Recent trends in corporate income tax

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Introduction

In Belgium – as in other European countries – corporate income tax is confronted by changes in the international environment. The advent of the global economy and the ensuing increase in capital mobility could lead to competition in terms of corporate income tax rates between countries aiming to attract direct investment and highly mobile profit flows. The corporate tax rate is actually a key point which firms consider when seeking an investment location (apart from such factors as the presence of a good infrastructure, labour and the proximity to raw materials and markets). That competition could cause erosion of the tax base in other countries, forcing them to cut their rates in turn. There are therefore fears that this will culminate in a "race to the bottom" for tax rates, with corporate profits taxed at rates which society considers too low, potentially obliging governments to cut worthwhile public expenditure or transfer the tax burden to other sources of revenue, such as labour or consumption.

This article aims to describe the changing international context as regards the tax burden on corporate profits and the way in which the Belgian public authorities are trying to respond. For this purpose, the article begins by discussing the various indicators which measure the tax burden on corporate profits. Next, it describes the recent international developments concerning rates of corporate income tax before analysing corporate taxation in Belgium, paying particular attention to the reforms made to this system. Another chapter will focus on the European coordination in the field of corporate income tax. Finally, it summarises the main conclusions.

(1) The authors would like to thank C. Valenduc for his comments.

1. Measuring the tax burden on corporate profits

It is useful to outline the indicators which will be used in this article to measure the tax burden on corporate profits. The literature on the subject of corporate taxation identifies various indicators which measure the tax burden, each presenting advantages and disadvantages. They complement one another, and a detailed analysis therefore entails using most of them.

1.1 Nominal standard rate

The best known yardstick is the nominal rate of corporate income tax, which is generally used for the purpose of international comparisons. This standard rate is the sum of the highest federal rate and any taxes levied at lower levels of government. Owing to its simplicity and availability, this rate plays a key role. It is a decisive factor in regard to the transfer of profits among the various entities belonging to a multinational company and based in various countries. Multinationals will in fact try to reduce the profits declared in countries with high nominal rates and transfer them to countries where nominal rates are low.

However, a survey of the highest nominal rates recorded in a number of countries provides only a partial picture of the true tax burden on companies. The reason is that the basis for levying corporate income tax may vary to a large extent from one country and company to another, owing to tax allowances, depreciation methods or the existence of preferential schemes, thus influencing the effective tax ratio. In addition, many countries (including Belgium) charge lower rates in certain cases.

Various other criteria have therefore been developed which try to provide a clearer picture of the effective tax ratio, taking account of the tax base. In this connection, a distinction can be made between criteria based on statistics and those based on parameters derived from the tax laws.

1.2 Implicit rates

Criteria based on statistics are generally called implicit rates. They indicate the tax burden imposed on corporate profits during a period in the past. They are highly diverse in terms of both the firms examined and the definition of the tax base. It is possible to calculate implicit rates on the basis of national accounts, annual accounts or tax returns.

In the case of implicit rates based on the national accounts, corporate income tax levied by governments is divided by a macroeconomic indicator corresponding as closely as possible to the tax base. This is often the sum of the net or gross operating surpluses of companies and an approximation of the financial result. This method has the advantage of using the most exhaustive statistics containing data on all companies, including quasi-corporations. It also takes account of all the characteristics of the tax system, such as tax expenditure or preferential schemes. However, it has the disadvantage that the macroeconomic base used may sometimes differ to a considerable extent from the basis on which the tax is actually calculated, e.g. because of the varying concepts used in regard to depreciation. The fact that these measurements are sensitive to the business cycle is another disadvantage. The operating surplus recorded in the national accounts is in fact the sum of corporate profits and losses. In periods of weak economic activity, the losses will be relatively larger, reducing the firm's total pre-tax income in the national accounts and pushing up the implicit rate calculated. To limit sensitivity to the business cycle, these rates are generally calculated in the form of averages over long periods.

The implicit rates calculated on the basis of the annual accounts do not have this last disadvantage since it is possible to identify the companies which are making a profit. These measurements are generally based on the individual sets of annual accounts, since that information is usually easy to obtain, unlike the consolidated annual accounts. This method could distort the implicit rate, since the dividends paid to the recipient company are included in the tax base, whereas they are largely tax free since the tax has already been charged to the company paying the dividends. This augments the tax base considered in the calculations, thus reducing the implicit rate.

Implicit rates can also be calculated on the basis of tax returns. These statistics cover all companies whose returns are processed within the specified time. It is also possible to divide the companies into those making a profit and those sustaining a loss, and to make adjustments for dividends received. However, comparable international data of this type do not exist.

1.3 Effective rates

The rates based on parameters of the tax laws are generally known as effective rates. These indicators take account of a number of important parameters specified by law, such as the nominal rate, the treatment of stocks, authorised methods of depreciation, any investment subsidies or allowances, the method of financing and the expected or required return. These rates are affected by the parameters considered. However, they have the advantage of being able to show the impact of taxation on new investment projects. For an investment with a given pre-tax return, the average effective rate indicates how much of that return has to be paid as taxes. The marginal effective rate shows the tax ratio applied to an investment which, after tax, generates only the minimum return required for proceeding with the investment.

2. International developments in corporate taxation

2.1 Overview of the current situation

The "old" Member States of the EU-15 still differ widely in terms of their maximum nominal rates of corporate income tax. In most countries, these rates range between 25 and 35 p.c. Germany and Italy charge the highest tax rate on corporate profits, with rates of 38.6 and 37.3 p.c. respectively in 2006. At the other end of the spectrum is Ireland, which has for some years now been adopting a favourable taxation strategy, with a rate which currently stands at 12.5 p.c. Apart from the Scandinavian countries, where the rate has remained more or less unchanged in recent years, Portugal and Austria are at the lower end of the range, having cut their rates in 2004 and 2005 respectively [1]. Although the nominal rate cut applied in 2003 reduced Belgium's corporate income tax rate to 33.99 p.c., this rate is higher than the unweighted average rate for the EU-15 which stood at 29.5 p.c. in 2006.

(1) The relatively low rates of corporate income tax charged in the Scandinavian countries contrast with the relatively high charges on other bases of taxation such as consumption or labour.

The accession of ten new Member States to the European Union on 1 May 2004 greatly heightened the fears of stronger tax competition. The average rate in force in those new Member States, which was 20.6 p.c. in 2006, was in fact around 10 percentage points below the EU-15 average. Malta, which has a rate of 35 p.c., is clearly an exception. The situation in Cyprus is also remarkable since the nominal rate there is only 10 p.c., i.e. below the rate charged in Ireland. In the other new Member States the rate mainly varies between 15 and 25 p.c. In the case of Estonia, the rate concerns distributed profits, as there is a zero rate applicable to retained earnings.

The nominal rates of corporate income tax charged in Europe are low compared to those charged elsewhere in the world. In the United States and Japan, the nominal rate came to around 40 p.c. in 2006, ten percentage points higher than the average rate in the EU-15 and also higher than the rates in force in each of the Member States. Like a number of European countries, the United States and Japan apply a system of imputation, i.e. multinationals are taxed in their own country on the whole of their profits, wherever they are made [1]. However, the companies may obtain a tax credit for taxes paid in other countries.

Comparison of the implicit rates for the period 1999-2004 based on the national accounts reveals that the Belgian rate more or less corresponds to the average for the EU-15 countries for which data are available. The implicit rates therefore present a picture which differs slightly from that offered by the nominal rates. That is due mainly to the existence of the Belgian system for coordination centres which enjoy substantial tax concessions. In contrast, the Scandinavian countries which charge low nominal rates have implicit rates which equal or exceed that average, as the low nominal rates in force in those countries are accompanied by extensive tax bases with few allowances.

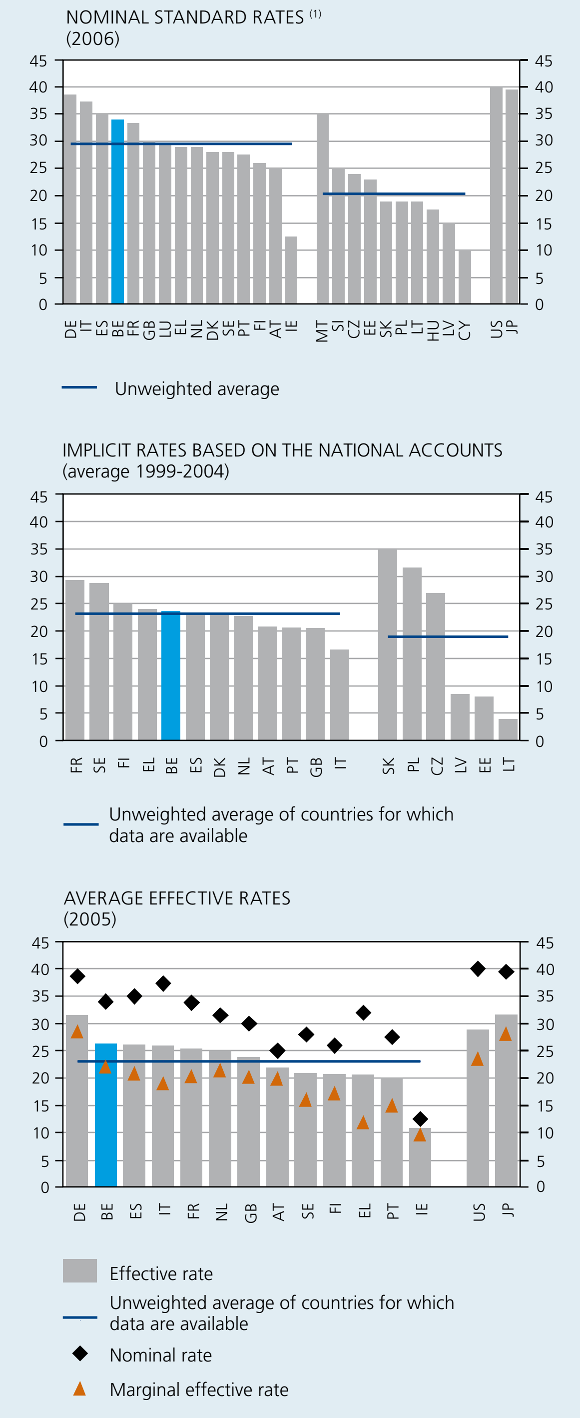
The data on average effective rates are published by the Institute for Fiscal Studies (IFS) [2]. These measurements are not exhaustive, since they only take account of the impact of the main tax rules; however, they do provide some idea of the complex laws. In 2005, all the average effective rates were below the nominal rates, which means that all countries grant tax concessions, e.g. in the form of accelerated depreciation. The ranking of the countries largely

(1) Profits made in other countries are not generally taxed unless the dividends are repatriated; moreover, there are generally numerous exceptions.

(2) These calculations are based on large firms in manufacturing industry which are able to raise finance on the international capital market but which are not established in the form of companies enjoying preferential tax status and which invest in five different product categories according to three methods of financing (capital contribution, borrowing and self-financing). The pre-tax return on investment is 20 p.c.

CHART 1 INDICATORS OF THE TAX BURDEN ON CORPORATE PROFITS

(percentages)



Sources: EC, IFS.

(1) This is the highest marginal rate, including any taxes levied on corporate profits at local or regional level.

coincides with that based on the nominal standard rates. That is hardly surprising, since the nominal rate plays a greater role if the pre-tax profits are higher, because tax allowances are often limited to a fixed amount. In terms of the average effective rate, Belgium is among the countries with a relatively high rate, being in second place behind Germany. At 26.4 p.c., the Belgian rate is 3.3 percentage points higher than the average of the EU-15 countries for which data are available.

2.2 Recent developments

2.2.1 Decline in nominal rates

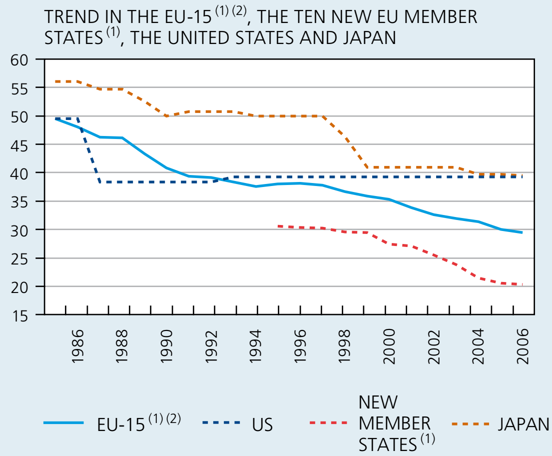
There is undeniably a downward trend in nominal rates of corporate income tax in Europe. However, that is not confined to the most recent period, as the average nominal rate of corporate income tax in the EU-15 has been falling practically continuously, from 49 p.c. in 1985 to just under 30 p.c. in 2006. The biggest reduction occurred between 1985 and 1995 : the rate dropped by over ten percentage points during that period to 38 p.c. Between 1995 and 2000, the average rate remained relatively constant, but in the past six years it has resumed its downward trend, falling to 29.5 p.c. In the ten new Member States, the rate has fallen even more sharply, dropping from 30.6 p.c. in 1995 to 20.3 p.c. in 2006. The United States and Japan have also cut their rates below their 1985 values. The last substantial reduction in Japan dates from 1999, whereas the last major reform in the United States already dates from 1987.

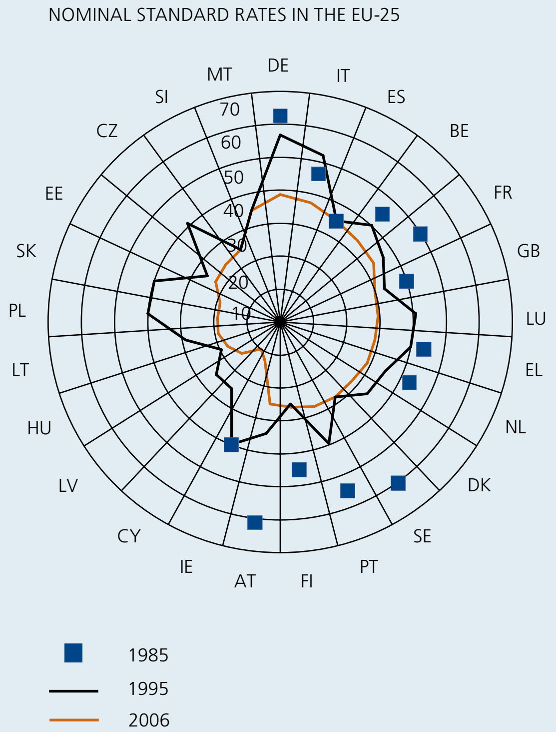
The decline in the average rate in the EU-25, down from 35 p.c. in 1995 to 25.8 p.c. in 2006, is not only due to the changes made in a few countries. Since 1995, the nominal rate of corporate income tax has in fact been cut on one or more occasions in almost all the European countries. Finland is the only country where, since 1995, the (low) rate applicable at the time has risen from 25 to 26 p.c. In Spain, Malta, Slovenia and Sweden, the nominal rate has remained constant. Between 2003 and 2005, no less than fourteen of the EU-25 Member States cut their rates. In almost all countries, the nominal standard rate is now at a level well below the 1995 figures, and those were themselves often much lower than in 1985. At that time, Sweden, Austria and Germany were still applying a rate of 60 p.c.

Furthermore, it is highly likely that the downward trend in nominal rates will persist in the near future. A number of countries have either already decided to cut the tax rate in the coming years, or draft laws to that effect are being circulated with government support. That applies

CHART 2 NOMINAL STANDARD RATES CHARGED ON CORPORATE PROFITS

(percentages)





Sources : EC, IFS.
(1) Unweighted average.
(2) Up to 1995, excluding Luxembourg and Denmark.

in particular in Germany, the Netherlands, the United Kingdom, Spain, Greece, Estonia, Slovenia and Lithuania. As a result of these changes, the current Belgian rate will probably soon be back among the highest rates in Europe. In the EU-25, only the Belgian, Italian and Maltese rates will exceed 30 p.c. and, unless new measures are taken, the difference between the Belgian rate and the average EU rate will widen once again.

2.2.2 No decline in revenues

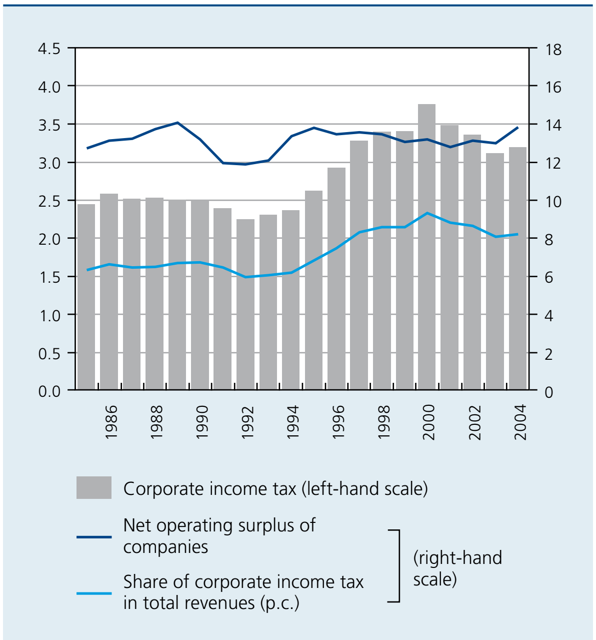
In recent decades, most of the European countries have cut their nominal rates of corporate income tax. The average nominal rate in the EU-15 has fallen by 19 percentage points since 1985. Nevertheless the real consequences of these cuts need to be qualified.

Despite this nominal rate cut, the average revenue generated by corporate income tax in relation to GDP has not declined in the EU-15. On the contrary, the revenue raised by this tax, which is of course influenced by the business cycle, has actually risen sharply since 1985.

That finding indicates the substantial expansion of the tax base during that period. However, on the basis of the available information on the net operating surplus, it is impossible to state that the movement in that surplus is the sole factor accounting for the rise in corporate tax revenues. That shows that the nominal rate cuts have also been accompanied by expansion of the base used to calculate corporate income tax. In practice, that may mean that compensatory measures have been taken, such as the abolition of tax relief or preferential schemes offering tax concessions. That information could also indicate that the measures to control tax avoidance and evasion have been intensified and become more successful. It also appears that the new rate reductions announced in certain EU countries will be accompanied by compensatory measures which will largely limit the cost to the budget.

CHART 3 TAX REVENUES AND TAX BASE IN THE EU-15

(percentages of GDP, unless otherwise stated)



Sources : EC, OECD.

Due to the decline in the rate of corporate income tax combined with the expansion of the tax base, corporate taxation has become more neutral, in that it causes less distortion in the allocation of resources, an aspect which is to be encouraged with a view to economic efficiency.

3. Corporate taxation in Belgium

3.1 Characteristics of corporate income tax

As in other countries, the calculation of the corporate income tax payable in Belgium is a complex matter. Tax is charged on the basis of the book profits or losses. However, these have to be adjusted in various respects, e.g. to take account of foreign profits, non-taxable components, dividends on shares in other companies (by the deduction for participation exemption), previous losses and the investment allowance [1].

The standard tax rate applied to the tax base thus defined is currently 33 p.c. Owing to the complementary crisis contribution of 3 p.c. payable on that tax, the highest nominal rate is in fact 33.99 p.c. Under certain conditions, reduced rates may apply to SMEs.

Apart from this general system of corporate income tax, Belgium also has a series of exceptional schemes, the main ones being those applicable to coordination centres [2] – scheduled for abolition at the end of 2010 – and to mutual funds with fixed or variable capital (SICAFs and SICAVs).

(1) For a detailed explanation of the method of calculation used, see the Tax Survey (Deloddere *et al.*, 2006).

(2) A coordination centre must belong to an international group with consolidated capital of at least 24 million euro and consolidated annual turnover of at least 240 million euro. The foreign equity capital must be a minimum of 12 million euro or 20 p.c. of the group's consolidated foreign equity. After two years, a coordination centre must employ at least ten full-time staff. Since 1993, a coordination centre has had to pay tax of 10,000 euro per full-time worker per annum. The profits which coordination centres make are tax free, but the standard rate of tax is charged on a percentage (generally 8 p.c.) of part of their operating expenses. Those expenses are calculated exclusive of staff costs or financial expenses. Apart from this advantageous definition of the tax base, coordination centres are exempt from the withholding tax on property incomes and the withholding tax on income from movable assets in respect of dividends paid to their shareholders or the interest paid to their creditors. As a result of these tax concessions, the implicit tax rate applied to coordination centre profits is around 1 to 2 p.c.

3.2 Components of corporate income tax

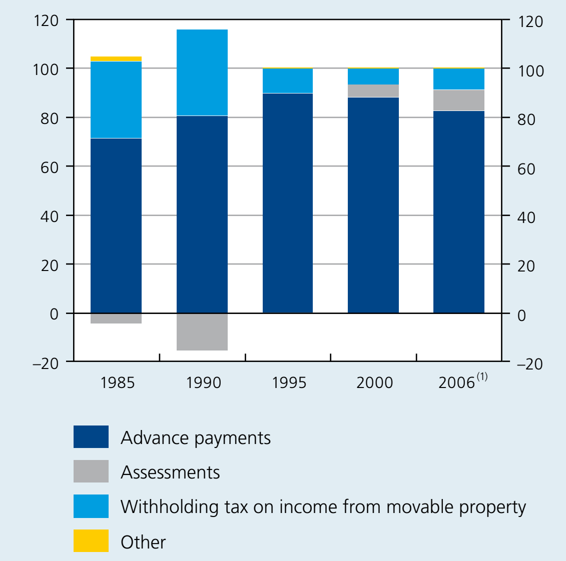
In Belgium, corporate income tax receipts comprise three main components: advance payments, withholding tax on income from movable property, and assessments.

The major part of corporate income tax is paid in the form of advance payments effected by firms at set intervals during the year. If the firms' advance payments are insufficient, they are subject to a substantial tax surcharge. In 2006, advance payments represented 82.7 p.c. of the total corporate income tax levied by the government.

The withholding tax which companies pay on income from movable property is a genuine advance deduction, in contrast to that payable by individuals which constitutes payment in full discharge. That withholding tax represented 8.8 p.c. of corporate income tax in 2006. However, in 1985 that figure was as high as 31.2 p.c. This sharp decline is due to the reduction – from 25 to 10 p.c. – in the rate of the withholding tax charged on new fixed-income financial assets in 1990 and the introduction of the directive on parent companies and subsidiaries on 23 July 1990, which stipulates that dividend payments effected by a subsidiary to its parent company are exempt from the withholding tax under certain conditions.

CHART 4 COMPONENTS OF CORPORATE INCOME TAX

(percentages of total corporate income tax)

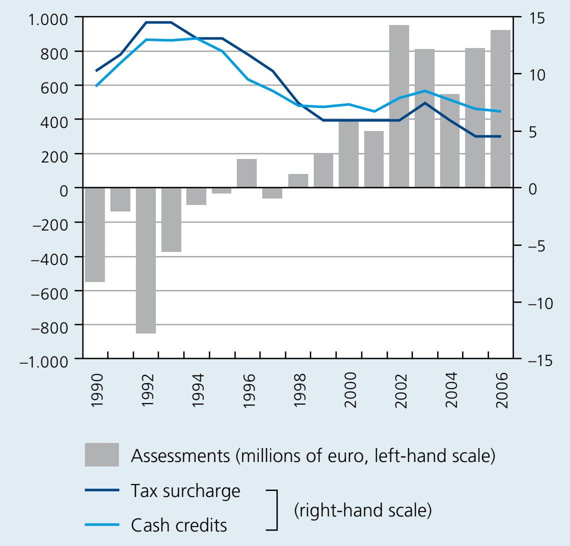


Sources: NAI, NBB.

(1) For 2006, the assessments have been adjusted for the accelerated rate of collection.

CHART 5 CORPORATE INCOME TAX ASSESSMENTS AND SURCHARGE RATES [1]

(percentages, unless otherwise stated)



Sources: NAI, FPS Finance, NBB.

(1) For 2006, the assessments have been adjusted for the accelerated rate of collection.

The final corporate income tax bill is settled via the assessments. If the amount of tax ultimately due is higher or lower than the sum of the advance payments and the withholding tax paid, the difference is settled in the form of a tax refund (in the case of negative assessments) or supplement (in the case of positive assessments). In 2006, net assessments generated government revenue totalling 8.4 p.c. of corporate income tax [1]. That outcome is in sharp contrast to the situation in the early 1990s when the assessments were decidedly negative. The main reason for this change is that, before the introduction of the directive on parent companies and subsidiaries on 23 July 1990, certain firms – mainly active in the financial sector – were paying a substantial withholding tax on amounts which had already been taxed and were exempt when the tax was calculated by the systems designed to prevent double taxation. Moreover, for companies lacking adequate liquidity, it has become less attractive to obtain a short-term loan from a bank and effect advance payments in order to avoid the tax surcharge. The decline in short-term interest rates has in fact led to a marked reduction in the rate of the tax surcharge, whereas the average

(1) For 2006, the assessments have been adjusted for the accelerated rate of collection.

interest rate applied to cash credits has also fallen, though to a much smaller degree [1].

3.3 Recent tax reforms

The highest nominal tax rate on corporate profits has also fallen sharply in Belgium in recent decades. In 1983 it was cut from 48 to 45 p.c., putting it slightly below the EU-15 average. However, in the ensuing period the average rate in the EU-15 was reduced far more rapidly than the Belgian rate, even though the Belgian rate was cut further in 1987 and during the period 1990-1991 [2], causing a gap which persisted throughout the 1990s. However, after 2000 that gap widened to 7 percentage points owing to further cuts by some EU-15 members. Since then, Belgium has implemented two corporate income tax reforms within a short space of time. The main objectives of these reforms were to narrow the gap in relation to other European countries and make Belgium more attractive to potential investors.

The corporate income tax reform which took effect on 1 January 2003 greatly reduced the nominal tax rates on corporate profits in Belgium [3]. The standard rate dropped from 40.17 to 33.99 p.c. (including a 3 p.c. complementary crisis contribution), and the reduced rates for SMEs were also cut. In addition, this reform provided for exemption in the case of profits which SMEs reserved for investment.

However, since this reform had to be introduced in a framework which was neutral for the budget, several compensatory measures were adopted. Thus, the rules on depreciation were modified, the conditions for applying the deduction for participation exemption were tightened up, and the liquidation bonuses applicable to a company's repurchase of its own shares or the apportionment of all or part of the company's assets are now subject to a 10 p.c. withholding tax. On the basis of an *ex post* analysis, the Court of Auditors considered it almost certain that the impact of this reform on the budget was at least neutral (Court of Auditors, 2005).

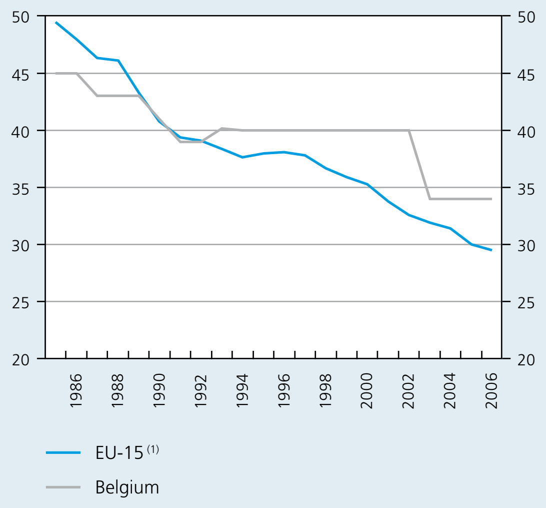
This reform considerably reduced the gap in relation to the average nominal rate in the EU-15. However, following recent rate cuts in a number of countries, the difference between the Belgian standard rate and the EU-15 average has once again widened to around 4 to 5 percentage points. In all probability, that differential will continue to grow in the coming years, unless the Belgian government adopts new measures.

Despite the steep reduction in the nominal rate in 2003, a further reform was quite soon seen to be needed. Rather than cutting the nominal rate again, it was decided to introduce a tax allowance for venture capital in the 2007 tax year (2006 income). This measure is better known as the "notional interest deduction". It was also decided to abolish the 0.5 p.c. registration fees for contributions to companies [4].

The venture capital allowance was introduced in order to reduce the differences of treatment between debt financing and equity financing. In contrast to interest which, in principle, is tax deductible and is thus not included in the tax base of a company, profits are an integral part of the tax base and are therefore taxed.

CHART 6 NOMINAL STANDARD RATE IN BELGIUM AND IN THE EU-15

(percentages)



Sources: EC, IFS, NBB.
(1) Unweighted average; excluding Luxembourg and Denmark up to 1995.

(1) The basic interest rate used in calculating the tax surcharge is the marginal borrowing rate applied by the ECB in the penultimate year preceding the tax year concerned. That interest rate is multiplied by an average factor of 2.25. Thus, for the 2006 tax year, the tax surcharge comes to 6.75 p.c. of the underlying shortfall; since the time elapsing between the advance payments and the assessments averages about 18 months, this gives a tax surcharge of 4.45 p.c. on an annual basis.
(2) The rate only increased in 1993 following the introduction of the 3 p.c. complementary crisis contribution charged on the rate of 39 p.c. applicable at the time.
(3) The law of 24 December 2002 amending the rules on companies in regard to tax on income and establishing a system of prior decisions on tax matters.
(4) The law of 22 June 2005 introducing a tax allowance for venture capital.

In practice, the new allowance is calculated as notional interest on the adjusted equity capital [1], which is deducted from the tax base. The rate used to calculate the notional interest is equal to the average interest rate (published monthly by the Securities Regulation Fund) on ten-year linear bonds issued by the Belgian government, prevailing during the penultimate year preceding the tax year. The average interest rate for 2005, namely 3.442 p.c., is therefore used for the calculations performed in the 2007 tax year. However, the rate cannot exceed 6.5 p.c. and the annual change is capped at 1 percentage point. For SMEs, the basic rate is increased by 50 basis points. Also, SMEs can opt not to apply the notional interest deduction for venture capital and to continue using the old investment reserve system.

The venture capital allowance reduces the effective rate of corporate income tax. That reduction is dependent on the company's return on equity. Thus, in the case of a company achieving a return on equity of 5, 10 or 15 p.c. and subject to the nominal rate of 33.99 p.c., this allowance reduces the effective tax rate for the 2007 tax year to 10.6, 22.3 and 26.2 p.c. respectively, leaving aside other possible deduction items.

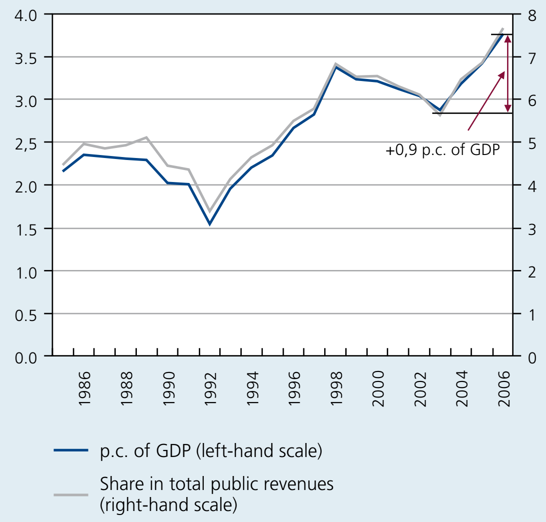
In order to offset the loss of revenue resulting from the introduction of the venture capital allowance and abolition of the registration fees for contributions to companies, various measures were adopted, the main one being the stricter definition of realised capital gains.

One of the aims of the venture capital allowance is to augment the business capital. Since the data on capital increases in 2006 indicate a very sharp rise, that objective seems to have been achieved. By introducing the venture capital allowance, the government also tried to offer a credible alternative to the coordination centres (that tax scheme is to be abolished by 2010) with a system conforming to the rules of European law.

3.4 Revenues generated by corporate income tax

In 2006, corporate tax revenues represented 3.8 p.c. of Belgium's GDP. That is a relatively small percentage compared to the taxes on wages (25.4 p.c. of GDP) and taxes on goods and services (11.5 p.c. of GDP). In 2006, corporate income tax represented about 7.7 p.c. of total public revenues. In 2006, both the corporate tax revenues and their share in public revenues were at their highest level for 35 years. It is also worth mentioning that these tax revenues have increased by no less than 0.9 p.c. of GDP since 2003.

CHART 7 REVENUES GENERATED BY CORPORATE INCOME TAX [1]



Sources : NAI, NBB.

(1) In 2006, the accelerated rate of collection augmented the assessments by 0.3 p.c. of GDP.

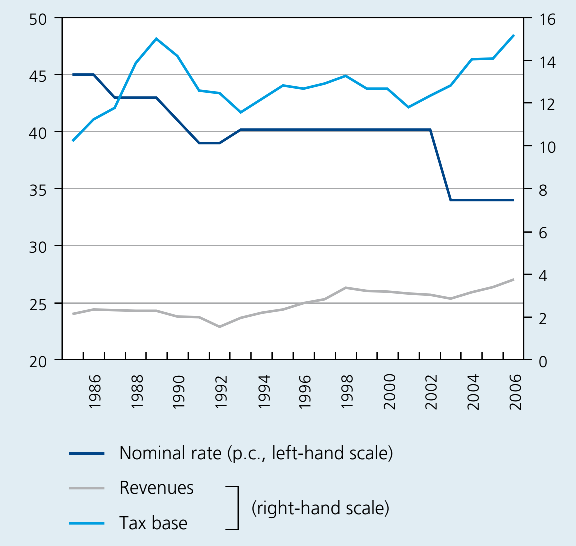
During the period 1985-1990, corporate income tax revenues fluctuated between 2.1 and 2.4 p.c. of GDP. The reduction in the nominal rate during that period was more than offset by the strong expansion of the approximate macroeconomic tax base [2]. While the nominal rate remained relatively constant between 1990 and 2003 and the approximate macroeconomic base declined slightly in the early 1990s, before hovering around a slightly lower level, Belgian corporate income tax revenues increased from 2.1 p.c. of GDP in 1990 to 2.9 p.c. of GDP in 2003. During the most recent period, revenues have continued to rise, despite the recent reforms reducing the effective rate.

These findings indicate that, since the early 1990s, various reductions and preferential schemes have been largely eliminated so that the effective tax burden on corporate profits has increased. Comparison of the movement in the various implicit rates shows that the implicit rate based on tax statistics and the Central Balance Sheet Office dropped to around 20 p.c. in 1989. The implicit rate based on tax returns and the national accounts increased up to the end of the 1990s, whereas the implicit rate based on

(1) The equity capital as shown on the balance sheet is adjusted in certain respects to prevent cascade effects and potential abuse.

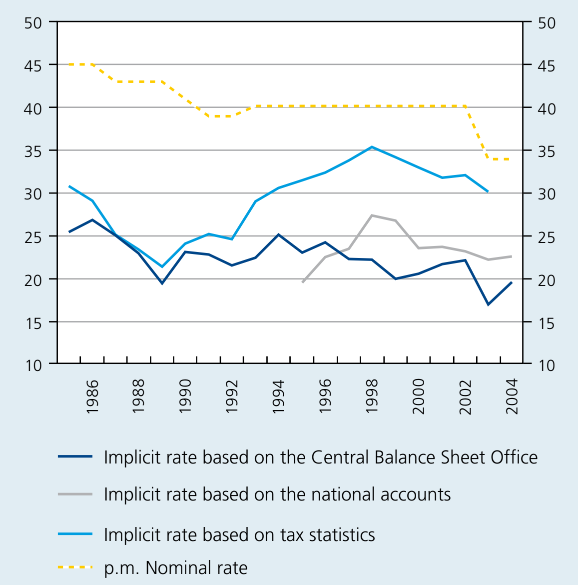
(2) This is estimated as the sum of the gross operating surplus and net interest received or paid, less depreciation. This is only an approximate tax base, and differs considerably from the base actually used to calculate the tax. The pre-1995 data were obtained by retropolation on the basis of older data, in the absence of these data in the new national accounts.

CHART 8 CORPORATE TAXATION: TAX BASE, TAX REVENUES AND NOMINAL STANDARD RATE
(percentages of GDP, unless otherwise stated)



Sources: NAI, NBB.

CHART 9 IMPLICIT RATES OF CORPORATE INCOME TAX
(percentages)



Sources: EC, FPS Finance, NAI, NBB.

the Central Balance Sheet Office annual accounts fluctuated around a constant level. This divergence is due to the increasing significance of the deduction of losses carried forward and the deduction of finally taxed incomes during this period. In the case of losses carried forward, it is not possible to make an adjustment on the basis of the Central Balance Sheet Office statistics, while only an approximate adjustment can be made to the figures for the deduction for participation exemption. In 2003, all indicators point to a reduction in the tax burden on corporate profits following the tax reform (1).

4. Corporate tax coordination in the EU

4.1 Tax competition versus tax coordination

The Member States of the European Union seem divided on the issue of whether tax harmonisation or coordination of corporate taxation is necessary, or whether tax competition is desirable, as the two options both have advantages and disadvantages.

Tax competition has the advantage of enabling Member States to retain their powers of taxation and hence their financing resources. In principle, the preferences of the national legislative authorities reflect the preferences of their own population better than those of a supranational legislative authority. Moreover, the Member States can use the tax, if so desired, as an instrument in their stabilisation policy. Also, some people consider tax competition to be a means of disciplining governments – which, by their nature, always want to spend more – by restricting the scope for levying taxes. It is thought that this would give them a strong incentive to operate more efficiently.

In the context of national strategies aimed at attracting investments and profits, tax coordination or total or partial harmonisation could prevent a "race to the bottom", which could put pressure on worthwhile public expenditure or cause taxation to shift towards less mobile sources of revenue. The tax rate might then cease to reflect the preference of a country's residents. Harmonisation or a high degree of coordination generates substantial efficiency gains for multinationals, which no longer have to comply with a number of tax systems. Moreover, the effective tax burden on companies will become much more transparent in the various Member States.

(1) This does not contrast with the neutral impact of this reform on the budget. A number of compensatory measures (such as those to combat tax evasion or the changing rules on depreciation) increase both the tax base and the taxes payable without affecting the methods of calculating the implicit rates described in this article.

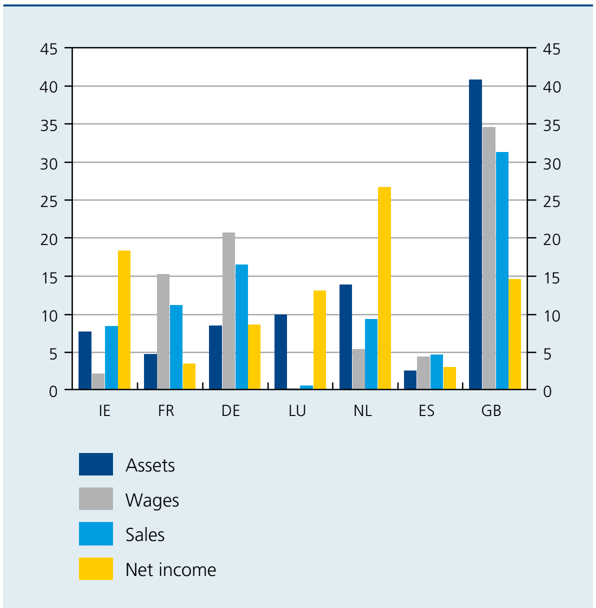
Examination of the literature reveals that, according to most studies, total harmonisation would enhance the community's prosperity, compared to the current situation. However, opinions are divided on whether these improvements in prosperity would be substantial or rather small, and on how they would be distributed among the various countries (Nicodème, 2006).

Tax competition will not occur unless a rate reduction triggers shifts in foreign direct investment or shifts in the bases of taxation. Econometric analysis has shown that it is primarily the effective rates that play a role in attracting foreign direct investment (De Mooij *et al*., 2006). Cuts in the effective rate can therefore be used to attract or retain foreign direct investment. Furthermore, empirical studies show that a reduction or increase in the nominal rate affects the reported profits of multinationals in a country, and hence also the tax revenues (Huizinga *et al*., 2006). Ways of shifting profits include the manipulation of transfer prices in respect of intra-group transactions, formulas for apportioning the subsidiaries' overheads (research and development, advertising, etc.), or the debt financing of subsidiaries based in countries with high tax rates.

Thus, a study of multinationals with their headquarters in the United States shows that the allocation of these firms' profits is largely influenced by tax considerations, since there is no real correlation between the activities which these firms pursue in various countries and the net operating result which they report there. High net incomes are reported in Ireland, Luxembourg and the Netherlands in comparison with the activities pursued there, while reported profits are low in Germany, the United Kingdom and France, even though these firms pursue significant activities there (Weiner, 2006a).

CHART 10 ALLOCATION OF PROFITS IN MULTINATIONALS WITH THEIR HEADQUARTERS IN THE UNITED STATES

(2003)



Source : Weiner (2006a).

As shown by the preceding chapters, the current downward trend in nominal rates of corporate income tax seems to point to a degree of tax competition between the European countries. However, the consequences of such competition ought to be qualified. Expressed as a percentage of GDP, corporate income tax revenues have in fact remained constant or even risen slightly. This is attributable to the expansion of the tax base. Apart from the effects of compensatory measures and, possibly, more efficient collection, the increase in the tax base could also be due to the decline in the nominal rates of corporate income tax. That decline has widened the difference in relation to marginal rates of personal income tax, making it more attractive to pursue certain activities in the form of a company. Companies are also less tempted to try to transfer profits to countries with lower tax rates.

Despite the steep fall in nominal rates in the EU, the difference between the highest and lowest rates in the EU-15 or in the ten new Member States has hardly changed in the past ten years. In both cases that difference was about 25 percentage points. The "agglomeration" theory tries to explain this phenomenon by stressing the importance of agglomerations, the proximity of markets, the presence of skilled staff, transport costs, infrastructure, etc. The presence of these factors appears to confer an advantage on central countries as opposed to peripheral countries, enabling them to charge a higher tax rate without prompting companies to relocate. That might explain why the central countries of the European Union charge higher rates of corporate income tax than the peripheral countries. Thus, large disparities could persist for a number of years between the centre of Europe and its periphery. However, the question is what would happen if a number of central countries were to make substantial cuts in their rates. In one of its reports, the French *Conseil d'analyse économique* estimates the sustainable differences in rates between the fifteen "old" Member States of the EU. According to that study, nominal rate differences in excess of 10 percentage points can be sustained between certain countries. This study also indicates that the rate differences could persist for a time, even though the equilibrium has become less stable owing to the much greater integration since 1995 (Gilbert *et al*., 2005).

4.2 Corporate tax coordination in the EU

In principle, like other direct taxes, corporate income tax falls entirely within the autonomous power of the EU Member States. Hence, the Member States are totally free to determine the stipulations of their own corporate income tax. However, the tax laws must respect the four basic freedoms of the EU Treaty (free movement of goods, persons, services and capital) and the restrictions on State aid. Multinationals active in Europe may therefore be confronted by twenty-seven different tax systems.

4.2.1 Attempts at harmonisation

Since the European Economic Community was created by the signing of the Treaty of Rome in 1957, some people have considered that the costs which businesses incur as a result of the various national legal systems are a major obstacle to the aims of European integration. Witness the virtually continuous activity of various committees of experts who have formulated proposals for the harmonisation of a number of crucial elements of the corporate income tax system, in particular in order to promote transparency and solve the double taxation problem.

Back in 1962, the Neumark Committee put forward suggestions for harmonising the national systems of corporate income tax by introducing a system of imputation with different rates for retained profits and distributed profits. Later, the Van den Tempel report (1970) proposed that all Member States should introduce a traditional system of company taxation, with a tax payable by both companies and shareholders at the time of the dividend distribution [1]. That report was followed by two resolutions in 1971 and 1972, in which the Ecofin Council endorsed the need for tax harmonisation. In 1975, spurred on by these developments, the European Commission formulated a proposal for a directive harmonising the corporate income tax rates, which were to range between 45 and 55 p.c., with a system of partial imputation for dividends. In this connection, the Commission had actually advocated a withholding tax of 25 p.c. on dividends. However, that proposal had been challenged by the European Parliament which considered that it was first necessary to harmonise the tax base [2]. Such plans for harmonisation of the tax base had been included in a 1988 proposal by the European Commission. However, owing to the strong opposition of a number of Member States, that proposal was never officially submitted to the Ecofin Council. The next harmonisation proposal dates from 1992, when the Ruding Report was published. This analysed the extent to which tax differentials influence the location of investments and distort competition. At the same time, minimum standards for the tax base had been proposed, as well as a minimum rate of 30 p.c. and a maximum of 40 p.c. These proposals were never taken up either.

Despite this large number of proposals, corporate income tax has never been harmonised in the EU. There are various reasons for this lack of success, the main one undeniably being that the Council has to be unanimous in approving such tax reforms. There is also a fundamental difference of opinion between the Member States which favour tax competition – represented mainly by the United Kingdom (and recently most of the new Member States as well) – and the majority of the "founding fathers" of the EU, among whom the Franco-German duo represents the driving force in the efforts to achieve tax harmonisation. In view of the reticence displayed by the Member States, the European Commission has since opted to proceed by a more pragmatic approach, with a number of specifically targeted measures which will be explained below.

4.2.2 Abolition of tax barriers for multinationals

Special tax barriers affecting cross-border economic activities, such as specific cases of double taxation, are regarded as a major obstacle to firms pursuing cross-border activities in the single market. In 1990, in order to eliminate these obstacles, the Ecofin Council approved two directives which entered into force in 1992. The mergers directive (90/434/EEC) aims to avoid the taxation of capital gains resulting from the restructuring of companies from different Member States. The directive on parent companies and subsidiaries (90/435/EEC) aims to eliminate the double taxation of profits distributed to parent companies in one Member State by subsidiaries established in another Member State.

4.2.3 Avoiding harmful tax competition

On 1 December 1997 the Ecofin Council reached agreement on "a package to tackle harmful tax competition in the European Union". That agreement comprised three elements, one of which concerns a code of conduct on harmful tax competition [3]. This package concerns tax measures specially designed to attract foreign firms or investors and reflected in a much lower level of taxation than that normally applied to the average firm in the country concerned. By this "code of conduct", the Member States agreed that existing harmful tax provisions would be abolished and that no new ones would be introduced.

(1) In a way, this proposal resulted from the Werner Report on economic and monetary union in Europe, which emphasises that tax harmonisation is necessary for the creation of a monetary union.

(2) The European Parliament did not express an opinion on this proposal, but merely produced an interim report in 1980.

(3) The other components of this "Monti package" concern tax on savings incomes and the abolition of the withholding tax on payments of interest and royalties between enterprises.

Following that decision, the "Primarolo" group was set up in 1998 (named after the then British State Financial Secretary to the Treasury) with the task of examining a list drawn up by the European Commission of tax regimes which could be called harmful. In this group's final report, dated November 1999, sixty-six harmful tax practices had been identified. For Belgium, the main one was the tax regime applicable to coordination centres.

Owing to that decision, the Belgian preferential tax regime applicable to such companies which conduct financial management for the other companies in an international group will be phased out. In 2000, the Ecofin Council classed the coordination centres regime as a harmful tax measure which must be abolished by 31 December 2005. In 2003, that Council stated that the coordination centres regime was incompatible with the rules on State aid, but that centres which came under that regime on 31 December 2000 could continue to make use of it until 31 December 2010. However, approvals expiring after 2005 could not be renewed. This provision was judged discriminatory and cancelled by the European Court of Justice on 22 June 2006.

4.2.4 Towards a single market without corporate income tax obstacles

The European Commission's current work on corporate taxation mainly follows on from the October 2001 report entitled "Towards an Internal Market without tax obstacles". That report was based on a European Commission study concerning "Company taxation in the Internal Market" analysing the effective rates in Europe, identifying various tax obstacles which hamper the efficient operation of the single market, and devising a number of solutions to eliminate those obstacles. The European Commission also deduced from that study – and continues to believe – that there is no sign of any real "race to the bottom", since the rate reductions are accompanied by compensatory measures, and tax revenues have remained stable. It therefore concludes that no action is required at present to harmonise the rates of corporate income tax or to introduce minimum rates.

In order to eliminate tax obstacles, a dual strategy was proposed comprising specific targeted measures for the short term accompanied by the launch of a debate with the long-term aim of achieving a harmonised tax base for companies pursuing cross-border activities in the EU.

The short-term strategy is intended to eliminate the obstacles identified by means of targeted measures. According to its November 2003 communication, the Commission has succeeded in implementing many of the targeted measures. Thus, the scope of the mergers directive and that of the directive on parent companies and subsidiaries has been extended. In 2005, a minimum stake of 25 p.c. was required for a subsidiary's dividends to qualify for exemption; that will be gradually reduced to 10 p.c. by 2009. In June 2003, the Ecofin Council approved the directive on the payment of interest and royalties which is intended to prevent tax obstacles in the case of cross-border interest and royalty payments within a group (1). The "Joint Transfer Pricing Forum" contributed to the publication, in June 2006, of a code of conduct which will standardise the documents required in the Member States, in order to reduce the transaction costs. Judgments passed by the European Court of Justice against one Member State in a case concerning a company also affect other Member States with similar legislation. The European Commission issues opinions on the way in which Member States should amend their legislation in order to achieve better harmonisation. Finally, a number of initiatives are also being examined, such as ways of allowing the offsetting of cross-border losses between enterprises and their permanent establishments, and an analysis is being conducted on the consequences for other EU Member States of bilateral treaties between countries (EC, 2003). These directives, decisions and judgments also have an influence on Belgian legislation, which sometimes has to be adapted.

However, the short-term strategy cannot solve all the problems, such as the high transaction costs for companies facing twenty-seven different tax systems. That is why a more permanent solution is being sought in the long term. The European Commission has set itself the aim of introducing a consolidated tax base for corporate taxation by means of a "Common Consolidated Corporate Tax Base" (CCCTB) (EC, 2001) (2). This method would offer international companies the possibility of calculating their tax base at group level. This would then be allocated according to a formula between the Member States which would charge their own rate (and, if so desired, grant tax credits). For companies not opting for the new system, the Member State's original legislation would continue to apply. This method would eliminate the problems of profit allocation via "transfer pricing" and other techniques by calculating the tax base at group level.

(1) Since 1 July 2005, these payments have been tax-exempt if the recipient company is located in another EU Member State.

(2) Other options which were not adopted concerned "Home State Taxation" (mutual recognition of each country's tax rules, in which the group of companies can choose to calculate its tax base according to the rules of the Member State where its headquarters is based, after which that tax base is allocated among the Member States which can charge their own rates), an "EU Company Income Tax" (creation of a European tax, possibly in favour of the EU), and a "Single Compulsory Harmonised Tax Base" (elimination of the twenty-seven current tax systems and total harmonisation leaving a single method of calculation which also applies to the smallest businesses).

At the informal Ecofin Council in September 2004 there was widespread support for the creation of a working group to continue developing this proposal for a common tax base. Nevertheless, five countries (Estonia, Ireland, Malta, the United Kingdom and Slovakia) did not endorse the idea. The working group is to propose, by the end of 2008, a legal framework which determines the tax base and also comprises a formula for allocating the tax base among the various Member States. Such a method is already in use in the United States and Canada and their respective federal states and provinces. The formula generally comprises variables such as the proportion of the assets located in the State in relation to the company's total assets, the proportion of sales taking place in the State and the proportion of wages in that State. Application of such a formula means, for example, that a country in which a company records losses, while the group makes a profit at international level, can still be allocated part of the tax base and thus obtain positive tax receipts.

The idea would be to leave freedom of choice for businesses: they could either opt for one of the twenty-seven national systems or for the new CCCTB. That actually means twenty-eight different systems. The underlying idea is that competition will thus develop between the "Community" system and the national systems, and that the majority of firms will opt for the CCCTB, so that eventually the national systems will become irrelevant and only the CCCTB will be used.

However, it is obvious that there are some serious technical problems yet to be overcome, and that it will not be easy to find a formula which gains the approval of the Member States. Some people consider that this plan has more chance of success than earlier initiatives because, in the legislative framework of enhanced cooperation, if eight Member States are willing to apply this method, that is already sufficient to make a start.

Conclusions

Countries try to attract additional activities and profits by reducing the tax burden on corporate profits. Thus, in the past, there was an obvious trend towards lower nominal rates of corporate income tax in Europe. Tax competition increased still further with the recent accession of the new EU Member States in 2004, which – in comparison with the EU-15 – mostly charge much lower rates. On the basis of the reforms announced in a number of countries, the nominal rate reductions will persist in the European Union in the immediate future.

Up to now, these nominal rate reductions seem to have been at least offset by the expansion of the tax base, so that public revenues generated by corporate income tax have actually increased overall.

Belgium is following the international trend towards lower nominal rates and a wider tax base. The 2003 reform aimed to eliminate the difference between the Belgian nominal rate and the EU-15 average. Despite this substantial cut in the Belgian rate, the difference in relation to the EU average has since widened again to around 4 to 5 percentage points. A further reform of Belgian corporate income tax therefore followed fairly swiftly, with the introduction of the venture capital allowance from the 2007 tax year (2006 incomes). This innovative measure reduces the discrimination between the tax treatment of equity capital and borrowings, and is a good incentive for increasing corporate solvency. Moreover, it is an acceptable European alternative to the coordination centres regime. The difference between the Belgian nominal standard rate and the average for the European Union still persists, however, and – in the absence of new measures – will probably continue to increase in the coming years.

The existence of twenty-seven different corporate tax systems in the European Union entails substantial costs for multinationals. At the same time, there is the fear that tax competition may erode the proceeds of corporate income tax, which could have a number of undesirable consequences. Both the European Commission and a number of committees of experts have therefore published several reports in recent decades, proposing a high degree of harmonisation of corporate income tax. So far, these initiatives have not succeeded, mainly because of the unanimity required for decisions on direct taxes. The European Commission has given up its efforts to introduce minimum rates and is now concentrating on achieving a common consolidated tax base for multinationals. More specific initiatives, such as the directives aiming to abolish tax distortion in the case of cross-border activities, and measures to combat harmful competition, have been more successful.

It is currently still an open question whether a genuine "race to the bottom" will ensue in the future at the level of corporate income tax – not only with rates continuing to fall, but public revenues also declining – or if the decline in nominal rates will be halted – spontaneously or otherwise. Only the future will tell.

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