EUROPEAN TAX HARMONISATION: Planning and adjustment

by Aaron A Rubenstein

Although a single EC-wide tax structure is still many years away, national taxes are already converging, and a layer of EC regulations is coming into force. It is not too soon to start planning for the changes ahead.

Freeing the tax barriers

As Europe gets closer to completing its internal market and embarks on the difficult task of creating a single currency, the likelihood that it will one day have a single, uniform tax system stretching from the south of Portugal to the northern tip of Denmark seems as remote as ever. Despite the distance of this reality, the 12-nation grouping of the EC is actually proceeding quite rapidly to a convergence or 'approximation' of its different tax systems, scheduled to take place in the mid-1990s.

These efforts fall short of complete harmonisation but they are aimed at producing a European-wide tax system that does not inhibit businesses from treating Europe as one big internal market. By removing existing tax barriers to the free movement of capital and finance around Europe, the EC is seeking to encourage cross-border mergers and investments, and ultimately, a single European economy.

For businesses based in Europe and beyond, these developments on the EC tax front have two major implications, according to Lieven Denys, an international tax partner in KPMG Brussels and the chairman of KPMG's 1992 Tax Network. 'First of all, although there will continue to be differences in tax rules from country to country, there will be an important layer of EC-wide tax regulations,' he says. 'And secondly, though this may all sound complicated, it also creates opportunities for re-examining a company's entire tax position in Europe and finding ways of taking advantage of the new situation to lower tax liability.'

A flurry of initiatives

Since 1990 in particular, the EC has unleashed a flurry of new initiatives in the tax field. These initiatives, especially two newly-published tax directives, will eventually be converted into national law by the 12 separate EC member states. Even so, there could still be nuances in interpretation and implementation from country to country, requiring companies to make a careful examination of these differences in doing their future tax planning.

Caution is an important watchword in the run-up to greater tax convergence. Not only are parts of the directives open to different interpretations, the directives are also silent on a number of critical issues. Not surprisingly, tax has always been a crucial element in hopes for — and progress towards — European integration: the challenge of creating common rules has confronted the EC partners since they signed the Treaty of Rome in 1958. For years, the expressed goal on tax was a full harmonisation of tax rates and tax rules.

But since 1990 it has become clear that diversity will remain for some time to come, largely because it has proved difficult, if not impossible, to get EC-wide agreement on direct taxes. Rather than pushing for harmonisation, the EC Commission has decided to let itself be guided by the concept of subsidiarity. In effect, this means that the Commission will not get involved in every aspect of Europe's economy but that it will do its best to reach well-defined goals that have been set by the member states. In practical terms, this implies that income tax rates will certainly continue to differ from country to country, as will systems imposing corporate tax rates, which are of critical concern to any business with operations in Europe.

Lord Cockfield, the former EC Commissioner and a current consultant for KPMG on European Community affairs, predicts that the EC will have a single corporate tax someday, but he stresses that this is very much a long-term prospect. 'A European corporate tax system will only come when you've not only completed the single market but also the single currency, and there will then be time to tackle it.'

Single tax system 'a dream'

Robert Kramer, an international tax partner at Meijberg, the Dutch KPMG tax firm also says that a single corporate tax should be regarded as a 'dream', at least for the time being and probably for the next 20 years as well.

Ironically, perhaps, corporate tax rates have started to converge anyway around the EC, with 35% the most common average figure. Kramer
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Much of the progress so far is contained in two path-breaking EC directives, one on the tax relationship between parent and subsidiary companies in Europe and the other on the tax implications of cross-border mergers and demergers. Two other draft directives have been prepared but are not yet approved. The first deals with the tax treatment of a company's losses in another EC country, while the other calls for the abolition of withholding taxes on inter-group interest and royalty payments. The EC has also drawn up an arbitration convention designed to prevent double taxation resulting from transfer pricing adjustments made by a company that is active in two or more member states. However, the status of the draft convention is different from that of a directive, making the directives of more immediate interest to business people.

Directive on group companies

The parent-subsidiary directive is revolutionary because it abolishes the right of member states to levy withholding taxes on profits distributed by a subsidiary company located in one EC country to a parent or holding company in another EC country. This is an important development on the road to harmonisation of taxes across Europe, though partial and temporary exemptions will be granted to – Germany, Greece and Portugal.

The directive seems simple enough at first glance, but KPMG tax experts such as Kramer caution: ‘You only need to scratch the surface gently and problems start jumping out at you very rapidly’. Two immediate problems are, firstly, that the directive applies only to limited types of companies as enumerated in the directive and, secondly, that these companies must be subject to ordinary corporate tax in their home country of establishment.

With these conditions in mind, several complications quickly emerge. In Germany, for instance, it is common for businesses – even major multinational businesses – to be legally organised as partnerships, raising the question of whether or how they will be treated for tax purposes. One implication of this problem – and it is an implication which is true, too, of other EC tax initiatives – is that companies may want (or need) to change their legal forms and structures in order to take advantage of the new tax rules and thereby lower their overall European tax bill.