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Featured Perspectives



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The European Community and its 27 member states are faced with somewhat of a dilemma in the area of direct taxes. Should direct tax rules be harmonized at the Community level, or should member states coordinate their different tax systems to produce rules that are more in keeping with the European internal market (EIM)? Surprisingly, even though the European Community has been in existence for the last 50 years, a variety of different views prevail. The European Commission expressed its view in a communication titled "Co-ordinating Member States' Direct Tax Systems in the Internal Market,"¹ supported by the commissioner in charge of taxation matters, László Kovács. However, Char-

lie McCreevy, European commissioner for the internal market and services, has made some less than positive remarks on the commission's strategy. Meanwhile, the U.K.'s paymaster general, Dawn Primarolo, has challenged the commission's competence to even have such views maintaining that direct taxes remain a matter for the member states alone. With such contrasting opinions, one wonders whether the European Community's common consolidated corporate tax base (CCCTB) project will ever get off the drawing board.

The Commission's Strategy

The commission's communication noted that currently, when member states design their direct tax systems, they do so primarily with domestic situations in mind. That gives rise to different treatment in a cross-border context that is often incompatible with Community law. Accordingly, the commission's communication suggests that there should be more coordination between the 27 national tax systems to help member states eliminate obstacles to cross-border trade and investment within the Community and to protect against the erosion of their tax bases. The commission's approach is, therefore, quite interesting because it builds on the desire of the member states to retain control over direct tax matters. The commission is simply saying that approach is generally acceptable in the EIM, but more coordination is necessary in the absence of harmonized rules at the Community level.

¹See the Europa Web site at [http://ec.europa.eu/taxation_customs/resources/documents/taxation/COM\(2006\)823_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/COM(2006)823_en.pdf). The communication was one of three issued in December 2006 by the commission in the area of direct taxation matters. See also [http://ec.europa.eu/taxation_customs/resources/documents/taxation/COM\(2006\)825_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/COM(2006)825_en.pdf) and [http://ec.europa.eu/taxation_customs/resources/documents/taxation/COM\(2006\)824_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/taxation/COM(2006)824_en.pdf).

Key Principles

The commission's strategy is flexible and relatively straightforward, and it is built on a number of key principles: remove discrimination and double taxation; prevent abuse and inadvertent nontaxation; and reduce compliance costs associated with being subject to more than one tax system.² Sometimes, unilateral action by member states may be sufficient. In other situations, bilateral or multilateral solutions may be needed at either the member state level (for instance, a double tax convention (DTC)) or at the Community level (for example, a directive). The Commission also notes that to safeguard the tax bases of the member states, better coordination is needed in relation to nonmember countries in some areas.

ECJ Litigation

The commission recognized that the biggest problem facing the member states was understanding the full implication of the rulings of the European Court of Justice. It recognized that this case law continues to evolve and that much of it was quite recent.³ It noted that member states sometimes reacted to ECJ decisions by removing tax advantages available domestically or by extending the obstacles to cross-border trade and investment to domestic situations. In particular, the commission highlighted international double taxation, as an example of a major obstacle to cross-border activity, and the EIM, which resulted from a lack of coordination between the 27 national tax systems and which can be resolved only through cooperation between the member states. Moreover, the existence of 27 different tax systems in the EIM generated burdensome compliance requirements that needed more administrative cooperation between the member states.

The commission's conclusion was that "appropriate co-ordination and co-operation between Member States can enable them to attain their tax policy goals and protect their tax bases, while ensuring elimination of discrimination and double taxation and reducing compliance costs." Further, it offered to assist the member states in this sphere and proposed a series of future initiatives covering key areas of direct taxation.⁴

Responses of Kovács and McCreevy

Commissioner Kovács, in charge of the taxation portfolio at the commission, supported the work of

the commission and noted that there was a need to have targeted measures to address the most urgent problems and a need to respond to the increase in ECJ cases in the tax arena. He commented that "we want to improve the performance of existing national direct tax systems. We need tax systems compatible with the Treaty and with each other so that taxpayers can benefit fully from the freedoms provided by the Treaty."⁵

In relation to the CCCTB project, the Commissioner indicated that his goal remained the same, "namely to present a Community legislative proposal in 2008."

McCreevy's approach is almost the complete opposite. As the former Irish minister for finance responsible for much of Ireland's "celtic tiger" success, McCreevy is almost completely against tax harmonization in his approach to tax developments in the EU, and he is not afraid to say so.

As European commissioner, he made it very plain in one of his first speeches — titled "Tax Harmonisation — No Thanks!" — that taxes should be kept as low as possible and that

the more we seek to harmonize taxes — be it tax bases or tax rates — the more will be the tendency for overall tax levels to drift up to the worst common denominator. And let nobody fool you: Consolidating the tax base is a condition precedent to consolidating the rate. And make no mistake: the agenda of most of those currently seeking to consolidate Europe's tax base is to have the framework in place to consolidate longer term Europe's tax rates.

McCreevy backs up his anti-tax-harmonization approach with his experience as Irish minister for finance: "When I halved the rate of capital gains tax, the following year the tax take doubled."⁶

More recently, Commissioner McCreevy explained:

One of the tools and one of the key ingredients in the competitiveness mix is taxation. It is neither sensible nor realistic to seek convergence of tax rates across Europe. Different Member States have different demographics, different social programmes, different sources of competitive advantage. Therefore, they need to use taxation in different ways. . . . That's

⁵See Commissioner Kovács' speech, available at http://ec.europa.eu/commission_barroso/kovacs/speeches/dhik_20061123.pdf.

⁶See Commissioner McCreevy's speech from 2005, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/05/679&format=HTML&aged=1&language=EN&guiLanguage=en>.

²See COM(2006) 823 final, section 2.1.

³*Id.*, section 2.2.

⁴*Id.*, part 4.

just one reason why harmonisation is off the agenda. . . . But while it is easy to oppose harmonisation by the front door, we must equally guard against its arrival through the back door. . . . I am emphatically opposed to tax harmonisation.

He concluded by saying that “[t]ax harmonization is not on the agenda, nor will it be. National vetoes will be retained and competition between Member States for attracting inward investment — some of it tax based — will continue. Tax competition is a healthy spur to governments across Europe to manage their public finances carefully.”⁷

U.K. Reaction

Primarolo appeared before the U.K. Parliament’s European Standing Committee and expressed the U.K. government’s views on the commission’s co-ordination communication. From the outset, some hostility can be detected toward the commission’s initiative because the U.K. government’s position is simply that competence for direct tax matters remains with the member states. While the U.K. recognizes that “greater co-operation is necessary and that closer working produces benefits,” and cites the work of the OECD and DTCs as examples of successful cooperation, “the U.K. does not see co-operation as a continuum that leads to European directives.” Thus, while the U.K. actively and constantly participates in work among member states in the EU, there should be “no presumption that co-ordination will lead to Europe-wide action” or the use of European Community legislative instruments.⁸

The paymaster general commented: “The Government are clear that there is a need for national tax systems to co-exist and fit together effectively in the EU and beyond, based on the principle of preserving the effective allocation between member states of powers to tax.”⁹

Disagreement With Commission’s Analysis

The U.K.’s approach is, therefore, at odds with the commission. Whereas the commission sees itself as the body putting forward new initiatives in this area, and that coordination is a step on the road to harmonization in some situations, the U.K. does not agree. The U.K.’s emphasis is on discussions between the member states and that “harmonisation is

not the way that things are heading.”¹⁰ Moreover, the U.K. does not accept the commission’s analysis in a number of areas.¹¹

Double Taxation

On the double taxation issue, in response to a question from another committee member,¹² the paymaster general pointed out that the U.K. deals with double taxation through DTCs and that the government had made it clear in the past¹³ that “there are many areas, particularly in respect of employment, social and tax policy, on which member states will wish to implement policies that reflect their particular national institutions.”

Broadening the Remit of an ECJ Judgment

One concern expressed in the committee meeting is worth noting because it is very much in line with Commissioner McCreevy’s views on the introduction of the CCCTB. That was the notion that coordination “can, step by step, lead to harmonisation.”¹⁴ The paymaster general’s response was short and to the point, emphasizing that the U.K. had a veto in this matter and that a “draft directive would require unanimity.” She went on to repeat that it was “sensible for the competitiveness of both the U.K. and the EU to have co-ordination and co-operation. They have absolutely no connection with harmonisation through directives, nor need they lead to that. Those are two specific and different procedures.”¹⁵

In the ensuing debate on the motion, it was suggested by an opposition representative¹⁶ that agreement on “more technical areas of tax can be used to drive forward harmonisation by stealth, using an incremental approach. These proposals [referring to the commission’s communications] are all about moving towards a goal of more harmonisation.” She went on to quote Romano Prodi, a former president of the European Commission, who said, “The genius of the founding fathers of the EU lay in translating extremely high political ambitions, which were present from the beginning, into a series of more specific, almost technical decisions. This

¹⁰*Id.* at column 7.

¹¹*Id.* at column 8.

¹²Julia Goldsworthy.

¹³See “The Single Market: A Vision for the 21st Century,” published by HM Treasury and the DTI in January 2007, available at <http://www.dti.gov.uk/files/file37083.pdf>.

¹⁴See *supra* note 8, question asked by Mrs. Villiers, at the end of column 9.

¹⁵*Id.*, end of column 9, beginning of column 10.

¹⁶*Id.*, the comments of Mrs. Villiers, at the end of column 14.

⁷See Commissioner McCreevy’s speech in February 2007, available at http://ec.europa.eu/commission_barroso/mccreevy/speeches/s07_75.en.pdf.

⁸See <http://www.publications.parliament.uk/pa/cm200607/cmgeneral/euro/070306/70306s01.htm> at column 4.

⁹*Id.* at column 5.

indirect approach made further action possible.”¹⁷ She continued: “That salami slice approach has been used to take forward political integration without proper democratic scrutiny and it is being used in the tax sphere. For example, if the CCCTB project goes ahead, there is every danger that it could start out as a voluntary system and end up as a compulsory one.”

In response, the paymaster general rejected the “salami slice” approach assessment put forward by her opposition colleague and emphasized that the “U.K. keeps the veto to avoid unwelcome integration in respect of tax.”¹⁸ Moreover, she repeated that this debate was not about harmonization and that the U.K.’s view was that “we do not consider coordination to mean harmonisation.”

The ECOFIN

The EU Council of Economic and Finance Ministers has also held a debate on the commission’s communication in March 2007 and concluded that the EIM “may be improved through co-operation on taxation among Member States and where appropriate at the European level, while respecting national competencies.” ECOFIN also noted that “appropriate solutions may take a variety of forms, in accordance with the subsidiarity principle.”¹⁹

Final Comments

The lack of consensus on a whole range of matters relating to direct taxation in the EU is plainly seen from the range of comments discussed above, and it seems certain that that lack of agreement is destined to continue into the foreseeable future with implications for the CCCTB project and the harmonization of exit taxes and cross-border loss relief.

The different views echo the division of competences between the member states and the European Community’s institutions in the area of direct taxation matters. It seems clear from the very entrenched views of the member states and from an examination of the history of tax rules in the EU that the member states are not willing to simply transfer direct tax competence to the Community. This status quo is likely to continue. Moreover, this desire to retain competence for direct tax matters reflects the importance of taxation to the member states as a tool for controlling their economies,

because when direct taxation rules move from the member state level to the Community level, the member states retain little control over tax rates and tax policy in general. This outcome will have a bigger impact on some member states because at the moment their tax rules are one form of their competitiveness in the global economy.

An analogy is seen in the area of company law rules, with some member states (like the U.K.) providing “light touch” regulatory rules concerning company formations and other member states maintaining very strict capital requirements.²⁰ Taxation rules are used in a similar way by the member states to attract mobile capital and to create local jobs. Thus, member states compete in the global market by using competitive corporate tax rates. Such competitive tax rates are one factor used by multinational enterprises in making their location decisions.

A question mark therefore remains over the future direction of the tax coordination vs. tax harmonization debate. It seems clear that member states will continue discussing cross-border tax issues, bilaterally in the context of tax treaties and multilaterally at the OECD/WTO level and the EU level. However, cooperation or harmonization will always depend on the national interest of each member state coinciding with that of all other member states. For instance, in relation to cross-border loss relief, each member state will work in its national interest to achieve the level of cross-border loss relief required by the ECJ under the *Marks & Spencer* judgment, or decide that it is in its national interest to offer more or less loss relief. That is a decision of the member state in question, because competence in direct tax matters remains with the member states. The amount of cross-border loss relief may be lower than that required under *Marks & Spencer*, provided that the member state in question applies a similar rule domestically.

Consequently, it is likely that member states (like the U.K.) will continue to try to find solutions that meet their national interests and will comply with their EC Treaty obligations, but it is unlikely that such solutions will be found at the Community level. When possible, best practice will be gleaned from the rules of other member states and implemented if in the U.K.’s national interest. Coordination therefore remains high on the tax agenda, but tax harmonization will be a slow and tedious long-term process that will only happen when the member states see the longer-term benefits for their citizens and companies. ♦

¹⁷*Id.*, column 15.

¹⁸*Id.*, column 18.

¹⁹See http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/93340.pdf at p. 18.

²⁰Examples seen in the case law of the ECJ include *Centros* (C-212/97) and *Inspire Art* (C-167/01).