] But such treaties merely contain an obligation to enter into negotiations.[143] They do not prescribe an absolute obligation to eliminate the double taxation, nor do they set a time limit for the negotiation procedure.[144] As a result, "[t]his has not proved satisfactory in many cases because of the difficulty of obtaining agreement between the tax authorities involved."[145]

The Transfer Pricing Convention establishes a non-judicial procedure to overcome these problems because "this double taxation is likely to cause distortions in the conditions of competition and in capital movements and therefore to affect the operation of the common market."[146] Of course, the Transfer Pricing Convention will not affect "the fulfillment of wider obligations with respect to the elimination of double taxation in the case of an adjustment of profits of associated enterprises resulting either from other conventions . . . or from the domestic law of the Contracting States."[147]

B. Content

Under the Convention, transfer pricing is governed by both of the arm's-length principles which are based on article 9 of the 1977 Organization for Economic Cooperation and Development ("OECD") Model Double Taxation Convention on Income and on Capital:[148]

1. If conditions are made between related enterprises[149] in their

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141. *Agreement on Three Directives*, *supra* note 3, at 21.

142. *Id.*

143. Thommes, *supra* note 140. "These treaties generally contain a mutual agreement provision, corresponding to article 25 of the [OECD] model treaty." *Id.*

144. *Id.*

145. *Agreement on Three Directives*, *supra* note 3, at 21.

146. The preamble to the proposal on the elimination of double taxation in connection with the adjustment of transfers of profits between associated enterprises (arbitration procedure). 1976 O.J. (C 301) 4.

147. Transfer Pricing Convention, *supra* note 23, art. 15.

148. I TAX TREATIES (P-H) ¶ 1017 (1989) [hereinafter TAX TREATIES].

149. According to the Convention, enterprises are related when "(a) an enterprise of a [Member] State participates directly or indirectly in the management, control or capital of an enterprise of another [Member] State, or (b) the same persons participate, directly or indirectly, in the management, control or capital of enterprises of [different Member States]." Transfer Pricing Convention, *supra* note 23, art. 4(1). It was agreed that the provisions of article 4 shall cover both cases where a transaction is carried out directly between two legally

> commercial or financial relations, which differ from those which would be made between independent enterprises, then any profits which would have accrued to one of the related enterprises, but by reason of said conditions, have not so accrued, *may* be included in the profits of that enterprise and taxed accordingly.[150]
>
> 2. If an enterprise of a Member State carries on business in another Member State through a permanent establishment, then, the profits which that establishment might be expected to make, if it would deal independently with the enterprise of which it is a permanent establishment, shall be attributed to that permanent establishment.[151]

The Transfer Pricing Convention does not contain any further substantive transfer pricing rules.[152] It merely sets out the procedure to be followed in case double taxation arises as a result of transfer pricing adjustments by national tax authorities. However, the obligation "for Member States to agree on transfer-pricing disputes presented to their tax authorities may in the long term bring about common substantive standards on [transfer pricing]."[153]

If a Member State intends to adjust the profits of an enterprise in accordance with the Convention, it has to inform the enterprise of the intended action in due time.[154] That enterprise is then given the opportunity to inform the other enterprise involved, so that the latter may inform the Member State in which it is situated.[155] The first Member State may, nevertheless, make the proposed adjustment.[156] If the two enterprises and the other Member State agree to the adjustment, neither article 6 (mutual agreement procedure) nor article 7 (arbitration procedure) apply.[157]

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distinct enterprises as well as cases where a transaction is carried out between one of the enterprises and the permanent establishment of the other enterprise situated in a third country (Declaration on article 4, annexed to the Convention). *Id.* art. 4.

150. *Id.* art. 4(1) (emphasis added).

151. *Id.* art. 4(2).

152. Thommes, *supra* note 140, at 10-11.

153. *Id.*

154. Transfer Pricing Convention, *supra* note 23, art. 5.

155. *Id.*

156. *Id.*

157. *Id.*

If, however, an enterprise considers that the arm's-length principles of the Convention have not been respected, it may initiate a mutual agreement procedure of article 6.[158] Apparently, only an effected enterprise, and not a Member State, can initiate this procedure;[159] however, the Member States can always advance their arguments in informal negotiations.[160] On the basis of article 25 of the OECD Model Double Taxation Convention, article 6 provides:

> 1. Where an enterprise considers that . . . the principles set out in article 4 have not been observed, it may, irrespective of the remedies provided by the domestic law of the [Member States] concerned, present its case to the competent authority[161] of the [Member State] of which it is an enterprise or in which its permanent establishment is situated. The case must be presented within three years of the first notification of the action which results or is likely to result in double taxation . . . .
>
> 2. If the complaint appears to be well-founded and if it is not itself able to arrive at a satisfactory solution, the competent authority shall endeavor to resolve the case by mutual agreement with the competent authority of any other [Member State] concerned, with a view to the elimination of double taxation on the basis of the principles set out in article 4 . . . .[162]

If a mutual agreement is not reached within two years,[163] an advisory commission will be set up to deliver its opinion on the elimination of the double taxation in question.[164] This advisory commission shall consist of two representatives of the relevant authorities of the two states involved, together with an even number of independent experts, appointed either by mutual agreement or by lot, and a chairman so that an uneven number of members is reached.[165]

158. *Id.* art. 6.

159. *See id.* art. 6(1).

160. *Id.* arts. 5(3), 6(2).

161. *Id.* art. 3 (defines the competent authority of each Member State).

162. *Id.* art. 6.

163. Under article 7(1), this period has to be computed from "the date on which the case was first submitted to one of the competent authorities in accordance with article 6(1)." Transfer Pricing Convention, *supra* note 23, art. 7(1).

164. *Id.*

165. *Id.* art. 9 (concerns the composition of the advisory commission); *see Corporate*

The procedural rules that apply to the advisory commission are lax because of the commercial nature of the subject matter. The enterprises concerned have the option of appearing or being represented before the commission.[166] They may "provide [any] information, evidence or documents which seem to them likely to be of use to the advisory commission in reaching a decision."[167] Subject to a few exceptions,[168] only the enterprises and the competent authority of the Member States involved shall "give effect to any request made by the advisory commission to provide information, evidence or documents."[169] The advisory commission has to reach a decision, by a simple majority,[170] within six months[171] and it must be based on the two basic arm's-length principles of article 4.[172] The costs of the procedure is to be shared equally by the Member States concerned.[173] Furthermore, the Convention provides for the adoption of additional procedural rules by the competent authorities of the Member States involved.[174]

Nonetheless, the decision of the advisory commission is not binding. According to article 12(1), the Member States involved have to make a final decision themselves. The final decision is to be based on the principles of article 4 and on the advisory opinion. But the Member States involved may make a decision which deviates from the advisory commission's opinion.[175] The reason the Convention provides for this "additional consultation between the countries involved after the

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Taxation Measures Published, *supra* note 69, at 1-2.

166. Transfer Pricing Convention, *supra* note 23, art. 10(2).

167. *Id.* art. 10(1).

168. *Id.* art. 10(1)(a) (administrative measures contrary to domestic law or normal administrative practice); *Id.* art. 10(1)(b) (supply information which is not obtainable under domestic law or normal administrative practice); *Id.* art. 10(1)(c) (disclosure of trade secrets and the like and disclosure contrary to public policy).

169. *Id.* art. 10(1).

170. *Id.* art. 11(2).

171. *Id.* art. 11(1).

172. *Id.* art. 11(1).

173. *Id.* art. 11(3). Article 11(3) makes an exception, of course, for the costs incurred by the associated enterprises. *Id.*

174. *Id.* art. 11(2).

175. *Id.* art. 12(1). *But see* Proposal for a Council Directive on the Elimination of Double Taxation, art. 3(1), 1976 O.J. (C 301) 4. Article 3(1) provides that "[i]f, in applying [the mutual agreement procedure], the tax authorities concerned fail to reach an agreement that eliminates the double taxation, they shall present the case to a commission, *whose decision they shall agree from the outset to accept.*" *Id.* (emphasis added). This implied, however, that the Member States could refuse, at the outset, to comply with the decision. *Id.*

commission has issued its opinion" is that "Member States were not prepared to subject themselves automatically to the decision of a commission with powers to arbitrate."[176] If the Member States fail to reach an agreement, however, they shall be bound to act in accordance with the advisory opinion.[177] It is only in this sense that this Convention is a true "arbitration" convention.

Overall this Convention creates two "hard"[178] obligations:[179] (1) the Member States have to eliminate the existing double taxation[180] through the mutual agreement procedure, or otherwise through the arbitration procedure; and (2) the Member States have to conclude the case within three years. On the other hand, Member States and enterprises retain certain rights: (1) enterprises may have recourse to available domestic remedies;[181] and (2) the submission of the case to an advisory commission shall bar a member state from initiating or continuing judicial or administrative proceedings after the submission of the case to the advisory commission[182]—subject to two exceptions:[183] (1) the case need not be submitted to an advisory commission when the domestic law of a Member State involved does not allow it to derogate from the decisions of its judicial bodies;[184] and (2) a Member State is not obliged to initiate the mutual agreement procedure or to submit the case to an advisory commission if a final ruling under its domestic law holds one of the enterprises concerned liable for a serious penalty.[185]

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176. Thommes, *supra* note 140, at 10-11.

177. Transfer Pricing Convention, *supra* note 23, art. 12(1).

178. The question remains, of course, how to enforce these obligations as long as the EC Court of Justice has no jurisdiction to review the Convention's application.

179. Thommes, *supra* note 140, at 10-11.

180. According to the Convention, the double taxation of profits is deemed to be eliminated if either "(1) the profits are included in the computation of taxable profits in one State only or (2) the tax chargeable on those profits in one State is reduced by an amount equal to the tax chargeable on them in the other." Transfer Pricing Convention, *supra* note 23, art. 14.

181. *Id.* arts. 6(1), 7(1).

182. *Id.* art. 7(2).

183. *Id.* These exceptions are: (1) the associated enterprise of that Member State has allowed the time provided for appeal to expire; or (2) that enterprise has withdrawn any such appeal before a decision has been delivered. *Id.* art. 73.

184. Transfer Pricing Convention, *supra* note 23, art. 7(3).

185. Transfer Pricing Convention, *supra* note 23, arts. 8(1), 8(2). For the Member States' interpretations of "a serious penalty," see Transfer Pricing Convention, *supra* note 23, at 22-24. These interpretations "reveal a tendency to extend the concept of 'serious penalty' even to marginal infringements, such as the delayed submission of tax returns. The future will show whether these extended interpretations will considerably restrict the application of the

Although the Transfer Pricing Convention was initially embodied in a directive, the council, in the end, preferred the convention format.[186] Article 220 of the EEC Treaty endorses this method.[187] The approach chosen in no way modifies the substance of the measure.[188] It simply means that the advisory committee will lie outside the EC structure.[189] This implies that "the Commission will have no role in supervising the functioning of the [committee]"[190] or the application of the convention in general[191] and that companies will not be able to challenge its decisions before the EC Court of Justice.[192] Furthermore, unlike a directive, the convention will enter into force after it has been ratified by all Member States (or Contracting States).[193] It will run for an initial period of five years.[194] According to the Convention, the Member States will meet "six months before the [expiration] of that period . . . to decide [by unanimous vote] on the extension of [the] Convention . . . ."[195] Because a single transfer pricing case may easily take three years to decide, the five-year period seems too short.[196]

The Member States seemed to be very hesitant to adopt the rules of this convention. That is probably the reason they chose the convention format. Under the convention they still need ratification in the national parliaments, and they can review the convention after five years. If, however, in practice the convention proves successful, "it may be extended beyond the present five-year time limit" and the Member States

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convention." Thommes, *supra* note 140, at 10, 12.

186. *Council Reaches Agreement*, *supra* note 3, ¶ 95,505.

187. Article 220 reads, in part: "Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals . . . the abolition of double taxation within the Community . . ." EEC TREATY, *supra* note 4, art. 220.

188. *Council Reaches Agreement*, *supra* note 3, ¶ 95,505.

189. *EC Council Approves Package*, *supra* note 6.

190. *Id.*

191. Thommes, *supra* note 140, at 10, 12.

192. *EC Council Approves Package*, *supra* note 6. This could be overcome by a protocol to the Convention endowing the Court of Justice with the authority to interpret the Convention and to review the arbitration panel's decisions. A precedent for this approach is the EEC Convention of June 19, 1980 on the Law Applicable to Contractual Obligations which was supplemented by such a protocol of December 19, 1988, *reprinted in* RICHARD PLEUDER, EUROPEAN CONTRACTS CONVENTION—THE ROME CONVENTION ON THE CHOICE OF LAW FOR CONTRACTS 293 (1991).

193. Transfer Pricing Convention, *supra* note 23, arts. 17-18.

194. *Id.* art. 20.

195. *Id.*

196. *Id.*; Thommes, *supra* note 140, at 10, 12. Furthermore, "[n]o provision has been made for the settlement of cases still pending at the time the convention expires." *Id.*

may confer jurisdiction over the Convention on the EC Court of Justice.[197]

V. THE PROPOSED INTEREST AND ROYALTIES DIRECTIVE

The proposed Interest and Royalties Directive[198] will restrict Member States from imposing withholding taxes on interest and royalties ("I&R") paid between related parties (minimum holding of twenty-five percent).[199] Portugal and Greece, which are primarily importers of technology and capital and host countries of subsidiaries, have to abolish these withholding taxes gradually over a period of seven years.[200]

Unlike I&R payments within one Member State, at present, cross-border I&R payments are usually subject to withholding tax in the country of the payor,[201] except when bilateral double taxation treaties between Member States eliminate this withholding tax.[202] Since the country of the payee normally taxes I&R income, these payments are subject to double taxation. Clearly, this penalizes companies operating in different EC Member States through a parent-subsidiary corporate structure. Therefore, these withholding taxes will be abolished.

As a result, this tax measure furthers the establishment of parent-subsidiary combinations. In this sense, the proposed I&R Directive is a corollary of the Parent-Subsidiary Directive in that sense.[203] As such, the proposal is closely "modeled after the Parent-Subsidiary Directive . . . ."[204] This will facilitate the application of this proposed Directive in that companies can use the same administrative procedures and documents as those provided for in the framework of the Parent-Subsidiary

197. Thommes, *supra* note 140, at 10, 12.

198. *See generally* Jonathan S. Schwarz, *EC Directives Cover Cross-Border Income Flows*, 2 J. INT'L TAX. 180 (1991).

199. *Two Proposals*, *supra* note 26, at G-4.

200. Up to 10% during the first five years and up to five percent during the last two years. *Single Market Reality*, *supra* note 1, at 2.

201. *See* EC PRESS RELEASE NOV. 28, 1990, *supra* note 28, annex 1.

202. But even where bilateral double taxation treaties "between the various member states theoretically eliminate this double taxation, industry experts said that it is often very difficult to eliminate it in practice." *Corporate Tax Plan*, *supra* note 45, at 5.

203. The Interest and Royalties Directive "aims to extend to interest and royalty payments EEC legislation exempting withholding tax for transfers of dividends between parent companies and subsidiaries." *Two Proposals*, *supra* note 26.

204. *EC to Prepare Draft Interest Royalty Withholding Directive, Official Says*, Daily Tax Rep. (BNA) No. 202, at G-7.

Directive.[205] This measure may be extended later to other types of inter-company transactions as the internal market is further established.[206]

VI. THE PROPOSED CARRY-OVER OF LOSSES DIRECTIVE

To facilitate cross-border expansion of EC companies, the Commission has proposed a measure that would take into account the losses of permanent establishments and subsidiaries located in other Member States.[207] During the start-up phase, such transfrontier activities usually generate losses.[208] The proposed Carry-Over of Losses Directive "will have a positive effect on an undertaking's cash position, enabling it to bear start-up losses more easily."[209]

In case of a permanent establishment,[210] it would not be economically sound if the mere fact that a permanent establishment is separated from its head office by a frontier prevented the undertaking from deducting the losses incurred by the permanent establishment.[211] To solve this problem some Member States already allow foreign taxes to be taken into account through the imputation or tax credit method or through the deduction method with subsequent re-incorporation.[212] However, until now, there has been "little consistency in the way in which . . . business losses are dealt with across the [EC]."[213]

Therefore, the proposed Directive offers Member States a choice between these two methods. Under the first method, the imputation method, the result (gain or loss) of a permanent establishment is entirely

205. *Single Market Reality*, *supra* note 1.

206. *Id.* at 2.

207. *Id.* at 1, 3; *Full Text of the 1991 Proposed EC Directive to Allow Cross-Border Loss Deductions*, 4 TAX NOTES INT'L 884 (1992); *see Two Proposals*, *supra* note 26; BREALEY & QUIGLEY, *supra* note 7, at 222.

208. *Single Market Reality*, *supra* note 1, at 3.

209. *Id.* at 3.

210. The proposed Directive defines a permanent establishment in accordance with article 5 of the 1977 OECD Model Double Taxation Convention on Income and on Capital, *reprinted in* TAX TREATIES, *supra* note 148, ¶ 1017.

211. *Id.*; *Single Market Reality*, *supra* note 1, at 3.

212. *Single Market Reality*, *supra* note 1, at 3. For a brief explanation of the tax treatment of corporate losses in the different EC Member States, see EC PRESS RELEASE NOV. 28, 1990, *supra* note 28, annex 3-4. For an explanation of these methods, see infra annex 1, 2.

213. Cussons et al., *supra* note 11, at 14-15, 21. "Only five Member States allow any form of carry-back; while all Member States permit some period of carry-forward, only three impose no time limit and a five year limit is the norm." *Id.* at 15.

included in the result of its head office.[214] This ensures the carry-over of all losses of a permanent establishment.[215] To prevent double taxation of a permanent establishment's profits, a tax credit is accorded to the head office equal to the tax paid in the country of the permanent establishment.[216]

The second method, the deduction method with subsequent reintegration, exempts the profits of a permanent establishment in the country of its head office.[217] The losses, however, can be deducted from the profit of the head office.[218] To allow Member States to recover the ensuing reduction of their tax income, the directive for the reintegration of subsequent profits of the permanent establishment are reintegrated into the profits of the head office.[219]

In the case of subsidiaries, most Member States do not permit, even under international agreements, the carry-over of their losses if the subsidiaries are located abroad.[220] The Commission's proposal extends the application of the deduction method with subsequent reintegration to subsidiaries under certain conditions.[221] In fact, since the function of a subsidiary is economically akin to that of a permanent establishment,[222] it makes little sense to deny this advantage to subsidiaries.[223] But certain countries, such as Italy, are opposed to an extension of loss consolidation to subsidiaries.[224]

To prevent fraud, however, this measure would only apply to subsidiaries where the parent company owns seventy-five percent of its shares and the majority of its voting rights.[225] Nevertheless, Member

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214. *Propositions de Directives en Matière de Fiscalité des Entreprises*, EC PRESS RELEASE, (Brussels Press), Nov. 28, 1990, 1, 5 [hereinafter *Propositions de Directives*].

215. *Id.*

216. *Id.* For an example of this method, see *infra* annex 1, which is based on Fiche Technique 2, EC PRESS RELEASE, (Brussels Press), Nov. 28, 1990 [hereinafter Fiche Technique 2].

217. *Propositions de Directives*, *supra* note 214, at 1, 5.

218. *Id.*

219. *Id.* For an example of this method, see *infra* annex 2, which is based on Fiche Technique 2, *supra* note 216.

220. *See* EC PRESS RELEASE, *supra* note 28, annex 3-4.

221. *Id.*

222. *Id.* at 5-6.

223. *Id.* at 6.

224. *Corporate Tax Plan*, *supra* note 45, at 5.

225. *Id.*

States could reduce these thresholds[226] and further, would be allowed to extend the benefits of this proposed Directive to permanent establishments and subsidiaries located outside the EC.[227]

VII. CONCLUSION

The adoption of the corporate tax measures discussed in this article is an important step towards the abolition of fiscal borders within the EC and towards the establishment of the internal market by the end of 1992.[228] These measures affect national tax laws that penalize companies operating in several Member States, and, as a result, most instances of double taxation will be eliminated. Under the Merger Directive, cross-border mergers and reorganizations will no longer be taxed differently than purely domestic mergers and reorganizations. Under the Parent-Subsidiary Directive, the proposed Interest and Royalties Directive, and the proposed Carry-Over of Losses Directive, cross-border parent-subsidiary structures will not be treated differently in tax terms than purely domestic parent-subsidiary structures. Finally, under the Transfer Pricing Convention, Member States will eliminate any double taxation arising from transfer-pricing adjustments by national tax authorities.

Several issues, however, still need to be addressed.[229] First, there are no uniform transfer-pricing rules within the EC. Such rules are the ultimate means of preventing double taxation of cross-border transactions among related parties. Since the Transfer Pricing Convention was adopted quite hesitantly, it is doubtful whether an agreement on substantive transfer-pricing rules will be reached in the near future. Secondly, the EC Member States have different kinds of tax incentives to attract foreign investment.[230] This gives Member States an unequal opportunity to

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226. Fiche Technique 2, *supra* note 216.

227. *Id.*

228. *See generally*, *Scrivener Talks on Taxation, the Internal Market and the U.S.*, 653 Common Mkt. Rep. (CCH) 10 (1990); *see* Boudewijn Barre, *New Directions*, WORLD TAX NEWS, Dec. 1990, at 13; Karl M. Meessen, *Europe en Route to 1992: The Completion of the Internal Market and Its Impact on Non-Europeans*, 23 INT'L LAW. 359 (1989); Martin Bangemann, *Fortress Europe: The Myth*, 9 NW. J. OF INT'L L. & BUS. 480 (1989); Cockburn, *Complexity and Chaos: Effect of EEC Tax Harmonization in European Business Ventures*, 125 TAX'N 66 (1990); David M. Benson, *Europe 1992 and Corporate Taxes: A U.S. Perspective*, 19 TAX MGMT. INT'L J. 216 (1990); Eleanor Lewis & Mark Goldstein, *The Effect of EC 1992 on U.S. Companies: A U.S. Government Perspective (European Unification 1992: Implications for Europe and the U.S.)*, 3 TEMP. INT'L & COMP. L. J. 153 (1989).

229. *See* Barre, *supra* note 228, at 13-14.

230. *See* Maskall & Cussons, *supra* note 15, at 3, 12-15 (summarizes the various tax

attract investment.[231] These incentive programs, therefore, have to be standardized to some degree. If this happens, it is likely that the minimal incentives will become the standard[232] and would result in a general erosion of these benefits and a corresponding increase in tax costs for multinational groups operating in the EC.[233] Finally, discriminatory tax practices must be abolished. For example, foreign corporations' subsidiaries and branches should not be taxed differently.

It is undisputed that the business community will benefit substantially from the establishment of a true internal market within the EC. The most direct and immediate advantage to industry and commerce will be the considerable reduction of red tape. Goods and services will no longer bear the unnecessary cost of delay and bureaucracy. Harmonization of corporate taxation, for its part, is vital to the completion of the internal market. Corporate taxation, which is both less complicated and more standardized will be benefit all investors in the EC.

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incentives given by EC Member States).

231. *Id.* at 5.

232. *Id.* at 6.

233. *Id.* at 5. "This is gradually happening, e.g., the original rules for Belgium's co-ordination centres were modified so as not to provide too great an advantage to Belgium over other countries." *Id.*

Appendix: Taxation of the European Economic Interest Grouping and the European Company

Two other important developments concerning corporate taxation in the EC have taken place. They will be mentioned very briefly in this Appendix.

First, on July 1, 1989, the EC witnessed the birth of a new legal entity: the European Economic Interest Grouping ("EEIG").[234] The EEIG was created "to facilitate or to develop the economic activities of its members and to improve or to increase the results of those activities."[235] The main aim of the EEIG is thus

> to enable [its members] to develop their own particular activities and to increase profits by combining activities, resources or services. . . . Consequently, the EEIG must neither replace its members nor absorb their activities. It is an instrument for economic co-operation not for integration. [Also, the primary] purpose of the [EEIG] is not to make profits . . . the achievement of profits by the grouping itself is viewed as secondary and ancillary.[236]

Concerning the taxation of an EEIG, the EEIG Regulation provides that the profits or losses resulting from the EEIG's activities are deemed to be the profits or losses of its members and shall be apportioned among them and taxed according to the proportions laid down in the contract that creates the EEIG.[237]

Second, on August 25, 1989, the proposed Statute for a European Company was amended.[238] The European Company is referred to as "SE," which comes from the Latin term "Societas Europaea." The

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234. Council Regulation (EEC) 2137/85 of 25 July 1985 R.20.8.2 on the EEIG, 1985 O.J. (L 199) 1 (entered in effect on July 1, 1990) [hereinafter Council Regulation 21317/85]. For an extensive monograph on the EEIG, EUROPEAN ECONOMIC INTEREST GROUPINGS (K. Van Gerven & C. Aalders eds. 1990).

235. EEC European File, EEIG, Apr., 1989, at 3, quoted in *Taxation of European Economic Interest Groupings: The Inland Revenue Consultative Document*, 1 BRITISH TAX REV. 7 (1990).

236. *Id.* at 7-8.

237. Council Regulation 2137/85, *supra* note 234, at 6, 9.

238. Proposal for a Council Regulation on the Statute for a European Company, 1989 O.J. (C 263) 41 [hereinafter European Company Proposal].

Statute would allow transnational companies to be established under EC law, rather than national law. The statute is highly complex, however, and is unlikely to be agreed to for several years, if ever.[239] The creation of an SE has lost much of its purpose since such a company can, among other possibilities, also be created by merging companies of different Member States.[240]

Moreover, for tax matters, the SE would continue to be subject to the laws of each Member State in which it is located. The proposal tries to make the SE more attractive through a tax incentive. Indeed, the proposal provides that if the operations of permanent establishments of an SE in a Member State or in a non-Member State result in a net loss, "that loss may be set against the profits of the SE in the State where it is resident for tax purposes. Subsequent profits of the permanent establishments of the SE in another State shall constitute taxable income of the SE . . . up to the amount of the losses imputed."[241] Member States may, however, choose not to apply these principles if double taxation would be avoided "by allowing the SE to set the tax already paid by its permanent establishments against the tax due from it in respect of the profits realized by those permanent establishments."[242]

These are considerable tax advantages, but they will lose their specific attractiveness when these incentives are extended to all European companies on the basis of the Carry-Over of Losses Directive as discussed above.[243]

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239. *Germany Remains Principal Obstacle*, *supra* note 134, at 83.

240. *Tax Treatment*, *supra* note 63, ¶ 3213.01.

241. European Company Proposal, *supra* note 238, art. 133(1)-(2), 67-68.

242. *Id.* art. 133(4).

243. *Two Proposals*, *supra* note 26.

Annex 1: Functioning of the Imputation Method

Consolidated taxation of the Headoffice in Country A and the Permanent Establishment in Country B:

Headoffice in Country A (tax rate: 50%)		Taxation of the Permanent Establishment in Country B (tax rate: 40%)	
First Year:			
Profit:	100	Profit:	100
Total Profit from Countries A & B:	200		
Taxation of Profit of Headoffice:	50	Taxation by Country B:	40
Taxation of Profit of Permanent Establishment:	50		
Minus Taxes paid in B (imputation):	-40		
Supplementary Tax:	10		
Total Taxation in A:	60		
Total Worldwide Taxation in First Year:	100		
Second Year:			
Profit/(Loss):	100	Profit/(Loss):	(100)
Total Profit from Countries A & B:	0		
Total Taxation in Second Year:	0		
Third Year:			
Profit:	100	Profit/(Loss):	100
Total Profit from		(Carry-Over Loss):	(100)
Countries A & B:	200		
Taxation of Profit of Headoffice:	100	Taxation by Country B:	0
Minus Taxes paid in B (imputation):	0		
Total Taxation in Third Year:	100		
Total Taxation for Entire Period:	200		

Annex 2: Functioning of the Deduction Method with Subsequent Reintegration

Consolidated taxation of the Headoffice in Country A and the Permanent Establishment in Country B:

Unlike the imputation method in Annex 1, under the deduction method with subsequent reintegration, the profits of a permanent establishment are not taxed in Country A.

Headoffice in Country A (Tax rate: 50%)		Permanent Establishment in Country B (Tax rate: 40%)	
First Year:			
Profit	100	Profit:	100
Taxation of Profit of Headoffice	50	Taxation by Country B:	40
Total Taxation in First Year:	90		
Second Year:			
Profit/(Loss):	100	Profit/(Loss):	(100)
Taxable Profit after Imputation of Loss in B:	100	Taxable profit after Imputation of Loss in B:	(100)
Total Taxation in Second Year:	0	Total Taxation in Second Year:	0
Third Year:			
Profit:	100	Profit:	100
Reintegration of Profit of Permanent Establishment after Imputation of loss in Second Year:	100	Reintegration of Profit of Permanent Establishment after Imputation of loss in Second Year:	(100)
Total Profit:	200	Total Profit:	0
Taxation:	100	Taxation:	0
Total Taxation in Third Year:	100		
Total Taxation for Entire Period:	190		