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European Tax Harmonization and the Implications for U.S. Tax Policy

Tracy A. Kaye*

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I. European Community Tax Harmonization

A. Introduction

Just as the U.S. Congress is most productive during the last few months of a legislative session, so too, the European Community (EC) made most of its progress on corporate tax harmonization to date in the last few years before the 1992 deadline for the completion of the internal market. Actually, use of the term tax harmonization is misleading, insofar as it means the establishment of identical tax bases, rates, and systems throughout the EC as a result of action at the Community level. It is only by abandoning the concept of full tax harmonization and substituting the concepts of "coordination" and "approximation" that there has been any agreement on direct taxation matters. In 1990, the EC Commissioner for taxation, Mrs. Christiane Scrivener, stated that the European Commission had abandoned its goal of full harmonization of direct taxation in the EC for a more practical approach—convergence of the respective corporate tax systems. This new approach incorporates the principle of subsidiarity which, for tax harmonization,
means that Member States should determine their own tax arrangements, except to the extent that major distortions would occur.6

The goal of the EEC Treaty, which created the European Economic Community, was to create a single, integrated European Market.7 To realize this goal, physical barriers to trade in the form of border controls, had to be removed. This required harmonizing indirect taxes such as value-added taxes (VAT) because tax differences like variations in the VAT rates are a primary reason for border controls in the first place. Direct taxes, such as corporate income taxes, can inhibit the free movement of capital.

The First and Second Council Directives laid the foundation in 1967 for the EC’s common VAT system,8 establishing the basic principles, structure, and method of application of this system.9 The Sixth VAT Directive replaced most of the First Directive and all of the Second Directive with a uniform basis of assessment.10 More importantly, this Directive specified that the VAT would be responsible for partly financing the Community itself.11 This key role for the VAT partly explains the substantial progress made with respect to indirect tax harmonization as compared to direct tax harmonization.

Slow but steady progress continued as the Council adopted a directive on the approximation of VAT rates on October 19, 1992.12 This Directive establishes a minimum standard VAT rate of fifteen percent and a minimum reduced VAT rate of five percent.13 Currently, busi-

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6 Id. at 2. The Maastricht Treaty now defines subsidiarity as the principle that, except in the areas where the Community has exclusive competence, it should only act when Member States cannot sufficiently achieve the objectives. TEU, supra note 1, art. G(5).

7 TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [hereinafter EEC Treaty or Treaty of Rome]. The term ‘EEC Treaty’ will be used to refer to the original treaty prior to the amendments brought about by the TEU. The term ‘Treaty of Rome’ will be used to refer to the original treaty after the amendments brought about by TEU. The EEC Treaty established the European Economic Community as of January 1, 1958.


9 Coopers & Lybrand, Value Added Tax, EC Commentaries, Nov. 9, 1995, available in LEXIS, World Library, Eurcom File, § 2.1 (hereinafter VAT). The adoption of the VAT is a mandatory condition of membership in the EC. Id.


11 VAT, supra note 9, § 2.1.


13 Id. art. 1; see also VAT, supra note 9, § 2.16. Member States are permitted to have up to two lower rates of at least five percent on a wide range of products. Id.
nesses pay VAT in the country of consumption of the goods, but the Commissioner is preparing a paper on a VAT regime that would allow for payment of the VAT in the country of origin.\textsuperscript{14} Further discussion of the harmonization of indirect taxes is beyond the scope of this article, but it is important to realize that the loss of sovereignty in the indirect tax area means that the Member States are anxious to retain as much flexibility as possible to collect revenue through direct taxes.

This article examines the status of direct tax harmonization in the EC, the implications to the United States of the actions taken so far, and makes recommendations for future actions by the United States. Part I of this article explains that the historical background and legal basis for tax legislation in the EC is partly responsible for the initial slow pace of direct tax harmonization legislation. An understanding of the legislative process and the participants involved in enacting EC tax legislation provides further insights. The structures of the Member States' varied tax systems also shed light on the difficulties in reaching tax harmonization agreements.

Part II of the article discusses the implications of these tax harmonization agreements, limited at this point to the Parent–Subsidiary Directive, the Mergers Directive, and the Arbitration Convention, for the European Community. This section concludes that complete harmonization of the EC's corporate tax laws is neither likely nor necessary, but movement toward more uniformity is inevitable.

Part III of the article analyzes the implications of European harmonization for U.S. tax policy. The provisions of subpart F of the Internal Revenue Code, which indirectly allow taxation of the foreign income of foreign corporations in certain situations, are reexamined in light of the tax harmonization developments in the EC.\textsuperscript{15} The Parent–Subsidiary and Mergers Directives provide compelling reasons for U.S. multinationals to form European holding companies, however, such corporate structures would implicate the subpart F regime. The subpart F rules endeavor to impose current shareholder taxation on undistributed income, such as dividends and related–party sales and services income, earned through a foreign corporation. The article concludes that given appropriate safeguards, administrability, simplicity, and economic efficiency can be achieved by treating the EC as a

\textsuperscript{14} VAT, \textit{supra} note 9, \S\ 7.1, \textit{see infra} note 236 for further discussion of the transitional VAT regime.

\textsuperscript{15} \textit{See infra} notes 248–79 and accompanying text for a discussion of the subpart F regime.
single country for purposes of the same-country exception from the subpart F provisions.16

United States tax treaty policy must also take into consideration the direct tax harmonization accomplished thus far and the proposals for the future. Although the negotiation of a single treaty with the EC would produce significant benefits for the United States, both substantively and administratively, the EC Member States are not yet willing to transfer to the Community their sovereignty to conclude tax treaties. The alternative is to strive toward uniformity in the tax treaty negotiations currently underway with many of the Member States.

The importance of examining the European experience cannot be overemphasized. With the accession of Austria, Finland, and Sweden, the EU comprises a single market of approximately 370.5 million people, and the future EU could include the rest of Scandinavia and Eastern Europe.17 A step in that direction was made on January 1, 1994, when the European Economic Area (EEA) Agreement established the world’s largest free-trade zone by extending the EU’s single market to the European Free Trade Association (EFTA) states of Austria, Finland, Iceland, Norway, and Sweden.18 Although the EEA Agreement did not confer full EU membership, it allowed for the free movement of goods,

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16 See infra notes 265–69 and accompanying text for a discussion of the same-country exception.

17 Maastricht European Union Treaty to Enter Into Force, EC Delegation Says, PR Newswire, Oct. 14, 1993, available in LEXIS, World Library, Prnews File; The Maastricht Recipe, ECONOMIST, Oct. 23, 1993, at 15 [hereinafter Maastricht Recipe]. Poland, Hungary, the former Czechoslovakia, Romania, and Bulgaria have all signed “Europe Agreements” with the EC which offers “associate membership” to these countries, but there has been no formal commitment regarding full membership. The Two Europes Poor Relations, ECONOMIST, May 1, 1993, at 54. In April 1994, Poland and Hungary formally applied for membership. EUROPEAN COMMISSION DELEGATION TO THE UNITED STATES, THE EUROPEAN UNION: A GUIDE 5 (1994) [hereinafter EU GUIDE]. Membership applications were previously received from Turkey, Malta, and Cyprus. EC: Europe Documents; No. 1790—Commission Report on the Criteria and Conditions for Accession of New Members, Reuters Textline Agence Europe, July 3, 1992, available in LEXIS, World Library, Allwld File. See generally Vincent John Ella, The Visegrad Countries of Central Europe—Integration or Isolation?, 2 MINN. J. GLOBAL TRADE 229 (1993). Article O of the TEU sets forth the procedure for countries to accede to the EU. TEU, supra note 1, art. O.

18 John Turro, European Economic Area Agreement To Enter Into Force January 1, 7 Tax Notes INT’L 1618 (Dec. 27, 1993); see also Europe Moves Closer to Single Currency, ST. PETERSBURG TIMES, Jan. 2, 1994, at 9A. Switzerland was the only member of the EFTA to reject membership into the EEA through national referendum. Klaus—Dieter Borchardt, European Integration: The Origins and Growth of the European Union 77 (1995) [hereinafter European Union]. Liechtenstein’s membership in the EEA was temporarily suspended pending clarification of its special relationship with Switzerland. Id. As of May 1, 1995, Liechtenstein is also a member of the EEA. Id.
persons, services, and capital throughout the seventeen countries.\textsuperscript{19} Then, in the spring of 1994, the Council finished negotiations with Austria, Sweden, Norway, and Finland so they could accede to the Union on January 1, 1995.\textsuperscript{20} The Austrians voted in a national referendum to accept the terms of EU membership and similar referendums passed in Finland and Sweden, but not in Norway.\textsuperscript{21}

To achieve a coherent system of international taxation, the United States must take note of how other countries tax international income.\textsuperscript{22} The EU is especially important, not only because of the fifteen Member States that currently comprise the Union, but also because of the countries that aspire to join. The EFTA countries in particular are making every effort to ensure that their tax systems comply with EC direct tax measures.\textsuperscript{23} The Eastern European countries are also closely monitoring the tax systems of the Member States, as well as the evolving body of EC tax law, as these countries develop their tax systems.\textsuperscript{24} The tax policies pursued by this entire group will have important implications for economic conditions in the United States and the EU.

In the international trade arena, the current trend is the formation of regional trading blocs.\textsuperscript{25} In 1992, the United States, Canada, and Mexico agreed to the terms of the North American Free Trade Agreement (NAFTA) to create a trade area in which goods and services are exchanged free of tariffs and other trade restrictions.\textsuperscript{26} On December 11, 1994, Chile was invited to join NAFTA.\textsuperscript{27} If negotiations are success-

\begin{footnotesize}
\textsuperscript{19} Turro, \textit{supra} note 18, at 1618. The EEA Agreement also extended the rules on competition and state aid. \textit{Id.}


\textsuperscript{24} See \textit{SEMINAR PROCEEDINGS: EC ’92 AND ITS IMPLICATIONS FOR GLOBAL COMPETITIVENESS} 9 (Tracy A. Kaye ed., 1992) [hereinafter \textit{SEMINAR PROCEEDINGS}].

\textsuperscript{25} See \textit{generally THE GROWTH OF REGIONAL TRADING BLOCS IN THE GLOBAL ECONOMY IX} (Richard S. Belous and Rebecca S. Hartley eds., 1990).


\end{footnotesize}
ful, Chile's admission into NAFTA could pave the way for invitations to future members such as Brazil and Argentina. By 2005, the United States intends to join thirty-three other democracies of the Western Hemisphere in negotiating a Free Trade Area of the Americas. The dispute-reconciliation and tariff-reduction procedures of NAFTA are expected to serve as blueprints for the Free Trade Area of the Americas.

Although NAFTA does not address the subject of income tax harmonization, it is logical to presume that as cross-border activity increases, NAFTA countries will increasingly feel pressure to attempt some harmonization of their respective tax systems. As the barriers to capital movements and physical trade are removed, the importance of the differences in tax systems will be heightened. The United States can learn valuable lessons from the tax harmonization experience of the EC, thus both the process of integration and the particular approach followed by the EC should be studied. United States policymakers must be increasingly global rather than domestic in their focus and tax measures must be consistent with international tax systems.

B. History of the European Economic Community

The EEC Treaty established the European Economic Community in 1958. The original Member States were Belgium, France, the Federal

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29 FTAA, supra note 27.


31 I am not ready to say that the EU model is necessarily the right model for the NAFTA countries. That topic requires further study and is the subject of another article.


33 EEC Treaty, supra note 7, art. 1. The TEU established the European Union founded on the
Republic of Germany, Italy, Luxembourg, and the Netherlands. The United Kingdom, Ireland, and Denmark joined in 1973, Greece in 1981, and Spain and Portugal in 1986. The objective of the EEC Treaty was to create a single common market that would increase the volume and the gain from trade between the Member States, thereby accelerating economic growth.

To create such a market, the Treaty contemplated the removal of obstacles to the free movement of goods, persons, services, and capital between Member States. Approximation of indirect taxes, necessary for the free movement of goods, and the harmonization of direct taxes, particularly corporate taxes, essential to the free movement of capital, were viewed as major necessary steps. Coordination of personal income and social security taxes has not been viewed as urgent except to ensure through bilateral agreements that frontier and migrant workers are not double taxed. In December of 1993, the Commission adopted a detailed recommendation on the taxation of cross-border or frontier employees which seeks to reduce the differences in the taxation of resident and non-resident workers. The Commission will assess the actions taken by the Member States in response to the recommendation and will determine whether binding legislation is in order.

European Communities (the European Economic Community, the European Atomic Energy Community, and the European Coal and Steel Community). TEU, supra note 1, art. A. Only the European Communities have international legal status. See, e.g., Treaty of Rome, supra note 7, art. 210. The TEU also formally renamed the European Economic Community the European Community. TEU, supra note 1, art. G(1).


35 See EEC Treaty, supra note 7, art 2. For example, the creation of a customs union, the first step towards a common market, was completed by 1968. EU GUIDE, supra note 17, at 12. As a result, trade increased among the original six Member States from $6.8 billion in 1958 to $60 billion in 1972. Id.

36 See EEC Treaty, supra note 7, arts. 54, 100a.

37 SIJBREN CNOSSEN, INTRODUCTION TO TAX COORDINATION IN THE EC 3–4 (Sijbren Cnossen ed., 1987). The Fredersdorf Report concluded in 1978 that it was not essential to harmonize personal income taxes. Id. at 41.

38 Jonathan Schwarz, Survey of World Taxation, FIN. TIMES, May 20, 1994, at III; see Commission Recommendation for the Regulation on Taxation of Non–Residents, 1994 O.J. (L 39) 22; see also infra note 114 and accompanying text for an explanation of the authority of a recommendation and infra notes 64–69 and accompanying text for an explanation of the role of the Commission in the legislative process.

Articles 95 through 99 of the Treaty of Rome discuss the harmonization of indirect taxes. For example, article 95 states that Member States may not use internal taxes to discriminate against products coming from other Member States. Article 220 of the Treaty contains the only explicit reference to direct taxes and states that Member States shall enter into negotiations to eliminate double taxation. It is understood, however, that article 100 of the Treaty, in the chapter on "Approximation of Laws," also provides a legal basis for direct taxation harmonization measures. This article authorizes the Council, acting unanimously on a proposal from the Commission, to issue directives for the approximation of laws that "directly affect the establishment or functioning of the common market."

In its 1980 "Report on the Scope for Convergence of Tax Systems in the Community," the Commission identified the elimination of border controls and the alignment of corporate tax burdens as the two most fundamental objectives. In June 1985, the European Council approved the Commission's White Paper on Completing the Internal Market which outlined a program to remove the remaining barriers to trade between the Member States. The White Paper contained a

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40 Treaty of Rome, supra note 7, art. 220.
41 Treaty of Rome, supra note 7, art. 100, amended by TEU, supra note 1, art. G(21); see also European Documentation, Consultancy Europe Associates Ltd., 1991, EU Background-Competition and Trade-Taxation in the Single Market, Jan. 1, 1991, available in LEXIS, Euromcom Library, Ttsec File, 6 [hereinafter Taxation in the Single Market]. Other provisions pertaining to company taxation are articles 52, 58, 73b, and 221. Articles 52 and 58 are intended to guarantee freedom of establishment for companies constituted in accordance with the law of a Member State; freedom of establishment includes the right to engage in and pursue activities as self-employed persons as well as to set up and manage enterprises. Treaty of Rome, supra note 7, arts. 52, 58. Article 73b is intended to ensure the free movement of capital by prohibiting restrictions on the movement of capital and payments between Member States as well as between Member States and third countries, subject to the framework provided in Chapter 4 of the treaty. Treaty of Rome, supra note 7, art. 73b. Under article 221, Member States are required to ensure that the other EC nationals receive the same treatment as their own nationals with respect to the participation in the capital of companies. Treaty of Rome, supra note 7, art. 221; see also Michael Daly & Joann Weiner, Corporate Tax Harmonization and Competition in Federal Countries: Some Lessons for the European Community?, 46 Nat'l Tax J. 441, 460 n.33 (1993); see infra notes 59-63 and accompanying text for an explanation of the Council's role in the legislative process.
43 CNOSSEN, supra note 37, at 4-5; see COMMISSION OF THE EUROPEAN COMMUNITIES, COMPLETING THE INTERNAL MARKET, WHITE PAPER FROM THE COMMISSION TO THE EUROPEAN COUNCIL 3 (1985) [hereinafter WHITE PAPER]. The European Council comprises Heads of State or Government and the President of the Commission. The European Council meets at least twice a year, at the end of each Member State's six-month presidency of the Council. TEU, supra note 1, art.
comprehensive list of 300 measures that the Commission deemed necessary to complete the internal market. One of the three major chapters in the White Paper was devoted to measures related to indirect taxation. With respect to direct taxation, only proposals related to parent companies and subsidiaries (the Parent–Subsidiary Directive), mergers, divisions, and contribution of assets (the Mergers Directive), an arbitration procedure (the Arbitration Convention), and taxes on securities transactions, were included in the timetable for completing the internal market.

The Single European Act (SEA) was signed by the twelve Member States in 1986 and amended the EEC Treaty by providing for institutional reform, European political cooperation, and formal extension of the scope of the EEC Treaty to five new policy areas. Article 13 of the SEA incorporated the objective of an internal market into the EEC Treaty and set December 31, 1992 as the target date for completion of the internal market. The internal market is defined as "an area without internal frontiers in which the free movement of goods, persons, services, and capital is ensured. . ." The Maastricht Treaty on European Union (TEU) was negotiated, in its last phase, in December 1991, was signed on February 7, 1992, and was ratified by all twelve Member States by October 13, 1993. The TEU became effective on November 1, 1993 and created the European Union, "founded on the European Communities, supplemented by the
policies and forms of cooperation established by this Treaty." It commits most of the Member States to follow a particular route to economic and monetary union (EMU), in particular, the achievement of a single European currency for many Member States by the year 2000. Article 3b formally incorporates the general principle of subsidiarity (making decisions at the lowest practicable level of government) into the EEC Treaty. The TEU also makes various changes to the EC institutions.

C. Formation of European Community Tax Legislation

The EEC Treaty established an institutional system which enables the Community to enact legislation that is equally binding on all of its members. Three Community institutions are involved in the production of EC legislation: the Council, the Commission, and the European Parliament. The Economic and Social Committee acts as an advisor to the Council and the Commission.

The Council consists of representatives of the Member States, usually the ministers responsible for the subject matter under discussion. For example, the Finance Ministers meet with respect to tax and other economic matters and are known as the Economy and Finance Council (ECOFIN). The foreign ministers are usually responsible for major overall policy decisions; the Council's Presidency rotates between the ministers at six-month intervals. The Council is the principal law-

52 TEU, supra note 1, art. A; see also EU GUIDE, supra note 17, at 3.
54 Treaty of Rome, supra note 7, art. 109(4); Patrick Oster, Europe Finds Economic Unity Elusive Dream; Protectionism, Regulation Slow Efforts to Create Single Market, WASH. POST, Jan. 23, 1994, at H1; see infra notes 237–39 and accompanying text for further discussion of EMU.
55 EEC Treaty, supra note 7, art. 3b, amended by TEU, supra note 1, art. G(5); see supra note 6 and accompanying text for further explanation of the subsidiarity principle.
56 See infra notes 59, 77 and accompanying text.
57 European Union, supra note 18, at 26.
59 Treaty of Rome, supra note 7, art. 146, amended by TEU, supra note 1, art. G(43); see European Union, supra note 18, at 26; see also FREESTONE & DAVIDSON, supra note 58, at 70; HARTLEY, supra note 58, at 14. After the TEU went into effect, the Council was renamed the Council of the European Union because it now has expanded powers as set forth in Titles V and VI of the TEU. EU GUIDE, supra note 17, at 8.
61 Treaty of Rome, supra note 7, art. 146, amended by TEU, supra note 1, art. G(43); see
maker of the Community, although it can act only on a proposal from the Commission, except in a few narrowly defined areas.\textsuperscript{62} The Council may also request the Commission to undertake studies on particular questions and to submit proposals for legislation.\textsuperscript{63}

As of January 1995, the Commission consists of twenty members who are appointed by mutual agreement between the member governments for a five-year term.\textsuperscript{64} These Commissioners are required to act in complete independence of their own governments and the Council, and for the good of the Community.\textsuperscript{65} Each Commissioner is assigned one or more portfolios and becomes the political head of one or several Directorates-General.\textsuperscript{66} In 1989, the Commission set up a post solely concerned with tax harmonization with Mrs. Christiane Scrivener as the first Commissioner for taxation.\textsuperscript{67}

The Commission formulates Community policy, makes proposals to the Council, and drafts the detailed measures needed for their implementation.\textsuperscript{68} The Commission must also ensure that the Treaties and Community law are respected and applied, and must act on any infringements. This includes referring matters to the Court of Justice, if necessary.\textsuperscript{69}

\textsuperscript{62}Treaty of Rome, \textit{supra} note 7, art. 152.

\textsuperscript{63}Id. art. 145; see also BERMANN, \textit{supra} note 58, at 51-52.

\textsuperscript{64}See Treaty of Rome, \textit{supra} note 7, arts. 157-158. The Commission, formerly 17 members, now has 20 members as the EU has enlarged to 15 Member States. \textit{Institutional Implications on Norwegian "NO,"} The Reuter European Community Report, Dec. 1, 1994, \textit{available in} LEXIS, World Library, Reuec File [hereinafter \textit{Institutional Implications}]; see also EC Institutions, \textit{supra} note 61, § 3.2.

\textsuperscript{65}See Treaty of Rome, \textit{supra} note 7, art. 157; Treaty Establishing a Single Council and a Single Commission of the European Communities (Merger Treaty), 1965, art. 10(2); BERMANN, \textit{supra} note 58, at 57; FREESTONE & DAVIDSON, \textit{supra} note 58, at 57; HARTLEY, \textit{supra} note 58, at 8-9; see also European Union, \textit{supra} note 18, at 26.

\textsuperscript{66}FREESTONE & DAVIDSON, \textit{supra} note 58, at 59-60; HARTLEY, \textit{supra} note 58, at 10.


\textsuperscript{68}Treaty of Rome, \textit{supra} note 7, art. 155.

\textsuperscript{69}Id. art. 169; see also European Union, \textit{supra} note 18, at 29; BERMANN, \textit{supra} note 58, at 292; FREESTONE & DAVIDSON, \textit{supra} note 58, at 61-62.
The European Parliament consists of 626 members, directly elected every five years. The most recent election was held in June 1994. At that time, the 567 seats were broken down as follows: Germany, 99; France, Italy, and the United Kingdom, 87 each; Spain, 64; the Netherlands, 31; Belgium, Greece, and Portugal, 25 each; Denmark, 16; Ireland, 15; and Luxembourg, 6. When Finland, Sweden, and Austria acceded to the EU on January 1, 1995, the number of seats increased to 626, affording Austria 21 seats, Finland 16, and Sweden 22.

While the EEC Treaty defined the role of the European Parliament as advisory and supervisory, the legislative role of the Parliament has been steadily increasing. For example, Parliament's role was enhanced by the cooperation procedure introduced in the SEA. The cooperation procedure provides the European Parliament two opportunities to comment on certain draft legislation, but is generally not applicable to legislation with respect to indirect or direct tax harmonization.
Parliament's role was further expanded by the Treaty on European Union.77

The Economic and Social Committee was established by the EEC78 and EURATOM79 treaties to involve various economic and social interest groups in the establishment of the Common Market. The Committee has 222 members who represent employers, employees, and other interests.80 The members are appointed by the unanimous consent of the Council for a four-year renewable term. The Economic and Social Committee must be consulted in cases concerning the harmonization of provisions that entail amending national legislation, such as tax legislation.81

Community law is comprised of basic legislation, which includes the treaties and their protocols, and secondary legislation, which are the legislative products of the Community institutions. Community law either has a direct internal effect as law in the Member States or requires the Member States to implement the legislation domestically.82

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77 The TEU created a third legislative process, the co-decision procedure, as outlined in new article 189b of the Treaty of Rome. Treaty of Rome, supra note 7, art. 189b(2); KMPG, supra note 67, at 8, 12; see also Dr. Hans-Joachim Glaesner, Formulation of Objectives and Decision-Making Procedure in the European Union, 18 FORDHAM INT'L LJ. 765, 772-73 (1995).

78 EEC Treaty, supra note 7, art. 4(2).

79 The European Atomic Energy Community was also established by a treaty signed on March 25, 1957. Treaty Establishing the European Atomic Energy Community (EURATOM), Mar. 27, 1957, art. 1, 298 U.N.T.S. 169. This Community was charged with the development of a common structure for nuclear energy. UNITED STATES DEPARTMENT OF STATE, EUROPEAN COMMUNITY, BACKGROUND NOTES 3 (1990).


81 Treaty of Rome, supra note 7, art. 100; see also BERMANN, supra note 58, at 83; FREESTONE & DAVIDSON, supra note 58, at 85–86; HARTLEY, supra note 58, at 36–37.

82 Treaty of Rome, supra note 7, arts. 5, 189; see also PRICE WATERHOUSE, EUROPEAN COMMUNITIES 17 (1987).
The principal types of secondary Community legislation are regulations, directives, decisions, recommendations, and opinions.\textsuperscript{83}

Regulations have general application and are binding in their entirety on all Member States without any further action by individual states.\textsuperscript{84} The Council, the European Parliament acting jointly with the Council, and the Commission promulgate regulations.\textsuperscript{85} In practice, most regulations are made by the Commission. Although the vast majority of the regulations relate to agriculture, there is a draft regulation which sets out a proposed statute for a European company.\textsuperscript{86}

Directives are addressed only to Member States and do not directly amend national law; they create obligations on the governments of the Member States to take implementing action to incorporate their provisions in national legislation.\textsuperscript{87} They are proposed by the Commission and adopted by the Council after consultation with the European Parliament.\textsuperscript{88} Directives are the legislative instruments most commonly used to harmonize the Member States' legislation.\textsuperscript{89} Nearly all of the steps taken to harmonize the tax laws to date have been achieved through the use of directives.

Directives are binding upon the Member States as to the result to be achieved but leave the national authorities free to choose the form and methods of compliance.\textsuperscript{90} When a Member State does not implement the directive into national law, the question arises as to whether the directive has direct effect, i.e., effective without such enactment.\textsuperscript{91} The European Court of Justice has observed that "a Member State which

\begin{thebibliography}{99}
\bibitem{83} Treaty of Rome, \textit{supra} note 7, art. 189.
\bibitem{84} \textit{Id.} Article 189 expressly provides that regulations are directly applicable. \textit{Id.}
\bibitem{85} Treaty of Rome, \textit{supra} note 7, art. 189, \textit{amended by TEU, supra} note 1, art. G(1). Article 189 adopts the same institutional framework, in accordance with the provisions of the EEC Treaty as amended, to directives, decisions, recommendations, and opinions. \textit{Id.}
\bibitem{86} Amended proposal for a Council Regulation on the Statute for a European Company, 1991 O.J. (C 176) 1; \textit{Price Waterhouse, supra} note 82, at 20; \textit{see infra} note 328 and accompanying text for a discussion of the regulation on the European Company Statute.
\bibitem{87} Treaty of Rome, \textit{supra} note 7, art. 189. Directives can never be directly applicable. \textit{See Bermann, supra} note 58, at 180. A provision of Community law is considered directly applicable only if it need not be incorporated into domestic legislation before becoming an element of the national legal order. \textit{Id. But see infra} notes 91–94 and accompanying text for a discussion of the possible direct effect of a directive.
\bibitem{88} Treaty of Rome, \textit{supra} note 7, art. 100, \textit{amended by TEU, supra} note 1, art. G(21).
\bibitem{89} \textit{Price Waterhouse, supra} note 82, at 18.
\bibitem{90} Treaty of Rome, \textit{supra} note 7, art. 189.
\bibitem{91} According to the \textit{Van Gend en Loos} case, a Community law rule has direct effect if it creates rights for private parties that Member State institutions are legally bound to enforce against the Member States themselves and possibly against other private persons. Case 26/62, \textit{Van Gend en Loos v. Nederlandse Administratie der Belastingen}, 1963 E.C.R. 1; \textit{see also Bermann, supra} note 58, at 166, 181.
\end{thebibliography}
has not adopted the implementing measures required by [a] directive within the prescribed period may not plead, as against individuals, its own failure to perform the obligations which the directive entails."92

The test is whether the provisions of the directive are unconditional and sufficiently precise to be relied upon in a conflict with an incompatible national provision.93 "It is necessary to examine, in every case, whether the nature, general scheme and wording of the provision in question are capable of having direct effects on the relations between Member States and individuals."94

Decisions of the Council and the Commission are binding on the government, enterprise, or private individual to whom they are addressed and are usually concerned with a specific problem and relate to individual cases.95 Recommendations and opinions are issued by both the Commission and the Council with respect to specific subjects on which advice has been sought and are not legally binding.96

The consultation procedure is the decision–making procedure that is still applicable to tax harmonization legislation.97 Under this procedure, the Commission prepares a preliminary draft of the directive, sometimes based on a report prepared by independent experts.98 The preliminary draft is sent to the Member States’ governments and often is shared with the appropriate EC professional organizations for comment. The Commission then prepares and adopts a proposed directive that is submitted formally to the Council. The European Parliament considers the proposed directive and publishes its opinion that either accepts, rejects, or suggests amendments to the proposal.99 The Commission may amend the proposed directive to incorporate any changes

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92 Case 8/81, Becker v. Finanzamt Munster Innenstadt, 1982 E.C.R. 53 (holding that although Germany had not yet implemented the Sixth VAT Directive, the directive was directly effective).
93 Becker, 1982 E.C.R. at 71; see also BERMANN, supra note 58, at 184.
94 Case 41/74, Van Duyn v. Home Office, 1974 E.C.R. 1337 (holding that a directive on the freedom of movement of workers was directly effective because it was clear, unambiguous, and capable of judicial application).
95 Treaty of Rome, supra note 7, art. 189; see also NOEL, supra note 34, at 9.
96 Treaty of Rome, supra note 7, art. 189; see also PRICE WATERHOUSE, supra note 82, at 12.
97 Treaty of Rome, supra note 7, art. 99. The SEA also amended article 99 to provide that the Council should adopt legislation harmonizing turnover taxes, excise duties, and other forms of indirect taxation to the extent necessary to ensure the establishment and functioning of the internal market by the end of 1992. Id.
98 KPMG, supra note 67, app. 1.
99 The Economic and Social Committee must also be consulted for any legislation deriving from article 100. Treaty of Rome, supra note 7, art. 100. See supra notes 76 and 77, respectively, for an explanation of the cooperation procedure and co-decision procedure, the procedures followed by the European Parliament for other types of legislation.
suggested by the opinions of either the European Parliament or the Economic and Social Committee. The Council then examines the proposed directive and, if approval is unanimous, it is adopted. 100

The SEA modified the EEC Treaty to allow for the adoption of many approximation or harmonization measures on the vote of a qualified majority of the Council. This procedure is applicable to the alteration or suspension of duties relating to common customs tariffs, legislation regarding the free movement of capital and services, and the harmonization of national standards. 101 In contrast, a unanimous vote is required for the harmonization of indirect and direct taxation. 102 This unanimity requirement explains, in part, why progress in the direct taxation area has been so slow. 103

D. Enforcement of European Community Tax Legislation

The Commission must ensure that the Treaties and Community law are respected and applied. 104 When a Member State fails to fulfill an obligation under the Treaty of Rome, the Commission provides a description of the treaty violation to that Member State and requests an end to the violation. 105 If the Member State fails to comply with the request, the Commission may refer the infringement to the European Court of Justice. 106 The Commission may also bring suit against a

100 PRICE WATERHOUSE, supra note 82, at 18–19. This unanimity requirement applies both to provisions for the harmonization of legislation concerning turnover taxes, excise, and other forms of indirect taxation under article 99, and to directives for the approximation of direct taxes under article 100. Id. at 5.

101 Treaty of Rome, supra note 7, art. 100a, amended by SEA, supra note 43, art. 18.

102 Treaty of Rome, supra note 7, arts. 99, 100a, para. 2.

103 Risinger, supra note 4, at 2. The TEU states that an Intergovernmental Conference (IGC) will begin in 1996 to deal with matters which were left unresolved by the TEU. Westendorp Stresses the Challenge of Enlargement and Transparency, Reuters Textline: Agence Europe, June 7, 1995 available in LEXIS, World library, Allwld File. One source of difficulty is that under the TEU the unanimity rule has been retained for taxation, as well as other issues. The unanimous voting requirement will be addressed at the 1996 IGC. THE EUROPEAN COMMISSION, INTERGOVERNMENTAL CONFERENCE 1996: COMMISSION REPORT FOR THE REFLECTION GROUP 33 (May 1995). Germany, the Commission, and several smaller Member States would like more European decisions to be made by majority vote. European Union: Veto Mania, ECONOMIST, Feb. 18, 1995, at 48. The United Kingdom, however, has often used the veto as a weapon and has been unwilling to lose its veto power in the area of taxation. Id.

104 Treaty of Rome, supra note 7, art. 155.

105 Id. art. 169; see also A.P. Lier ET AL., TAX AND LEGAL ASPECTS OF EC HARMONIZATION 18 (A.P. Lier ed., 1993).

106 Treaty of Rome, supra note 7, art. 169; see also EUROPEAN UNION, supra note 18, at 26.
Member State in the Court, when the Commission believes that the country has failed to enact or enforce EC directives.\(^{107}\)

The Court of Justice’s rulings are binding on Member States. For example, in 1978 the Court delivered judgments requiring several Member States to revise tax policies that favored domestically produced spirits to the detriment of imported products.\(^{108}\) Thus, France and Italy may no longer tax cognac at a lower rate than gin, whiskey, and vodka, and Denmark was forced to raise its tax on aquavit.\(^{109}\) The Maastricht Treaty strengthened the enforcement powers of the Court.\(^{110}\) For example, the Court of Justice may impose fines on any Member State that refuses to comply with a Court ruling that it has infringed Community law.\(^{111}\)

The European Court of Justice is composed of fifteen judges, each appointed for a renewable six–year term, and is assisted by nine Advocates General.\(^{112}\) The Court’s duties are multi–faceted although its fundamental task is to “ensure that in the interpretation and application of this Treaty the law is observed.”\(^{113}\) The Court has jurisdiction to examine the validity of all acts adopted by the Council and the Commission, including regulations, directives, and decisions.\(^{114}\) Appeals can be brought on the grounds of: lack of competence; misuse of powers; or infringement of an essential procedural requirement, the Treaty of Rome, or any rule of law relating to its application.\(^{115}\)

\(^{107}\) Treaty of Rome, \textit{supra} note 7, art. 175. The Member States and other EC institutions may also bring an action before the Court, if the Council or the Commission fails to fulfill its obligation under the Treaty. LIER, \textit{supra} note 105, at 19. Article 169 does not make a distinction between the Treaty and a directive, therefore, the transposition of the result of a directive into national law is a treaty obligation. See Treaty of Rome, \textit{supra} note 7, arts. 169, 189.

\(^{108}\) Price Waterhouse, \textit{supra} note 82, at 62–63.


\(^{110}\) Treaty of Rome, \textit{supra} note 7, art. 171.


\(^{113}\) Treaty of Rome, \textit{supra} note 7, art. 164; see also Klaus–Dieter Borchardt, \textit{European Documentation, The ABC of Community Law} 35 (1991) [hereinafter Community Law].

\(^{114}\) Treaty of Rome, \textit{supra} note 7, art. 173. The Court of Justice does not opine on the validity of recommendations or opinions because recommendations and opinions have no legally binding force. LIER, \textit{supra} note 105, at 19.

\(^{115}\) LIER, \textit{supra} note 105, at 19.
To ensure the uniform interpretation of Community law, the European Court of Justice will render, at the request of any court or tribunal of a Member State, a legally binding preliminary ruling in a case where any question of Community law arises.\textsuperscript{116} These preliminary rulings concern such matters as the interpretation of provisions of the Treaties or of acts of the Community institutions and the examination of the validity of Community legal acts. The Court will not rule on the merits of the pending case but rather limits the judgment to the interpretation or validity of the relevant question of Community law.\textsuperscript{117} Other national courts can rely on these article 177 rulings as authoritative interpretations of Community law or may resubmit the question to the Court for a preliminary ruling in the hope that the Court of Justice departs from its previous decision.\textsuperscript{118}

Although the Court's judgments in the direct tax area have been few in number, the implications of these decisions are far-reaching. It is clear that national income tax regimes must be exercised consistently with the Treaty provisions establishing the fundamental freedoms of the Community.\textsuperscript{119} The fundamental freedoms encompass a prohibition of discrimination on the grounds of nationality, specifically found in article 48 for the free movement of workers, article 52 for the freedom of establishment, article 59 for the freedom of provision of services, and article 73b for the free movement of capital.\textsuperscript{120} Because tax law often distinguishes between resident and non-resident taxpayers and between permanent establishments and subsidiaries, the application of this non-discrimination principle may result in the incompatibility of national tax provisions with EC law. The Court of Justice has ruled that when such distinctions result in the unequal treatment

\textsuperscript{116} Treaty of Rome, \textit{supra} note 7, art. 177; \textit{see also} Community Law, \textit{supra} note 113, at 37.
\textsuperscript{117} \textit{Lier}, \textit{supra} note 105, at 20.
\textsuperscript{118} \textit{Stephen Weatherill & Paul Beaumont, EC Law}, 157–58 (1993). As of October 31, 1989, a new court, the Court of First Instance, resolves disputes between the EC and its employees as well as appeals against an EC institution concerning competition regulations. \textit{Lier, supra} note 105, at 10. The jurisdiction of the Court of First Instance was extended to most direct actions brought by natural or legal persons as of September 1, 1993. \textit{Id.} These decisions may be appealed to the Court of Justice on points of law. \textit{Id.}
\textsuperscript{119} \textit{See, e.g.}, Case 279/93 Finanzamt Köln v. Schumacker, 1995 E.C.R. 225, para. 21. The four freedoms are: the free movement of goods (arts. 9–37); the free movement of persons (arts. 48–58); the free movement of services (arts. 59–66); and the free movement of capital (arts. 67–73H). Treaty of Rome, \textit{supra} note 7.
of individuals or companies from other Member States, the tax law must be struck down unless the Member State can justify a derogation.\textsuperscript{121} Member States can justify a restriction on one of the fundamental freedoms with a legitimate general interest that cannot be assured by less restrictive measures.\textsuperscript{122} Belgium was able to justify a discriminatory provision in its tax law which allowed a deduction for insurance premiums, but only if the policies were with insurance companies located in Belgium. Mr. Bachmann, a German national working and living in Belgium, had insurance contracts with German companies and sought to deduct the premiums he paid from his Belgium income.\textsuperscript{123} Although the tax provision infringed Mr. Bachmann's rights under article 48, the Court agreed that it would undermine the coherence of the Belgian tax system to allow a deduction when there was no satisfactory assurance that Belgium would be able to tax the proceeds of his policies.\textsuperscript{124}

The coherence of the tax system justification has limits. For example, in the \textit{Wielockx} case, the Court found Dutch tax rules, which deny the deductibility of private pension allowances for non-resident self-employed individuals, incompatible with article 52, the freedom of establishment.\textsuperscript{125} Because the Netherlands had agreed to forgo the taxation of the pension income in its tax treaty with Belgium, the Netherlands had compromised its argument that there was no less restrictive means of ensuring the coherence of its system.\textsuperscript{126} The Court determined that coherence between the availability of a deduction and the taxability of

\textsuperscript{121} See, e.g., Case 270/83 Commission v. France, 1986 E.C.R. 273 (holding that failure of French law to extend a tax credit granted to French companies for French-source dividends to the permanent establishments of foreign companies, constituted a restriction on their freedom of establishment); Case 330/91 The Queen v. ex parte Commerzbank 1993 E.C.R. 4017 (holding that a United Kingdom law prohibiting non-resident companies from obtaining interest on tax repayments, was incompatible with articles 52 and 58 of the EC Treaty); Case 279/93 Finanzamt Koln v. Schumacker 1995 E.C.R. 225 (holding that a German law denying non-resident taxpayers special tax deductions allowed residents for family circumstances, was incompatible with article 48 when the non-resident worker receives almost all his income from that Member State); see also Michel de Wolf, \textit{The Power of Taxation in the European Union and in the United States}, 13 EC Tax Rev. 124, 127–28 (1995).


\textsuperscript{123} \textit{Id.} at 79.


\textsuperscript{125} Case 80/94, Wielockx v. Inspecteur der Belastingen, 1995 E.C.R. 876; \textit{see} Kees Van Raad, \textit{EC Court of Justice Decides Wielockx Case, Restricting the Scope of Bachmann Decision}, 11 Tax Notes Int'l. 779, 780 (Sept. 18, 1995).

\textsuperscript{126} Gammie & Brannan, \textit{supra} note 120, at 395.
the corresponding income, must take applicable tax treaties into consideration.\textsuperscript{127}

Finally, one must always keep in mind that the Treaty of Rome rules on free movement are designed to protect Community nationals in their efforts to engage in genuine cross-border economic activities.\textsuperscript{128} The Court of Justice confirmed this in \textit{Factortame II} with regard to the freedom of establishment: “The concept of establishment within the meaning of article 52 of the Treaty involves the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period.”\textsuperscript{129} Therefore, the Treaty’s provisions on free movement cannot be relied upon where the transaction is predominantly motivated by tax considerations.\textsuperscript{130}

\textbf{E. Taxation in the Community}

The unanimity requirement for tax legislation helps explain why progress towards tax harmonization has been so slow. But it is also important to recognize that the Member States have extremely wide variations not only in their tax rates but also in their basic approach to taxation. The following tables illustrate the structure of taxation in the EEC countries.

Table 1 contains information on the sources of tax revenue as a percentage of total tax revenue in each of the twelve Member States in 1992. The last entry represents an unweighted average that has been computed for the EEC. The sources of the revenue are divided into six categories: corporate income, personal income, social security, property, consumption, and other taxes.

All of the EEC member countries derived over seventy-five percent of their tax revenues from personal income taxes, social security taxes, and consumption taxes in 1992. With the exceptions of Luxembourg and Italy, corporate taxes play a very minor revenue-raising role.

\textsuperscript{127}Van Raad, \textit{supra} note 125, at 780.


\textsuperscript{129}Case 221/89 The Queen v. The Secretary of State for Transport, ex parte \textit{Factortame Limited} and Others, 1991 \textit{E.C.R.} 3905, para. 20.

\textsuperscript{130}Wouters, \textit{supra} note 128, at 184. For example, in the \textit{Daily Mail} case, the company tried to transfer its central management and control from the United Kingdom to the Netherlands in order to avoid capital gains tax. The Court would not interpret articles 52 and 58 as conferring a right to transfer central management and control to another Member State. Case 81/87 The Queen v. H.M. Treasury and Commissioners of Internal Revenue, ex parte \textit{Daily Mail and General Trust PLC}, 1988 \textit{E.C.R.} 5483, para. 25–24.
Table 1. Sources of Tax Revenue as a Percentage of Total Tax Revenue.

<table>
<thead>
<tr>
<th></th>
<th>Corporate Income</th>
<th>Personal Income</th>
<th>Social Security</th>
<th>Property Taxes</th>
<th>Consumption Taxes</th>
<th>Other Taxes</th>
</tr>
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<tbody>
<tr>
<td>1992</td>
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<td>31.2</td>
<td>36.0</td>
<td>2.5</td>
<td>25.5</td>
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<td>53.6</td>
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<td>4.0</td>
<td>32.5</td>
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<td>3.5</td>
<td>13.8</td>
<td>44.6</td>
<td>5.0</td>
<td>26.8</td>
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<td></td>
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<td>28.0</td>
<td>38.4</td>
<td>2.7</td>
<td>26.9</td>
</tr>
<tr>
<td></td>
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<td>10.2</td>
<td>30.7</td>
<td>4.4</td>
<td>46.1</td>
</tr>
<tr>
<td></td>
<td>Ireland</td>
<td>6.8</td>
<td>32.0</td>
<td>15.3</td>
<td>4.4</td>
<td>40.2</td>
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<tr>
<td></td>
<td>Italy</td>
<td>11.6</td>
<td>27.2</td>
<td>31.3</td>
<td>2.4</td>
<td>26.9</td>
</tr>
<tr>
<td></td>
<td>Luxembourg</td>
<td>13.1</td>
<td>22.2</td>
<td>28.4</td>
<td>7.9</td>
<td>28.4</td>
</tr>
<tr>
<td></td>
<td>Netherlands</td>
<td>6.6</td>
<td>24.8</td>
<td>38.8</td>
<td>3.6</td>
<td>25.8</td>
</tr>
<tr>
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<td>20.4</td>
<td>25.4</td>
<td>2.3</td>
<td>43.0</td>
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<tr>
<td></td>
<td>Spain</td>
<td>6.4</td>
<td>23.6</td>
<td>36.6</td>
<td>4.7</td>
<td>28.5</td>
</tr>
<tr>
<td></td>
<td>U.K.</td>
<td>7.6</td>
<td>28.4</td>
<td>17.8</td>
<td>7.9</td>
<td>34.4</td>
</tr>
<tr>
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<td>6.7</td>
<td>26.3</td>
<td>28.9</td>
<td>4.3</td>
<td>32.1</td>
</tr>
</tbody>
</table>


Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Spain, and the United Kingdom appear to rely most heavily on direct taxes131 (corporate income, personal income, and social security taxes) as the predominant source of revenue, whereas Greece and Portugal rely predominantly on indirect taxes such as property and consumption taxes.132 Belgium, France, Germany, the Netherlands, and Spain raise over one third of their tax revenue from social security taxes.

Table 2 contains data on total tax revenues as a percentage of gross domestic product (GDP) for each of the twelve Member States and the EEC as a whole. Table 3 illustrates the source of these revenues as a percentage of GDP for 1992. Tax revenues as a percentage of GDP, also known as the tax ratio, measures the size of the tax burden in each country relative to the value of goods and services produced within its physical boundaries. In 1992, the tax ratios ranged from a high of 49.3% in Denmark to a low of 33.0% in Portugal, over a 16 percentage

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131 Direct taxes include the OECD categories of Income and Profits (1000), Social Security (2000), and Payroll (3000) taxes which correspond to corporate income, personal income, and social security taxes in Table 1. This classification is in accordance with the System of National Accounts, United Nations, 1968. See OECD, REVENUE STATISTICS OF THE OECD MEMBER STATES 1965–1994 41 (1995 ed.).

132 Indirect taxes include the OECD categories of Property (4000) and Goods and Services (5000), taxes which correspond to property and consumption taxes in Table 1. This classification is in accordance with the System of National Accounts, United Nations, 1968. See id.
point spread. The common denominator, however, is that the residents of EEC countries are very heavily taxed. In comparison, U.S. federal tax revenues equaled 29.4% of GDP in 1992.

The trend since 1965 has, for the most part, been increased taxation. Total tax revenues as a percentage of GDP have increased over fifteen percentage points in countries like Denmark, Greece, Italy, Luxembourg, and Spain. However, since 1986, with the exceptions of Italy, Germany, Greece, the Netherlands, and Spain, tax ratios are either leveling off or slightly declining and the spread is narrowing. In 1986, the tax ratios ranged from a high of 50.8% in Denmark to a low of 30.6% in Spain, over a 20 percentage point spread. By 1992, Denmark still had the highest tax ratio, 49.3%, and Portugal had the lowest tax ratio, 33.0%, narrowing the spread between the EEC countries to 16.3 percentage points. Within the EEC, Belgium, Denmark, France, Germany, Greece, Italy, Luxembourg, and the Netherlands would be considered high–tax countries (tax ratios approximately 40% and above) and Ireland, Portugal, Spain, and the United Kingdom would be considered low–tax countries.

As pointed out in the public finance literature, the reasons for the varying high levels of taxation can be traced to the different levels of acceptance of a larger role for the public sector in each of the EEC countries.133 There has also been an increased demand for income

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Table 3. Sources of Tax Revenue as a Percentage of Gross Domestic Product.

<table>
<thead>
<tr>
<th></th>
<th>Corporate Income</th>
<th>Personal Income</th>
<th>Social Security</th>
<th>Property Taxes</th>
<th>Consumption Taxes</th>
<th>Other Taxes</th>
</tr>
</thead>
<tbody>
<tr>
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<td>16.3</td>
<td>1.1</td>
<td>11.6</td>
<td>—</td>
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<td>26.4</td>
<td>1.5</td>
<td>2.0</td>
<td>16.0</td>
<td>0.1</td>
</tr>
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<td>1.5</td>
<td>6.0</td>
<td>19.4</td>
<td>2.2</td>
<td>11.7</td>
<td>1.8</td>
</tr>
<tr>
<td>Germany*</td>
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<td>11.1</td>
<td>15.2</td>
<td>1.1</td>
<td>10.7</td>
<td>—</td>
</tr>
<tr>
<td>Greece</td>
<td>1.9</td>
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<td>18.7</td>
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<td>12.0</td>
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</tr>
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</table>


redistribution through the budget leading to increased public outlays of varying degrees for transfer programs for the unemployed, elderly, sick, etc.134

Table 4 illustrates this income redistribution theory. Much of the growth in tax revenues has been from increased taxes on income and profits, particularly for the period between 1965 and 1988.135 This source of revenue is generally perceived to be more progressive than taxes on goods and services.136 With the exception of the United Kingdom, every EEC country’s taxes on income and profits grew by at least two percentage points, with Denmark growing by a phenomenal 15.7 percentage points since 1965. Denmark, Greece, Luxembourg, Portugal, and Spain also saw significant growth in taxes on goods and services as a percentage of GDP. Only in Greece, Luxembourg, and


135 Most of the increase took place between 1965 and 1975. See Messere, supra note 133, at 82–83.

136 See id. at 145, 394.
Table 4. Selected Taxes as a Percentage of Gross Domestic Product

<table>
<thead>
<tr>
<th></th>
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Source: Based on Revenue Statistics of OECD Member Countries, 1965–1993, Tables 8 and 24, Paris, 1994. * Taxes on Income and Profits covers taxes levied on the net income or profits of individuals and enterprises. ** Taxes on Goods and Services include all taxes and duties levied on the production, extraction, sale, transfer or delivery of goods, and the rendering of services such as multi-stage cumulative taxes, general sales taxes, VATs, and excise taxes.

Portugal did the percentage point increases in taxes on goods and services exceed that of taxes on income and profits.

As illustrated by Tables 1 and 4, the distribution of the tax burden between direct and indirect taxes differs greatly from one country to another. The disparity between the highest direct tax ratio, Denmark at 29.4%, and the lowest, Greece at 7.4%, has broadened greatly since 1965 (22.0 percentage points versus 11.7 percentage points). This phenomenon is not as significant in the case of indirect taxation. In 1992, Greece had the highest indirect tax ratio at 18.7% and Spain the lowest ratio at 10.2%. This is comparable to Ireland’s indirect tax ratio of 13.7% and Spain’s at 6.0% in 1965. Thus, while the gap has widened, there has not been a significant increase in the disparity. This diversity in tax structures among the Member States partly explains the slow progress being made in the area of tax harmonization.

II. DIRECT TAXATION

A. The Directives and the Arbitration Convention

The scope of EC direct tax legislation is much more limited than indirect tax legislation. As discussed previously, the legal basis for proposals on direct taxes is confined to those having a direct impact
on the functioning of the common market. The goal is to "ensure that firms operating across frontiers are not subject to less favorable tax conditions than those applicable to their activities in the Member State in which they are established." Until 1990, no substantive progress had been made in the area of direct tax harmonization. Previously, in 1975, the Commission had proposed a draft directive on the harmonization of corporate and individual income taxes and withholding taxes on dividends. It called for the adoption of an imputation system with a single corporate tax rate to range between forty-five and fifty-five percent, an income tax credit on dividends, and uniform dividend withholding rates of twenty-five percent. Too ambitious an undertaking, this draft languished. Harmonization of corporate tax rates and the tax treatment of dividends seemed senseless in light of the extreme differences that existed in the calculation of taxable corporate income.

The Commission withdrew the draft directive of 1975 and concentrated on those measures deemed essential by the White Paper for Completing the Internal Market by December, 1992. The Commission made progress after years of stagnation when the Council reached agreement in July 1990 on three corporate tax proposals: (1) a common system of taxation applicable to parent companies and their subsidiaries in different Member States ("Parent-Subsidiary Directive"); (2) a common system of taxation applicable to mergers, divisions, transfers of assets, and exchange of shares involving companies from different Member States ("Mergers Directive"); and (3) a transfer-price arbitration procedure ("Arbitration Convention").

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137 Treaty of Rome, supra note 7, art. 100; Taxation in the Single Market, supra note 41, at 25.
140 See infra note 151 for an explanation of imputation systems.
141 Cnossen, supra note 134, at 39.
142 See GUIDELINES ON COMPANY TAXATION, supra note 5, at 10. See supra notes 43-45 and accompanying text for a discussion of the White Paper.
146 Convention 90/436 on the Elimination of Double Taxation in Connection with the Adjust-
1. The Parent–Subsidiary Directive

The Parent–Subsidiary Directive evolved from a Commission proposal submitted to the Council in 1969.\(^{147}\) It provided that a Member State should not impose a withholding tax on dividends paid to a parent company by a subsidiary owned twenty-five percent or more by the parent.\(^{148}\) The implementing legislation must either exempt the dividends from corporate tax or allow a credit for any tax paid by the subsidiary on the profits from which the dividend is paid.\(^{149}\) Thus, this Directive will go some distance toward guaranteeing the neutrality of the tax law with respect to investment decisions.\(^{150}\)

In most cases, there will be no double taxation when a company decides to set up a subsidiary in another Member State. The Parent–Subsidiary Directive, however, does not extend across borders the benefit of the imputation systems that integrate corporate and shareholder taxation in several Member States.\(^{151}\) As the corporate tax imputed to shareholders as a credit against their personal income tax liability can be denied to foreign shareholders, the effect of the Directive is to allow the source country to collect a single, full level of

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\(^{147}\) Taxation in the Single Market, supra note 41, at 25.

\(^{148}\) Parent-Subsidiary Directive, supra note 144, art. 5. Imputation taxes such as the precompte in France, imposta di congraulio in Italy, equalization tax (Ausschuttungsbelastung) in Germany, and advance corporation tax (ACT) in Ireland and the United Kingdom are still allowed. Ruding Report, supra note 2, at 54. These taxes ensure that all dividends paid out for which there is a shareholder tax credit have actually been subject to domestic corporate tax. Id.; see Parent-Subsidiary Directive, supra note 144, art. 7.

\(^{149}\) Parent-Subsidiary Directive, supra note 144, art. 4. The Directive is limited in its application to a company that takes one of the legal forms listed in the Annex to the Directive, is resident for tax purposes in a Member State, and is subject to one of the corporate taxes listed in article 2. Id. art. 2; see infra notes 229-32 and accompanying text for discussion of expansion of the scope of the Parent-Subsidiary Directive. Member States have the option of not applying the Directive to companies which do not maintain their holdings in the subsidiary for a continuous period of at least two years. Parent–Subsidiary Directive, supra note 144, art. 3.

\(^{150}\) Muray, supra note 143, at 75; see also Taxation in the Single Market, supra note 41, at 26.

\(^{151}\) Ruding Report, supra note 2, at 195–96. Luxembourg and the Netherlands operate classical corporate tax systems under which corporate profits distributed as dividends are fully taxable at the corporate level and again at the shareholder level. Id. at 194. The other Member States provide relief for this double taxation at either the corporate level, the shareholder level, or both levels. Id. Germany levies a lower tax rate on dividend distributions and Greece allows a partial or full deduction for dividend payments. Id. Germany, France, Italy, Ireland, and the UK provide shareholder relief by granting imputation credits with France, Germany, and Italy providing a full credit for corporate taxes actually paid. Belgium, Denmark, and Portugal levy reduced personal tax rates on dividend receipts. Id.; see infra notes 219-21 and accompanying text for Ruding Committee recommendations.
tax from the distributing subsidiary.\textsuperscript{152} Therefore, in many situations, cross-border tax structures will remain biased.\textsuperscript{153}

The Directive required implementing legislation to be effective by January 1, 1992, although Germany, Greece, and Portugal were given extensions with respect to the zero withholding tax requirement.\textsuperscript{154} Every Member State has implemented the Directive, although Italy met this deadline only by a legislative decree on March 5, 1993 retroactive to profits distributed on or after January 1, 1992.\textsuperscript{155} The legislation adopted by Italy is typical and relies on the exemption method\textsuperscript{156} so that ninety-five percent of the profits distributed by EC subsidiaries are not included in the taxable income of the Italian parent.\textsuperscript{157} To qualify for this tax treatment: (1) the parent must have held a minimum of twenty-five percent of the subsidiary’s capital for at least a continuous year when the distribution is made; (2) the subsidiary must

\textsuperscript{152} Risinger, \textit{supra} note 4, at 21. Germany integrates corporate and shareholder taxation by means of a combination of imputation credit and split rate (the use of a lower corporate rate for distributed profits than for retained earnings). \textit{Id.} Because of the nondiscrimination clause of Germany’s tax treaties, the benefit of the split rate cannot be denied to foreign shareholders. \textit{Id.} As zero rate withholding effectively forces Germany to extend the benefit of the split rate to foreign parent companies, Germany may continue to exact a five percent withholding tax until mid-1996, provided it continues to grant a rate reduction for distributed profits of at least eleven percentage points. \textit{Id.} at 20.

\textsuperscript{153} Muray, \textit{supra} note 143, at 78.

\textsuperscript{154} Parent-Subsidiary Directive, \textit{supra} note 144, art. 8. Germany may withhold 5% on dividends until July 1, 1996 as long as the corporate income tax rate on retained earnings exceeds the rate on distributed profits by 11%. \textit{Id.} art. 5, para. 3. Greece may withhold on dividends distributed to parent companies in other Member States until it implements a corporate tax on distributed profits. \textit{Id.} art. 5, para. 2. Note, Greece abolished dividend withholding tax for years after June 30, 1992. Cussons, \textit{supra} note 23, at 108. Portugal may withhold 15% on dividends until 1997 and 10% until 2000. Parent-Subsidiary Directive, \textit{supra} note 144, art. 5, para. 4.


\textsuperscript{157} The Parent-Subsidiary Directive permits a Member State to disallow expenses relating to the subsidiary holding not to exceed five percent of the profits distributed by the subsidiary if expenses are fixed at a flat rate. Parent-Subsidiary Directive, \textit{supra} note 144, art. 4, para. 2. Thus,
be a resident in an EC Member State and incorporated under one of the legal forms listed in the appendix of the Directive; and (3) the subsidiary must be subject to corporate income tax in its state of residence.\(^{158}\)

The Parent–Subsidiary Directive allows for the adoption of an anti-avoidance regime.\(^{159}\) Some commentators are concerned that the lack of harmonization with respect to the anti-avoidance rules may thwart the Directive.\(^{160}\) The French legislation, for example, denies the benefit of the exemption from withholding taxes when dividends are paid to entities directly or indirectly controlled by one or several residents of non–EC Member States.\(^{161}\)

2. The Mergers Directive

The Mergers Directive also originated from a 1969 proposal.\(^{162}\) The Mergers Directive seeks to remove barriers to the free and unimpeded flow of capital by, under some conditions, deferring or eliminating gains at the corporate level in mergers, divisions, transfers of assets, or exchanges of shares\(^{163}\) involving corporations from multiple EC countries.\(^{164}\) This Directive was to facilitate the restructuring deemed neces-

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\(^{158}\) Bellentini, supra note 155, at 36.

\(^{159}\) Parent-Subsidiary Directive, supra note 144, art. 1, para. 2.

\(^{160}\) Augusto Fantozzi & Andrea Manganelli, Italy, 1 EC TAX REV. 32, 38 (1993) (noting that differences in the effectiveness of the anti-avoidance rules in a particular jurisdiction are likely to distort competition and decisions on the location of investment).


\(^{162}\) Taxation in the Single Market, supra note 41, at 26.

\(^{163}\) Mergers Directive, supra note 145, art. 2. Article 2(a) defines "merger" as a combination of two or more existing companies into an existing company or a new company (including a parent) in which the shareholders of the merged companies receive securities of the surviving or new company and cash, if any, not exceeding 10% of the nominal value or accounting par value of those securities. A "division" is defined in article 2(a) as a transfer by an existing company of all its assets and liabilities to two or more existing or new companies in exchange for the issuance of securities to the transferor's shareholders. A "transfer of assets" is defined in article 2(c) as a transfer of one or more branches by one company to another company in exchange for securities to the transferee. An "exchange of shares" is defined in article 2(d) as 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 of the accounting par value of the securities issued in exchange. Id.; see also Aland, supra note 44, at 1075 n.29.

sary to compete in the internal market. Without the Directive, a cross-border merger could cause the recapture of depreciation, the taxation of capital gains on appreciated property, and the disappearance of carryforward losses.165

Pursuant to the Directive, the resulting corporation inherits the tax history of the assets and any carryover losses from the former company.166 The Mergers Directive also provides for deferral of tax consequences until the sale of the assets to a third party.167 The Mergers Directive rules are roughly comparable to the U.S. tax rules governing tax-free reorganizations.168

Unfortunately, many of the cross-border transactions contemplated by the Directive cannot yet be legally implemented because progress in the tax field has actually outpaced developments in the company law area.169 The Mergers Directive must be supplemented by commercial law changes required by the proposed Tenth Company Law Directive before cross-border mergers and divisions are permitted under some domestic company laws.170 For example, laws presently exist in Belgium and the United Kingdom permitting mergers but only between domestic entities. Cross-border mergers and divisions as set forth by the Directive are not legally possible or recognized in these countries.171

In contrast, cross-border transfers of assets and exchanges of shares, also within the scope of the Directive, generally are already possible in all Member States except for Greece.172 All EC countries except for Belgium, Germany, Greece, and the United Kingdom have implemented the Mergers Directive.173 Belgium, Germany, and the United

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165 See Mergers Directive, supra note 145, art. 4, art. 6.
166 Id. art. 4., para. 2, art. 6.
167 Id. art. 4.
168 Aland, supra note 44, at 1075; see I.R.C. § 368 (CCH 1995).
169 Muray, supra note 143, at 77.
172 Muray, supra note 143, at 78–79; see infra notes 229–31 and accompanying text for discussion of proposed amendments to the Mergers Directive.
173 Consolidated Commentary, supra note 171, at 4–22. As for the newest EC members, Sweden
Kingdom have taken the position that their legislation already conforms with the Directive because the Directive is only relevant for the exchange of shares and the transfer of assets. Greece is the furthest from implementing the Mergers Directive because it has no tax or company laws governing cross-border transactions as set forth by the Directive. The specific provisions in each country's tax laws vary as to the conditions for the tax-free or tax-deferred treatment of the transactions (mergers, divisions, transfers of assets, or exchanges of shares).

3. The Arbitration Convention

The final measure adopted by the Council was an arbitration procedure designed to eliminate the double taxation resulting from adjustments made by one tax authority that are not accompanied by a corresponding adjustment by the other Member State's tax authority, for example, in the area of transfer pricing. The Community has realized that optional provisions of bilateral agreements are insufficient to prevent such double taxation.

The Arbitration Convention establishes a mandatory arbitration procedure upon failure by the competent authorities to reach an agreement, and sets forth a specific timetable for the resolution of the matter. If the competent authorities fail to reach agreement within two years, the case is referred to an advisory commission for arbitration. This commission then has six months to deliver its opinion which the

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174 LIER, supra note 105, at 185.
175 Consolidated Commentary, supra note 171, at 10.
176 Unlike the Parent-Subsidiary Directive and the Mergers Directive, the Arbitration Convention is actually a multilateral treaty. LIER, supra note 105, at 159. Article 220 authorizes Member States to enter into negotiations in order to avoid double taxation. Treaty of Rome, supra note 7, art. 220.
177 Taxation in the Single Market, supra note 41, at 27.
178 Income tax treaties usually provide for a dispute resolution mechanism where taxpayers initially bring claims of improper treatment under a tax treaty to a representative of their own government, known as the "competent authority." MICHAEL McINTYRE, THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES 2–71 (2d ed. 1992).
179 Arbitration Convention, supra note 146, art. 7, para. 1.
competent authorities must implement within the next six months.\footnote{180 Id. art. 11; see also Muray, supra note 143, at 76.} Ratified by the legislature of each Member State,\footnote{181 Patrick L. Kelly, EU Arbitration Convention Ratified by all Member States, 9 Tax Notes Int’l 152-56 (1994). As of June 1995, the three newest EC members, Austria, Sweden, and Finland have not yet ratified the Arbitration Convention. Jan-Willem Gerritsen, Report on Baker & McKenzie 1995 European Tax Conference, 10 Tax Notes Int’l 1938 (1995).} this Convention entered into force on January 1, 1995, the first day of the third month following the deposit of the last ratification instrument.\footnote{182 \textit{European File, Tax Law and Cross-Border Cooperation Between Companies} 6 (1991) [hereinafter \textit{European File}]. Portugal deposited its instrument of ratification on October 20, 1994. John Turro, \textit{EU Arbitration Convention to Enter Into Force January 1, 1995}, 9 Tax Notes Int’l 1602 (1994). The Convention will initially be effective for five years. Kelly, supra note 181, at 153. The signatory countries will meet again prior to the conclusion of the five-year time period to decide upon an extension or any other modifications. \textit{Id.}}

4. Proposed Directives

Also during 1990, the Commission proposed two directives with respect to cross-border loss relief\footnote{183 \textit{Proposal for a Council Directive Concerning Arrangements for the Taking into Account by Enterprises of the Losses of their Permanent Establishments and Subsidiaries Situated in Other Member States, 1991 O.J. (C 53) 30} [hereinafter Loss Directive].} and the elimination of withholding taxes on inter-company royalties and interest payments.\footnote{184 Proposals for a Council Directive Concerning Arrangements for the Taking into Account by Enterprises of the Losses of their Permanent Establishments and Subsidiaries Situated in Other Member States, 1991 O.J. (C 53) 30 [hereinafter Loss Directive].} The Loss Directive is applicable to companies with loss-generating permanent establishments or subsidiaries in another EC country. Under the proposal, each Member State would choose one of two methods of relief. The first method, the credit method, allows aggregation of the profits and losses of all of the permanent establishments of the company with a credit for the foreign taxes paid on the profits of the permanent establishments.\footnote{185 Loss Directive, supra note 183, arts. 6-7; see also Direct Tax, supra note 39, § 3.6.}

The second method, the re-incorporation method, provides a deduction for foreign tax losses from the profits taxable by the home country and re-incorporation of foreign tax profits to the extent of the losses previously allowed. The re-incorporation method must be chosen for losses of a subsidiary.\footnote{186 See Loss Directive, supra note 183, art. 9.} In March 1992, the European Parliament issued its opinion on the Loss Directive.\footnote{187 Direct Tax, supra note 39, § 3.6.} The proposal for
this directive is under consideration by the Council but negotiations are progressing very slowly.\textsuperscript{188}

Similar to the Parent–Subsidiary Directive, the proposal regarding the limitation of the withholding tax on interest and royalties paid between affiliated EC companies required that Member States exempt cross-border interest and royalty payments made between parents and subsidiaries from withholding taxes.\textsuperscript{189} Although the EC finance ministers began discussions in 1991, they were unable to adopt this Directive.\textsuperscript{190} On November 30, 1994, the Commission formally withdrew the proposed Interest and Royalty Directive.\textsuperscript{191} The Commissioner will consult with interested parties and present a new proposal in the near future.\textsuperscript{192}

The Parent–Subsidiary Directive’s most immediate effect is an appreciable reduction in the cross-border tax burdens of the affected companies. The Mergers Directive is already effective for transfers of assets and exchanges of shares, but must wait for Community company law action with respect to mergers and divisions. The European Parliament has not yet opined on the Commission’s proposal on cross-border mergers of public limited companies (Tenth Company Law Directive), and the Council is still examining the modified proposal for a regulation for a European Company Statute.\textsuperscript{193} Finally, unlike double taxation conventions, the Arbitration Convention involves the affected company in the proceedings at an early stage, which should result in significant savings realized from the time restrictions.\textsuperscript{194}

Besides the establishment of substantive rules, these directives and the proposed directives have and will continue to have an important

\textsuperscript{188} Id.

\textsuperscript{189} Interest and Royalty Directive, supra note 184, art. 4. In March 1991 and February 1992, both the Economic and Social Committee and the European Parliament respectively adopted favorable opinions on this proposal. Direct Tax, supra note 39, § 3.5. Pursuant to the recommendations of the Parliament, the Commission amended the proposed directive expanding the definition of included interest and royalty payments. Amended Interest and Royalty Directive, 1993 O.J. (C 178) 15.

\textsuperscript{190} Nigel Tutt, EC Finance Ministers Discuss Easing Withholding Tax on Interest, TAX ANALYSTS’ DAILY TAX HIGHLIGHTS AND DOCS., Apr. 9, 1991, at 303; see also Richard G. Minor, Euromoney Conference Focuses on EC Tax Policy, Eastern Europe, and Transfer Pricing, 6 TAX NOTES INT’L 1548 (1993).


\textsuperscript{192} Id.


\textsuperscript{194} EUROPEAN FILE, supra note 182, at 16.
indirect influence on the interpretation of treaties. Most tax treaties follow article 3(2) of the OECD Model Treaty and require the use of a nation's domestic law to interpret an undefined term. The directives, once enacted, become part of the domestic law of the EC Member State, and any definition found in them will also apply for treaty interpretation.

B. *The Ruding Committee Report*

Progress in the direct taxation area has come about because the Commission adopted a flexible approach. Convergence, approximation, and cooperation rather than harmonization are encouraged. In keeping with this new approach, in December, 1990, Commissioner Scrivener established a committee of independent experts chaired by Mr. Onno Ruding, a former Dutch Finance Minister, to identify future proposals on company taxation after 1992. The Committee's mandate was to evaluate the need for greater harmonization of business taxation. The Committee considered the following questions: (1) whether the differences in corporate taxation among the Member States create distortions with respect to investment decisions and competition in the single market; (2) whether the distortions should be eliminated through Community measures or whether market forces and competition between national tax systems should be allowed to run their course; and (3) what specific Community measures are required to remove or mitigate these distortions.

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198 *Id.*


200 The Committee was set up pursuant to the Commission Communication "Guidelines on Company Taxation." *Guidelines on Company Taxation, supra* note 5, at 148. Other members included Mr. de Buitelir, Mr. Descours (president of Andre, French clothing company), Mr. Gascon (Spanish economist), Mr. Gatto (Fiat director), Mr. Messere (former head of the Fiscal Affairs Division of the OECD), Dr. Radler (Professor at the University of Hamburg, Germany), and Dr. Vanistendael (Professor at the Catholic University of Leuven, Belgium). Ruding Report, *supra* note 2, at 7.


202 *Id.*
On March 18, 1992, the Ruding Committee presented its report to
the Commission. The Committee noted that there were major diffe-
rences in the corporate tax systems, tax rates, and tax bases utilized by
each Member State. Based on a simulation study and an empirical
survey, the Committee concluded that the tax burdens on the domestic
companies in each Member State differed and that overall, there was
discrimination against foreign investors. Although the Committee
found that there had been some convergence of the Member States’
tax regimes, the Committee decided that further action was needed at
the Community level. The priorities outlined in the Ruding Report
were: (1) removing the discriminatory and distortionary features of
each country’s tax system that impede cross-border business invest-
ment and shareholding; (2) setting a minimum statutory corporate tax
rate and common rules for the tax base in order to limit excessive tax
competition between the Member States; and (3) encouraging maxi-
mum transparency of any tax incentives granted by a Member State.

The Report also contained a three-phase schedule for implement-
ing the corporate tax measures that the Committee deemed necessary
to achieve a true internal market. Phase I proposals were considered
urgent and were to be implemented by the end of 1994. These pro-
posals predominantly refine proposed and adopted Community meas-

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203 Id. Chapter 3 of the report provides an overview of the tax base, the nature of the corporate
tax system, and the corporate income tax and withholding tax rates in each Member State. Id. at
49–65. As of January 1992, the corporate tax rates ranged from 33% in Luxembourg to 50% in
Germany, with some income in Ireland taxed at a rate as low as 10%. Id. at 50. As of January
1995, EC Member States imposed corporate tax rates that ranged from 28% in Sweden to 45%
in Germany, with a 10% tax rate for manufacturing and certain internationally traded service
income available in Ireland. ERNST & YOUNG, WORLDWIDE CORPORATE TAX GUIDE 154 (1995). The
rate quoted for Germany applies to retained profits. Id.

204 Ruding Report, supra note 2, chs. 4–5. The simulation study of chapter 4 modeled the
corporate tax component of the cost of capital in each country from domestic and foreign
sources. The empirical survey of chapter 5 examined the influence of tax considerations on
location decisions.

205 Id. chs. 7–8. As much of this convergence was attributable to the downward convergence of
interest and inflation rates, the Committee concluded that any further convergence must be
achieved from changes to the tax systems themselves. Id.; see also Frans Vanistendael, The Ruding

206 Ruding Report, supra note 2, at 13. Due to the Commission’s close scrutiny of the use of
direct subsidies, the Ruding Committee expressed concern that Member States may instead resort
to tax incentives. Id. at 42. The Committee stressed the need to ensure that hidden tax incentives,
particularly those affecting the tax base, did not distort competition within the Community. Id.
at 192.

207 Id. ch. 10.
Phase II concerned the harmonization of the tax base, and Phase III included an integration proposal and refinements of the tax base keyed to the common accounting rules. The Committee linked the timing of these proposals to the development of the European Economic and Monetary Union (EMU). Phase II should be implemented during the second phase of EMU, and Phase III was envisaged as being implemented concurrently with the completion of the EMU.

In general, the Ruding Committee’s recommendations can be divided into two categories: (1) those designed to eliminate the double taxation of cross-border income flows; and (2) those designed to harmonize the corporate tax systems of the Member States. The Committee acknowledged the progress made in removing obstacles to cross-border capital flows by the implementation of the Parent-Subsidiary Directive. To further this progress, the Committee recommended that the twenty-five percent ownership prescribed in the Directive be reduced for Phase I. The Committee also urged that during Phase I, the Member States adopt both the proposed Interest and Royalty Directive, and the proposed Loss Directive, ratify the Arbitration

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208 Id. Phase I proposals were designed to eliminate the most pervasive discriminations and the greatest obstacles to multinational business operations. These proposals were also expected to raise the least political controversy. Vanistendael, supra note 205, at 91.

209 Ruding Report, supra note 2, ch. 10. The Ruding Committee called for the introduction of a common corporate income tax system, with source-country entitlement as a feature, during the final step of EMU. Id. Seven of the eight Committee members endorsed a corporate tax system of shareholder relief developed by Radler and Blumenberg. Id. at 439–60. This proposal was not incorporated into the report because Mr. Messere dissented. Id. at 461–63; see also Jens Blumenberg, Germany, 2 EC Tax Rev. 116, 118 (1993).


211 Ruding Report, supra note 2, at 203. The Committee recommended an extension of the Parent-Subsidiary Directive to all other enterprises subject to income tax for Phase II. Id.

212 The Committee also recommended that the scope of the Interest and Royalty Directive be extended to include all payments between enterprises with appropriate measures to ensure effective taxation of the income to the beneficiary. Id. at 204–05; see supra notes 184–92 and accompanying text for further discussion of the proposed Interest and Royalty Directive and its withdrawal by the Commission.

213 For Phase II, the Committee recommended that the Member States allow full vertical and horizontal loss-offsetting within groups of enterprises at the national level and full Community-wide loss-offsetting within groups of enterprises for Phase III. Ruding Report, supra note 2, at 206; see supra notes 183–88 and accompanying text for further discussion of the Loss Directive.
Convention, conclude comprehensive bilateral income tax treaties between themselves, and work in concert with the Commission to develop a common policy on double taxation agreements with respect to non-EC Member States. To combat tax evasion and ensure a sufficient level of source taxation, the Committee recommended that during Phase II the Commission propose a uniform withholding tax of thirty percent on dividend distributions by EC-resident companies to non-EC-resident taxpayers.

The Committee recommendations with respect to corporate tax harmonization concerned the Member States' systems of integration of the corporate and personal income tax, their statutory corporate tax rates, and their corporate tax bases. The Ruding Committee concluded that "the manner in which Member States currently provide relief for the double taxation of corporate profits distributed to individual shareholders in the form of dividends constitutes a source of discrimination against cross-border investment flows." The Ruding Committee did not recommend that Member States with imputation systems extend imputation credits to non-resident shareholders, arguing that this step would not be in accordance with the principle of the

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214 Ruding Report, supra note 2, at 205. The Convention has been ratified and became effective January 1, 1995. See supra notes 181-82 and accompanying text.

215 Ruding Report, supra note 2, at 206. There is a long standing, comprehensive body of income tax treaties between the individual members of the EC. Id. A notable exception to this is Portugal, which has no income tax treaties or agreements with Finland, Luxembourg, the Netherlands, and Sweden. Id. In addition, there are no income tax treaties or agreements between the following countries: Spain and Greece and Ireland and Greece. TAX ANALYSTS, WORLDWIDE TREATY INDEX (1994).

216 Ruding Report, supra note 2, at 203-04.

217 Germany, France, Italy, Ireland, and the United Kingdom currently alleviate the economic double taxation of dividends through an imputation credit system. Id. at 194. The imputation system subjects a company's profits to corporate tax liability. J.D.R. ADAMS & J. WHALLEY, THE INTERNATIONAL TAXATION OF MULTINATIONAL ENTERPRISES IN DEVELOPED COUNTRIES 14 (The Institute for Fiscal Studies, ed. 1977). When these profits are distributed as dividends, part of the corporate tax is treated as tax paid by the shareholder, i.e., part of the corporate tax is imputed to the shareholder as a credit against the individual personal income tax liability. Id.

218 Ruding Report, supra note 2, at 207. A country operating an imputation system to integrate corporate and personal income taxes can deny the tax credit to foreign shareholders without infringing tax treaty provisions. ADAMS & WHALLEY, supra note 217, at 86. A new article relevant to direct taxation, article 73d, enables Member States "to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested," as long as these provisions are not arbitrary. Treaty of Rome, supra note 7, art. 73d, amended by TEU, supra note 1, art. G(15). Some commentators assert that article 73d allows Member States to continue to deny the benefit of imputation tax credits to foreign shareholders and clarifies that this system
source state's primary right to tax income attributable to activities within its borders. However, the Committee did recommend for Phase I that those countries currently providing relief for domestic source dividends paid to domestic shareholders, either in the form of an imputation credit or a reduced rate of personal tax, be required to provide equivalent relief for dividends paid out of profits from operations in other Member States. The Committee acknowledged the Member States' unwillingness to accept a uniform system of corporate integration in the near future, and therefore, established as a goal for Phase III that the Commission and the Member States determine the most appropriate corporate tax system for the Community.

In the area of tax rates, the Committee recommended that the Commission prepare a directive prescribing a minimum statutory corporate tax rate of thirty percent during Phase I and that all Member States adopt a maximum statutory corporate tax rate of forty percent during Phase II. As harmonization of the corporate rates makes little sense without some minimum degree of harmonization of the corporate tax base, the Committee called for the establishment of an independent group of technical experts to study the various aspects of the tax base during Phase I. In addition, the Ruding Committee recommended that the Commission issue detailed proposals on items such as depreciation, intangibles, leasing, and stock valuations for Phases I and II.

A communication of June 24, 1992, set out the Commission's initial reactions to the Ruding Committee's conclusions and recommendations. Generally speaking, the Commission was very supportive of the

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219 The jurisdictional claim to tax transnational income based on a nexus between a state and the activities that generated the income is known as source jurisdiction. McIntyre, supra note 178, at 1–3. The OECD Model generally recognizes the source state's primary right to tax business profits attributable to activities conducted within that state. Richard Doernberg, Amending the OECD Model Treaty and Commentary in Response to Corporate Tax Integration, 1 INTERTAX 3, 4 (1995).

220 Ruding Report, supra note 2, at 207–08.

221 Id. at 208–09.

222 Id. at 209–10.

223 Id. at 212.

224 Id. at 212–18.

225 Commission of the European Communities, COMMISSION COMMUNICATION TO THE COUNCIL
proposals eliminating the double taxation in cross-border flows.\textsuperscript{226} With respect to the Committee's recommendations on corporate tax harmonization, however, the Commission was more restrained.\textsuperscript{227} The Commission believed that these recommendations went beyond what was necessary at the Community level. "In Mrs. Scrivener's view, it is important not to be carried away by a drive for harmonization which is not justified on economic grounds and which would not be consistent with the principle of subsidiarity and the respective responsibilities of the Member States and the Community."\textsuperscript{228}

Specifically, the Commission considered the extension of the scope of the Parent-Subsidiary Directive and the Mergers Directive to be desirable and necessary.\textsuperscript{229} In July, 1993, the Commission proposed a directive that would extend the scope of these directives to all enterprises subject to corporate tax.\textsuperscript{230} The proposed Directive also amends the Mergers Directive to require a holding of a minimum of twenty-five percent of the subsidiary's capital in order to be consistent with the Parent-Subsidiary Directive\textsuperscript{231} and amends the Parent-Subsidiary Directive to take into account taxes levied by the lower-tier subsidiaries when using the imputation method.\textsuperscript{232}

The Commission also endorsed both the establishment of appropriate procedures for transfer price adjustments and a common approach
to the definition and treatment of thin capitalization.\textsuperscript{233} The Commission considered the recommendation regarding full vertical and horizontal offsetting of losses within groups of enterprises at the national level to be beyond the scope of necessary Community action.\textsuperscript{234} The Commission concurred with the Committee's goal of neutrality of treatment as between foreign-source and domestic-source dividends. The Commission expressed concern, however, over the Committee's recommendation because the condition of reciprocity (requiring only those Member States currently providing relief for domestic-source dividends to provide equivalent relief for foreign-source dividends) limits the benefit to Member States applying imputation systems and tax relief systems.\textsuperscript{235}

C. Future of Direct Tax Harmonization

Since the adoption of the Parent-Subsidiary Directive, the Mergers Directive, and the Arbitration Convention, the Council has made no further progress on direct tax harmonization. In part this can be explained by a preoccupation with the bigger picture. Effective January 1, 1993, the new VAT system came into force, allowing Member States to lift internal border controls on goods, and Mrs. Scrivener had been consumed with making the new system work.\textsuperscript{236} Also, the second stage of EMU began on January 1, 1994.\textsuperscript{237} During this transitional stage, the Member States are to strive towards price and exchange-rate stability and deficit reduction.\textsuperscript{238} The Council adopted recommendations estab-

\textsuperscript{233} Commission Response, supra note 225, at 13–14.

\textsuperscript{234}Id. at 16.

\textsuperscript{235}Id. at 17–18; see supra notes 219–21 and accompanying text for a description of the Committee's recommendation.

\textsuperscript{236} Andrew Hill, Survey of World Taxation: First Months Are Critical - Andrew Hill Measures The Progress of the EC's New VAT System, Fin. Times, Feb. 18, 1993, at 32. After a negative reaction by the Council to the Commission's 1987 proposals to approximate all Member States' VAT rates, collect the VAT in the country of origin of the goods, and redistribute the proceeds through a clearing house mechanism, the Commission adopted a more flexible approach. The new proposals submitted by the Commission in June, 1990, set forth a two-phased approach to the elimination of fiscal frontiers. Although, an origin-based collection system was the ultimate goal, a transitional regime was established to continue the payment of VAT by businesses in the country of consumption of the goods. VAT, supra note 9, § 6.1. This transitional regime will remain in place until at least the end of 1996. As of January 1, 1993, however, individuals, institutional non-taxable persons, and tax-exempt persons may pay VAT in the country of purchase of the goods, subject to some exceptions for cars, mail order sales, etc. VAT, supra note 9, § 7.1.

\textsuperscript{237} Treaty of Rome, supra note 7, art. 109(e).

\textsuperscript{238} Coopers & Lybrand, Economic and Monetary Union, EC Commentaries, Apr. 6, 1995, available in LEXIS, World Library, Allnws File, § 6.3 [hereinafter EMU].
lishing broad guidelines regarding the economic policies of the Member States' and the Union in preparation for monetary union, which further distracted the Council from the issue of direct tax harmonization.239

The Ruding Committee presented evidence that the EC average cost of capital for a transnational investment project undertaken with the parent company's funds by a subsidiary in another Member State was 2.1% as compared to 0.7% for a similar project carried out domestically.240 The Committee attributed this difference to three factors: (1) withholding taxes on cross-border inter-corporate dividend and interest payments; (2) use by some Member States of the credit rather than the exemption method to relieve cross-border double taxation; and (3) differences in corporate tax rates.241 The Ruding Committee believed that these differences distorted the functioning of the internal market both for goods and capital, and that these distortions required action at the Community level.242 The Commission's reaction that many of the recommendations go beyond what is strictly necessary reflects the understanding that Member States are extremely reluctant to cede any of their sovereignty in tax matters to the Community, as well as self-imposed restraint in respect of the principle of subsidiarity.

The fiscal sovereignty of the Member States will nonetheless erode as the Member States' economies are increasingly integrated.243 The thrust toward EMU, in particular the adoption of a single currency, will so intertwine the domestic economies that greater uniformity in the Member States' corporate tax systems, rates, and bases is inevitable.244 The differences in the corporate tax systems of the fifty states in the United States provide evidence that complete harmonization of


241 Daly & Weiner, supra note 41, at 460 n.23.

242 Ruding Report, supra note 2, at 69-77.

243 Daly & Weiner, supra note 41, at 457.

244 If a majority of the Member States fulfil the convergence criteria for entry into stage three of EMU, the European Council can decide to move to EMU in 1997. Treaty of Rome, supra note 7, art. 109j(3). As of April 1995, however, not one Member State was able to meet the criteria for entry into the third stage of EMU. EMU, supra note 238, § 6.2. Assuming the first deadline passes,
corporate tax laws is not necessary. If the goal of accelerated economic unification is to be achieved, however, the differences in the Member States' tax systems cannot remain at the present magnitude. The business community is not satisfied with the progress thus far, so it is possible that business pressures and fear of preemption may also drive the Member States towards a more complete alignment of corporate tax systems.245

III. IMPLICATIONS OF EC DIRECT TAX HARMONIZATION ON U.S. TAX POLICY

A. Implications for Subpart F

Tax harmonization developments in the EC, particularly the adoption of the Parent-Subsidiary and the Mergers Directives, require that U.S. multinationals reassess their European operations. For some multinationals, a European holding company structure could be extremely advantageous. In many cases, the Parent-Subsidiary Directive would allow the coordination of investment activities within the EC without a withholding tax cost.246 The Mergers Directive would also then be available for subsequent restructurings.247 Alternatively, the integrated European market allows some multinationals to consolidate their operations. Unfortunately, both options run afoul of a U.S. tax regime known as subpart F.248 The provisions of subpart F need to be reexamined in light of these tax harmonization developments in the EC.

The subpart F rules were first enacted in 1962 and endeavor to impose current shareholder taxation on designated undistributed in-

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246 The location of the holding company must be carefully selected as France, Germany, Italy, Spain, and Spain have anti-abuse clauses in their national laws that implement the Parent-Subsidiary Directive, which bar application of the Directive where the ultimate parent is a non-EC resident. See Peter Dieben, Eurocompatibility of the Swiss Tax System, 6-7 INTERTAX 313, 313-14 (1993); see also supra notes 159-61 and accompanying text.


248 Sections 951-64 of the Internal Revenue Code are collectively known as Subpart F, spe-
come earned through a foreign corporation.\textsuperscript{249} Generally, in the absence of subpart F, a U.S. shareholder of a foreign corporation would not be taxed on that foreign corporation's earnings until those earnings were distributed, which distribution could occur in a subsequent tax period, if ever.\textsuperscript{250} This delay in the payment of U.S. tax until the earnings are repatriated is referred to as deferral.\textsuperscript{251} If the effective rate of foreign tax of the foreign corporation is higher than the U.S. rate, this deferral of U.S. taxes does not provide any tax benefit. If the foreign corporation's effective rate of foreign tax is less than the U.S. rate, however, its U.S. shareholders may enjoy substantial benefits from this deferral.\textsuperscript{252}

As part of a series of tax reform proposals in 1961, the Kennedy Administration recommended the complete termination of the deferral of U.S. tax on earnings of foreign corporations that were controlled by U.S. taxpayers.\textsuperscript{253} The Administration justified this proposal on the basis of capital export neutrality, desiring to be tax neutral with respect to the U.S. shareholder's choice of domestic or foreign investment.\textsuperscript{254} Those opposed to this proposal argued that the deferral of U.S. tax on


\textsuperscript{250}The foreign corporation itself pays current U.S. tax only on U.S. source income and income effectively connected with the conduct of a U.S. trade or business even if the foreign corporation is owned by U.S. shareholders. McIntyre, supra note 178, § 2/A, 2–7. I.R.C. § 881(a) imposes a 30% tax on U.S. source income such as interest, dividends, rents, salaries, and other fixed or determinable annual or periodical gains, profits, and income received by a foreign corporation. I.R.C. § 882(a) states that a foreign corporation engaged in a trade or business within the United States is taxable on its effectively connected income. Effectively connected income is "U.S. source gross income, reduced by properly allocable deductions, that has been derived from business activities or the performance of personal services carried on by a foreign taxpayer in the United States." McIntyre, supra note 178, § 2/A, 2–7. Foreign source income earned through a U.S. office may in some cases also be characterized as effectively connected income. Id. See generally Harvey Dale, Effectively Connected Income, 42 Tax L. Rev. 689 (1987).


\textsuperscript{253}Message of the President Relative to Our Federal Tax System, Apr. 20, 1961, reprinted in H.R. Rep. No. 140, 87th Cong., 1st Sess. 6–7 (1961). For nontax reasons, some income derived by foreign subsidiaries in less developed countries was excepted.

\textsuperscript{254}Id. Capital export neutrality refers to a system of international taxation where there is no effective domestic tax burden differential between domestic and foreign investments. U.S. Taxa-
the income of U.S.-controlled foreign corporations was necessary to
achieve capital import neutrality, thus enabling U.S. companies to
compete effectively in foreign markets. Congress compromised by
eliminating deferral for some categories of undistributed foreign-source
income of U.S.-controlled foreign corporations, essentially non-operating
income derived from passive foreign financial investments and
income from manipulable activities in foreign tax-haven countries.

Two requirements must be met for subpart F to apply. First, a U.S.
taxpayer must own at least ten percent of the foreign corporation’s
voting stock. A ten percent shareholder is known as a “U.S. share-

tion of CFCs, supra note 252, at 37; see also PEGGY RICHMAN (now MUSGRAVE), TAXATION OF
FOREIGN INVESTMENT INCOME 8 (1963). An international tax system in which only the investor’s
country of residence imposes tax achieves capital export neutrality. U.S. TAXATION OF CFCs, supra
note 252, at 37. Capital export neutrality would also be possible if each country taxed income
derived from within its borders while the investor’s residence country granted unlimited foreign
tax credits. Id. Neither of these two situations exist in the world today. According to most
economists, only capital export neutrality satisfies the goal of economic efficiency—allocating
production factors in such a way that productivity will be optimal. VOGEL, supra note 195, at 22.

255 Capital import neutrality refers to a system of international taxation where income from
investment located in each country is taxed at the same rate regardless of the residence of the
investor. U.S. TAXATION OF CFCs, supra note 252, at 37.


Businessmen argue that the tax system should be neutral as between U.S. foreign investors and
their competitors abroad. PEGGY MUSGRAVE, UNITED STATES TAXATION OF FOREIGN INVESTMENT INCOME ISSUES AND ARGUMENTS 119 (1969); see also PRESIDENT'S 1961 TAX RECOMMENDATIONS: HEARINGS BEFORE THE COMM. ON WAYS AND MEANS HOUSE OF REPRESENTATIVES, 87TH CONG., 1ST SESS. 2618, 2622 (statement of Fred W. Peel, Acting Chairman of the Committee on Taxation, U.S. Council of the International Chamber of Commerce). The “territorial” or “exemption” system of international taxation in which each residence country exempts income earned from foreign jurisdictions achieves capital import neutrality. U.S. TAXATION OF CFCs, supra note 252, at 37-38.

Arguments for capital import neutrality may be found in RICHMAN, supra note 254, at 8–9; Mitsuo Sato & Richard M. Bird, INTERNATIONAL ASPECTS OF THE TAXATION OF CORPORATION AND SHAREHOLDERS, 22 INT'L MONETARY FUND STAFF PAPERS 384, 407 (1975).


Your committee’s bill does not go as far as the President [sic] recommendations. It does
not eliminate tax deferral in the case of operating in the economically developed
countries of the world. Testimony in hearings before your committee suggested that the
location of investments in these countries is an important factor in stimulating American
exports to the same areas. Moreover, it appeared that to impose the U.S. tax currently
on the U.S. shareholders of American-owned businesses operating abroad would place
such firms at a disadvantage with other firms located in the same areas not subject to
U.S. tax.

H.R. REP. NO. 1447, supra note 251, at 57–58.

258 I.R.C. § 951(b) (CCH 1995).
holder." Second, U.S. shareholders must own more than fifty percent of the foreign corporation's voting power or value. A foreign corporation that satisfies these requirements is known as a "controlled foreign corporation" (CFC). U.S. shareholders must include in their taxable income as dividends, their pro rata share of certain types of income known as subpart F income regardless of the fact the CFC has not actually distributed the income to them. In addition, U.S. shareholders must include in income any increase in earnings invested in specifically defined U.S. property.

Subpart F income primarily includes "foreign base company income," such as foreign personal holding company income and foreign base company sales and services income. Although foreign personal holding company income includes dividends and interest, these items of income are not tainted if received from a related person organized and engaged in business in the same foreign country as the recipient corporation. This is known as the same-country exception. The theoretical justification appears to be that as payor and payee are organized and operating in the same country, the considerations of capital import neutrality are applicable. As the choice of corporate structure depends entirely on considerations unique to the country of business operation, the CFC is not deriving any inappropriate advantage by using a holding company to coordinate its investment activities within that country.

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259 Id.
260 I.R.C. § 957(a) (CCH 1995).
261 Id. Such a corporation is commonly referred to as a CFC.
262 I.R.C. § 956(a) (CCH 1995). Section 956(b) defines such U.S. property as any property acquired after December 31, 1962, which is (a) tangible property located in the U.S., (b) stock of a domestic corporation, (c) an obligation of a U.S. person, or (d) any right to the use in the U.S. of - (i) a patent or copyright; (ii) an invention, model, or design (whether or not patented); (iii) a secret formula or process, or; (iv) any other similar property right which is acquired or developed by the controlled foreign corporation for use in the U.S.
I.R.C. § 956(b) (CCH 1995).
263 I.R.C. § 952(a) (CCH 1995). Subpart F income also includes certain insurance income, international boycott income, foreign bribe income, and unfriendly country income. Id.
265 I.R.C. § 954(c)(3)(A)(i) (CCH 1995). This exception does not apply, however, to interest payments that have reduced the payor's subpart F income. § 954(c)(3)(B) (CCH 1995).
266 ALI-I, supra note 256, at 254; see supra notes 254-57 and accompanying text for a discussion of the compromises made in enacting subpart F.
267 ALI-I, supra note 256, at 254.
Foreign base company sales income is defined as sales income involving a related party where the products are manufactured, produced, grown, or extracted and consumed or used in a foreign country other than the country in which the CFC is organized.\textsuperscript{268} In defining foreign base company sales income, Congress was primarily concerned with the income of a subsidiary established to market products and which had been separated from the manufacturing activities of a related corporation solely to obtain a lower tax rate for the sales income. The provision does not apply in those cases where the property is manufactured or sold in the same country where the CFC is organized because Congress believed that a lower rate of tax was likely to be obtained only through purchases and sales outside of the country of incorporation.\textsuperscript{269}

Similarly, foreign base company services income is income derived from the performance of services for or on behalf of a related person outside the country in which the CFC is organized.\textsuperscript{270} As in the case of sales income, the purpose of subpart F as applied to services income was "to deny tax deferral where a service subsidiary is separated from manufacturing or similar activities of a related corporation and organized in another country primarily to obtain a lower rate of tax for the service income."\textsuperscript{271}

Congress has always provided an exception from the subpart F rules for foreign subsidiaries that are not established in tax-haven countries.\textsuperscript{272} As enacted in 1962, income could be excluded from subpart F if it were established that the CFC did not substantially reduce taxes.\textsuperscript{273} This exception was revised by the Tax Reform Act of 1969\textsuperscript{274} so that it subsequently became necessary to establish that reducing taxes was not a significant purpose of earning the income through the CFC.\textsuperscript{275}

\textsuperscript{268} I.R.C. § 954(d)(1) (CCH 1995).
\textsuperscript{269} S. Rep. No. 1881, supra note 257, at 3387.
\textsuperscript{270} I.R.C. § 954(e)(1) (CCH 1995). Such services include technical, managerial, engineering, or similar services. Id.
\textsuperscript{271} S. Rep. No. 1881, supra note 257, at 3387.
\textsuperscript{272} The term "tax haven" is subject to varying interpretations. See U.S. TAXATION OF CFCs, supra note 252, at 9–10. Relatively low rates of tax; high levels of bank secrecy; no tax treaties or treaties that provide for no, or very limited, exchanges of information; a disproportionately large financial sector; and self promotion as an offshore financial center are some of the generally accepted characteristics of tax havens. Richard Gordon, U.S. Department of the Treasury, Tax Havens and Their Use by United States Taxpayers - An Overview 14–20 (1981).
\textsuperscript{273} I.R.C. § 954(b)(4)(CCH 1962).
\textsuperscript{274} Pub. L. No. 91–172, 83 Stat. 487.
practice, as this was difficult to establish, taxpayers relied on regulations allowing the exclusion from subpart F if the sales income had borne an effective tax rate equal to at least ninety percent of, or no more than five percentage points less than, the rate of tax applicable in either the country of manufacture or the country of destination of the goods.\textsuperscript{276} For services income, reference was made solely to the tax rate in the country in which the services were performed.\textsuperscript{277}

Section 954(b)(4), as amended, now provides that foreign base company income does not include any item of income, measured under U.S. tax rules, that is subject to an income tax imposed by a foreign country at an effective rate exceeding ninety percent of the highest U.S. corporate tax rate.\textsuperscript{278} Such income is exempt from subpart F taxation because Congress concluded that the denial of deferral was not necessary when foreign countries tax the income at rates approximating or exceeding the U.S. corporate rate.\textsuperscript{279}

The rationale for requiring a comparison between the foreign tax paid and the U.S. tax rate is unclear.\textsuperscript{280} Because foreign base company sales income arises only if the CFC deriving the income is incorporated in a jurisdiction that is neither the country of manufacture nor the country of the destination of the sale, there are no subpart F tax consequences if the CFC is incorporated at the destination of the sale regardless of the tax rate in that jurisdiction.\textsuperscript{281} Thus, tax deferral is accepted so long as the CFC is organized and operated in its natural business locus to protect the competitive position of the corporation in that country.\textsuperscript{282} Under the rate comparison test that was in effect prior to 1986, a single CFC could sell into more than one foreign country without generating subpart F income provided that the for-

\textsuperscript{276} Treas. Reg. § 1.954–1(b)(3) & (4)(iii)(a) (1972).
\textsuperscript{277} Id.; see also Treas. Reg. § 1.954–1(b)(4)(iii)(b) (1972).
\textsuperscript{278} I.R.C. § 954(b)(4), \textit{amended by} Tax Reform Act of 1986, Pub. L. No. 99-514, § 1221(d), 100 Stat. 2085, 2553. Currently, the highest corporate tax rate is 35%, so the exclusion applies whenever foreign countries tax an item at an effective rate exceeding 31.5% (for taxable years prior to 1993, 90% of 34%, or 30.6%). I.R.C. § 11 (CCH 1995); see Boris I. Bittker & Lawrence Lokken, Fundamentals of International Taxation 56–68 (2d ed. 1991). This is referred to as the high-tax exception.
\textsuperscript{279} \textit{Staff of Joint Comm. on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986, 983 (Comm. Print 1987) [hereinafter Bluebook].}
\textsuperscript{280} \textit{ALI-I, supra} note 256, at 289. The House Ways and Means Committee’s explanation is as follows: “The committee’s judgment is that because movable income could often be as easily earned through a U.S. corporation as a foreign corporation, a U.S. taxpayer’s use of a foreign corporation to earn that income may be motivated primarily by tax considerations.” H.R. Rep. No. 3838, 99th Cong., 1st Sess. 40 (1986).
\textsuperscript{281} \textit{ALI-I, supra} note 256, at 289; see Treas. Reg. § 1.954–3(a)(3)(iv), ex. 2 (as amended in 1983).
\textsuperscript{282} \textit{ALI-I, supra} note 256, at 260.
eign taxes paid were not substantially less than the tax the CFC would have paid if it had been organized and operated in the destination country. The effect of the 1986 amendment is to require the formation of a CFC in each foreign country for which goods are destined, or to encourage the manufacturing of goods in the foreign country in order to achieve the same tax result.

United States multinationals have complained that the high-tax exception of § 954(b)(4) does not always exempt U.S. foreign subsidiaries that are located in non-tax haven countries such as the EC Member States. Thus, in order to sell products in the EC without being subject to current taxation under subpart F, U.S. multinationals must establish a separate subsidiary in each EC country in which they plan to do business. Furthermore, if the U.S. multinational establishes a European holding company in order to take advantage of the Parent–Subsidiary Directive, the dividends paid to the holding company (if not organized in the same country as the subsidiary) are subpart F income. Certain U.S. companies have testified that this has resulted in inefficient operation of their businesses and an inability to compete effectively in the EC single market.

While most countries do not tax the foreign profits of non-resident entities until repatriated, countries such as Australia, Canada, France, Finland, Germany, Japan, New Zealand, Norway, Sweden, and the United Kingdom have all followed the U.S. example by enacting some form of CFC legislation. However, these anti-deferral systems are generally much narrower in scope than the U.S. system. For example,

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283 Id. at 291.
284 Id. at 290. “[I]t is unclear what policy goal is served by requiring taxpayers to proliferate foreign tax entities to achieve a tax result when the same result could be more efficiently achieved through a single entity.” Id. at 291.
285 EC Member States impose corporate tax rates that range from 28% in Sweden to 45% in Germany (as of January 1995). The rate quoted for Germany applies to retained profits. Ernst & Young, supra note 203, at 154. Ireland, however, has a 10% tax rate for manufacturing and certain internationally traded services income. Ruding Report, supra note 2, at 50, 64. Luxembourg, the Netherlands, and Ireland do not fit the classic definition of tax havens but do offer tax incentives to attract the mobile aspects of multinational corporations. Sandler, supra note 32, at 6–7; see also supra note 272.
286 See Seminar Proceedings, supra note 24, at 8. Mr. Michael Smart of Rank Xerox also complained that the current subpart F rules encourage the manufacture of goods in Europe in order to avoid the application of the rules. Id.
288 Sandler, supra note 32, at 11 nn.11, 24. The elimination of foreign exchange controls has prompted most countries to enact CFC legislation. Id. at 10.
most CFC regimes do not require their residents to include currently unremitted active business income derived from wholly foreign activities by foreign subsidiaries.\textsuperscript{289} Treaty relief is possible for residents of countries such as Germany and Japan that include tainted sales and services income.\textsuperscript{290} In the case of Germany, the attributable tainted income is treated like a dividend and is eligible for any tax treaty exemption for dividends received from foreign subsidiary corporations.\textsuperscript{291} Seventeen of Japan’s treaties include tax-sparing provisions that grant tax credits in Japan even when subsidiaries operate abroad in a country under a tax holiday.\textsuperscript{292}

Furthermore, the CFC regimes in all countries except New Zealand, Germany, Canada, and Japan apply to designated jurisdictions rather than certain defined transactions; the scope of the regime is limited to CFC’s in tax haven or low tax jurisdictions specified on a “black list.”\textsuperscript{293} Few of those countries using the designated jurisdiction approach have any EC Member States on their list. Thus, foreign–based multinationals can use a single company to sell and service products throughout the EC yet still defer home country tax on their cross–border sales and service activities.\textsuperscript{294} To enhance the ability of U.S. companies to compete in global markets, the United States should seek greater harmonization of its tax rules with those of its major competitors.\textsuperscript{295}

In response to these concerns, Congressman Gibbons (D–FL), a senior member of the House Ways and Means Committee, introduced legislation in the 101st, 102nd, and 103rd Congresses which would have amended § 954(b) to treat the Member States as a single country for purposes of the subpart F rules.\textsuperscript{296} Similar legislation was introduced in the Senate by Senator Roth in the 102nd Congress.\textsuperscript{297} Congressmen


\textsuperscript{290}Income from the sales of goods which neither originate from Germany nor are delivered into Germany is not, however, tainted income. Dr. Juergen Killias, \textit{Business Operations in Germany}, 962 Tax Mgmt. 1, A–71 [hereinafter Germany].

\textsuperscript{291}Sandler, supra note 32, at 20, 90; see Germany, supra note 290, at A-71.


\textsuperscript{293}Sandler, supra note 32, at 87 n.9; see also Smith, supra note 289, at 373.

\textsuperscript{294}Merrill & Patrick, supra note 289, at 137.

\textsuperscript{295}\textit{Id.}

\textsuperscript{296}H.R. 1401, 103rd Cong., 1st Sess. (1993) is the latest piece of legislation.

\textsuperscript{297}Senator Roth’s bill would have treated the EC as a single country for subpart F purposes
Levin and Houghton have included a provision to treat countries in
the EU as a single country for purposes of the same-country exception
in the International Tax Simplification and Reform Act of 1995.\(^{298}\)

The Treasury Department was opposed to this legislation. In its view,
"the lack of direct tax harmonization creates inappropriate tax plan­
ing opportunities."\(^{299}\) The prior Administration had also stated the
concern that a U.S. company could establish a subsidiary in a low-tax
member of the EC and avoid subpart F inclusion on a significant
portion of its EC business income.\(^{300}\) The Treasury’s position was that
the possibility of tax avoidance in the establishment of a single EC base
company was too great so long as the effective income tax rates varied
as greatly as they did.\(^{301}\) The Treasury Department was concerned
about the myriad of deduction and credit rules and enterprise zones
that result in low taxes for certain industries in specific locations and
provide unwarranted tax avoidance opportunities.\(^{302}\)

While EC countries generally are not considered low-tax countries,\(^{303}\)
some Member States have special tax regimes for specific locations that
offer significantly reduced tax rates or other tax incentives such as
accelerated depreciation.\(^{304}\) A number of Member States such as Bel­
gium, France, Ireland, and Luxembourg have created special regimes
for financial and management activities that may take advantage of a
partial or total exemption from corporate tax, a special definition of
the tax base, and other incentives.\(^{305}\) For example, companies estab­
lished in Dublin’s financial center or the customs-free airport zone in

\(^{299}\) Miscellaneous Revenue Issues: Hearings Before the Subcomm. on Select Revenue Measures of the
Committee on Ways and Means House of Representatives, 103rd Cong., 1st Sess. 299, 299 (1993)
(statement of Leslie B. Samuels, Assistant Sec. Dept. of Treasury).
\(^{300}\) Letter from Kenneth W. Gideon, Asst. Sec. of Treasury (Tax Policy), to Dan Rostenkowski,
Chairman of the Comm. on Ways and Means 3 (Mar. 15, 1990) [hereinafter Gideon letter].
\(^{301}\) Id.
\(^{302}\) Id. at 4.
\(^{303}\) See ERNST & YOUNG, supra note 203, at 154.
\(^{304}\) Ruding Report, supra note 2, at 53. Some examples are the Shannon Free Airport Develop­
ment Zone in Ireland, the special enterprise zones located near Dunkirk, Aubagne-La-Ciotat, and
Toulon La Seyne in France, the enterprise zones in the UK, the reconversion zones and T-zones
in Belgium, the free zones of Madeira and Santa Maria Islands in Portugal, and the Canary Islands
of Spain. Id.
\(^{306}\) Id. Some examples are the Belgium Coordination Centers, the Dublin International Finan­
cial Services Centre, and the Luxembourg Societes des Participations Financieres (SOPARFI). Id.
Shannon prior to the end of the year 2000 are eligible for a ten percent tax rate until the year 2005. The corporate tax rate for service companies established elsewhere in Ireland is forty percent.306

The Ruding Committee shared the U.S. Treasury Department's concern that the growing mobility of capital increases the temptation for EC Member States to attract capital from each other's jurisdictions by offering lower effective tax rates and special tax schemes designed to attract internationally mobile business.307 As economies become increasingly globally integrated, the competition for investment will become more intense.308 Nevertheless, the Committee concluded there was no convincing evidence that tax competition would lead to a serious erosion of corporate tax revenues.309

As a safeguard against such competition, the Community has prescribed the amount of State aid that can be paid to companies.310 In addition, the Commission has a competition department that must approve tax law changes.311 Since 1986, every Member State except for Italy and Spain has reduced its corporate tax rates,312 yet corporate tax revenues as a percentage of GDP and of total tax revenues have risen.313 These rate reductions were usually accompanied by base broadening involving the curtailment or repeal of special allowances such as investment tax credits and incentives for investment in certain industries or regions.314

The same-country exception from subpart F allows for deferral so long as the CFC is organized and operated in its natural business locus, and tax planners have questioned whether the EC, as a whole, can be considered such a natural business locus. The most obvious objection to this suggestion is that the EC does not have a single corporate income tax system and thus may provide inappropriate tax avoidance

307 Ruding Report, supra note 2, at 143.
308 Id. at 165.
309 Id. at 200–01.
310 Id. at 160.
311 Seminar Proceedings, supra note 24, at 19.
312 Messere, supra note 133, at 327.
313 Ruding Report, supra note 2, at 166. Average EC corporate tax revenues accounted for 3% of GDP in 1989 as compared with 2.5% in 1980, and 7.5% of total revenues in 1989 as compared with 6.6% in 1980. Id. at 154. Average EC corporate tax revenues accounted for 2.8% of GDP and 6.7% of total revenues in 1992. OECD, Revenue Statistics of OECD Member Countries 1965–1993 78 (1994) [hereinafter OECD Table].
314 Ruding Report, supra note 2, at 154.
opportunities. Firms located in a single country, however, may have similar tax avoidance opportunities because many federal governments do not have the same corporate income tax system at the subnational level.

Switzerland is illustrative of the diversity in tax laws acceptable within a single country. Of the federal countries, Switzerland is most analogous to the EC as it was created by an association of completely sovereign cantons with the goal of maintaining the traditions, languages, and customs of each of these cantons. The Constitution of 1848 transformed the confederation of cantons into the present federal state and transferred the power to raise custom duties to the national government.

The national government of Switzerland relies predominantly on indirect taxes while the twenty-six cantons and approximately 3,000 communes earn most of their revenues from direct taxation. Specifically, the cantons of Switzerland raise approximately 12.6% of their total tax revenues from corporate taxes, relying more heavily on corporate taxes than most of the national governments in the EC Member States. Each canton has its own income tax act and these tax acts are in some cases quite diverse. For example, while the classical system of corporate taxation prevails in Switzerland, three cantons operate a split-rate system whereby a lower rate of tax is levied on a corporation’s distributed earnings than on retained earnings.

There is, however, progress toward the harmonization of the cantons’ direct tax systems. The Swiss Parliament adopted the Federal Law on Harmonization of the Direct Taxes of the Cantons and Municipalities in December 1990, and the law became effective January 1, 1993. Although the cantons are expected to amend their own legislation in alignment with the basic taxation principles established in the Federal Income Tax Act, the cantons will continue to establish their own tax schedules, rates, deductions, and allowances. Currently, the com-

315 Daly & Weiner, supra note 41, at 444.
316 Ruding Report, supra note 2, at 397.
317 Id.
318 OECD Table, supra note 313, at 74.
319 Daly & Weiner, supra note 41, at 442.
320 Ruding Report, supra note 2, at 401.
321 Daly & Weiner, supra note 41, at 447. The cantons are allowed eight years to change their cantonal laws but thereafter the law becomes self-executing. Id. The model tax law provides a mandate for working toward uniform definitions of tax entities, the tax base, and taxpayers, and rules for tax dispute resolution. Ruding Report, supra note 2, at 408.
322 Daly & Weiner, supra note 41, at 447.
bined cantonal and communal corporate income tax rates range from 9.9% to 29.6%, not too different from the corporate income tax rates in the EC, which range from 10% to 45%.

The Swiss cantons freely compete for business investment through tax rate reductions and tax concessions designed to encourage regional development. The cantons also have the authority to conclude tax treaties with foreign governments and some have done so, although these cantonal treaties are primarily concerned with inheritance taxes or the taxation of frontier workers. Obviously, the harmonization of Swiss cantonal corporate tax law is greater than that of the EC Member States due in part to the common accounting practices as well as a single currency within Switzerland. But the tax diversity within Switzerland, which is considered a natural business locus, strongly suggests that the EC could be considered a natural business locus.

Other factors to consider include the fact that incorporation as a European corporation in Europe is not yet possible. The proposed regulation on the European Company Statute has not been adopted because of political differences concerning worker representation. Adoption of this statute requires only a qualified majority, but Germany, Ireland, and the United Kingdom remain opposed. Movement may occur in the future as a result of the enlargement of the EC because the qualified majority necessary for adoption has changed.

Similarly, in many cases European companies are unable to consolidate their separate country subsidiaries because corporate law does not

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323 Id. at 448. The tax rates depend on the return on equity of the corporation. Dieben, supra note 246, at 316.
324 ERNST & YOUNG, supra note 203, at 154.
325 Daly & Weiner, supra note 41, at 448.
326 Id. at 449.
327 Id. at 445.
329 The regulation is based on article 100a and therefore only requires a qualified majority in the Council for adoption. Treaty of Rome, supra note 7, art. 100a.
330 The U.K. and Ireland are strongly opposed to a mandatory model for worker participation while Germany does not believe the Commission has gone far enough. Torres, supra note 328.
331 John Robinson, Tax and the Single European Company, EC TAX NOTES, Oct. 1993–Apr. 1994, at 3. When Austria, Finland, and Sweden joined the EU, the qualified majority blocking vote
provide for such mergers. In France, Italy, Portugal, and Spain, however, it appears that mergers of subsidiaries into new or pre-existing European companies may take place within the existing legal framework. Transfers of assets and exchanges of shares generally are also already possible as all Member States, except for Greece, have domestic laws which permit and recognize such cross-border transactions. All Member States but Greece have also implemented the relevant provisions of the Mergers Directive so that tax deferral of any capital gains tax liability is available. Thus, European companies can establish a single European company structure indirectly by using the asset transfer provision.

There are changes in the way European companies are doing business; centralized warehouses and the consolidation of operations allow European companies to become more efficient. The new VAT system for intra-community trade became effective January 1, 1993 and, in general, the transition went more smoothly than anticipated. Of the 282 measures in the White Paper, only eighteen have not been approved by EC members. Enough progress has been made to ensure that the Community will begin to reap the financial rewards that were promised by the EC 92 program. Furthermore, the push toward EMU will make harmonization inevitable.

In the meantime, U.S. companies should not be encouraged to establish or continue inefficient corporate structures solely for U.S. tax purposes as they strive to take advantage of EC opportunities. The advantages of an EC holding company structure are often outweighed by the implementation and operational costs imposed under U.S. tax law. U.S. companies are unable to reallocate capital within an EC

increased, diluting the UK, Ireland, and Germany "veto" on this issue. See EU Enlargement, supra note 80, § 3.3.

332 SEMINAR PROCEEDINGS, supra note 24, at 5. The Tenth Company Law Directive, which would enable cross-border legal mergers and divisions to the extent not provided for by domestic company law, has not yet been adopted. Cussons, supra note 23, at 111; see also Coopers & Lybrand, Company Law, EC Commentaries, Jan. 19, 1995, available in LEXIS, World Library, Eurom File, § 3.3.

333 See supra notes 171–75 and accompanying text.

334 Robinson, supra note 331, at 2.

335 Oster, supra note 54, at H3.


337 Robinson, supra note 331, at 2.

338 Ruding, supra note 247, at 4. Gain recognition or a potentially punitive gain recognition agreement with the IRS is required when a U.S. parent company transfers ownership of a foreign subsidiary to a foreign holding company. Temp. Treas. Reg. § 1.367(a)–3T(g) (1986).
holding company structure efficiently because dividends between related companies organized in different countries are treated as subpart F income. 339 Furthermore, they may not be able to avoid foreign dividend withholding taxes because, France, Germany, Italy, and Spain have anti-abuse clauses in their laws implementing the Parent–Subsidiary Directive which bar application of the directive where the ultimate parent is a non-EC resident. 340

The concern over tax avoidance is legitimate, but most of the EC special tax regimes are targeted at manufacturing or financial services income. Manufacturing in the CFC’s country of incorporation is sufficient to preclude application of subpart F regardless of where the sales activity transpires. For example, under present law a U.S. company is able to locate a manufacturing plant in Ireland to take advantage of the special ten percent tax rate for manufacturing income, sell this product throughout the EC, and preserve the benefit of deferral on all the income. 341 This income would not be considered foreign base company sales income because the manufacturing took place outside the United States. Similarly, many of the EC special tax regimes are targeted at services income, which is also eligible for the same-country exception as long as the services are performed in the country in which the CFC is incorporated. The Treasury’s tax avoidance concerns should be alleviated if a foreign base company is permitted to treat the EC as a single country only if subject to the regular corporate tax regime of the country of its incorporation.

The Treasury Department also argues that other regional trading blocs can contend with equal force so that they should also be treated as a single country if the EC receives such treatment. Treasury’s concern, that general application would unravel subpart F, seems premature. 342 Single country treatment of other economic regions is justified only after they have established, as the EC has done, an institutional structure that allows the trading bloc to vigorously pursue the harmonization of their economies, currencies, and laws. To date, none of the regional trading blocs have any of the federal characteristics of the EC or the goal of pursuing far-reaching economic, monetary, and legal

339 I.R.C. § 954(c)(3) (CCH 1995); see Ruding, supra note 247, at 4.
340 Dieben, supra note 246, at 313; see also supra notes 159-61 and accompanying text.
341 See SEMINAR PROCEEDINGS, supra note 24, at 8. Mr. Michael Smart of Rank Xerox complained that the current subpart F rules encourage the manufacture of goods in Europe in order to avoid the application of the rules. Id.
342 Gideon letter, supra note 300, at 4.
harmonization. Although there is not a compelling case to treat the EC as a single country at this time, given the work that remains on the harmonization of direct taxes, company law, and monetary union, administrability, simplicity, and economic efficiency argue for such treatment. 343

B. U.S. Tax Treaty Policy Implications

The sovereignty to conclude bilateral tax treaties has not been transferred from the Member States to the EC.344 Instead, the United States has ratified individual tax treaties with each of the fifteen Member States.345 As an integral part of its treaty policy, the United States now includes in all tax treaties, a limitation on benefits article designed to prevent persons without a sufficient nexus to the treaty country from obtaining the benefits of the treaty.346 The U.S.–Netherlands Income

343 Taxpayers record-keeping burden would be reduced for purposes of tax return filing, the tracking of previously taxed income, and determining the credibility of foreign taxes under I.R.C. § 960. U.S. DEPARTMENT OF THE TREASURY, INTERNATIONAL TAX REFORM: AN INTERIM REPORT 10 (1993). If a taxpayer is not in an excess foreign tax credit position, there is also a reduced need for tax planning either to avoid the foreign base company sales and services income provisions or to arrange for the cross–crediting of high foreign taxes paid on other foreign earnings against the residual U.S. tax on this income. Id.

344 The Community’s authority to engage in negotiations with respect to the taxation of dividends by a subsidiary to its parent or the exchange of information seems clear. However, the EC does not have authority to negotiate and conclude a double taxation convention that would cover the whole range of income taxation. VOGEL, supra note 195, at 15. The Treaty of Rome only confers external powers on the Community with respect to specific policy areas such as the common commercial policy (arts. 110–115), association agreements with third countries (art. 238), and the environment (art. 130r(4)). BEN TERRA & PETER WATTEL, EUROPEAN TAX LAW 44 (1993). Pursuant to the AETR case, the Community also has implied powers with respect to non–Member States whenever the Community law confers internal powers upon the Community in order to obtain an objective. Id.


346 Only residents and nationals of a treaty country are entitled to benefits under a tax treaty. McINTYRE, supra note 178, at 2–72. Residents of third countries sometimes attempt to obtain treaty benefits by organizing some juridical entity in one treaty country to serve as a conduit for income earned in the other treaty country. Id. This practice is referred to as treaty shopping, thus limitation on benefits articles are also known as anti–treaty shopping clauses. Id.
The issue is whether article 26, the limitation on benefits article of the U.S.–Netherlands treaty, is compatible with articles 6, 52, and 58 of the Treaty of Rome, which prohibit discrimination on grounds of nationality and provide for the freedom of establishment. Article 26 contains several shareholder tests designed to ensure that only genuine residents benefit from the treaty. These tests may result in the denial of a treaty benefit, such as a reduction in withholding tax on dividends, interest, or royalties, where the shareholder of the Dutch company resides in another Member State. Some commentators argue that excluding Dutch companies with EC parents from treaty benefits conflicts with the freedom of establishment under the Treaty of Rome. The bilateral tax treaties between the United States and Germany, France, Italy, Belgium, and Spain present similar issues.

The Ruding Committee noted that although multilateral relations between Member States with respect to withholding taxes have become increasingly harmonized because of the Parent-Subsidiary Directive, relations with non-Member States have not been affected. The Member States continue to negotiate bilateral treaties with non-Member States that exclude cross-border dividend, interest, and royalty payments.


350 See TERRA & WATTEL, supra note 344, at 46; see also infra notes 368–70 and accompanying text.


352 Martin Du Bois, EC Commission Outlines Cautious Corporate Tax Plan, WALL ST. J., June 19, 1992, at 2; see also Ruding Report, supra note 2, at 138. Vogel asserts that article 28 of the U.S-German Tax Convention, which denies certain treaty benefits to companies owned by citizens of third states, is an infringement upon Community law. Vogel, supra note 195, at 15. The
from treaty protection in the case of treaty shopping situations.\textsuperscript{353} The Committee also stated that treaty provisions such as the limitation on benefits provisions negotiated by the United States may not be compatible with the fundamental principles of Community law such as the freedom of establishment as far as residents of other Member States are concerned.\textsuperscript{354} Therefore, the Ruding Committee stressed the need for coordinating the Member States' tax treaty policies at the Community level with the goal of approximating the tax treaty provisions in areas covered by Community law (such as withholding taxes on dividends) and avoiding conflicts with the Treaty of Rome.\textsuperscript{355} Other problem areas are the different definitions of essential terms such as residency, permanent establishments, dividends, etc., and the extension of imputation tax credits in a more favorable way than to taxpayers in the other Member States.\textsuperscript{356}

Limitation on benefits provisions, also known as anti–treaty shopping clauses, have become an integral part of U.S. tax treaty policy. The U.S.–Luxembourg Treaty was the first U.S. tax treaty to incorporate such a provision.\textsuperscript{357} Treasury was initially responding to the situation where a foreign investor who resides in a country without a treaty

\textsuperscript{353} Ruding Report, \textit{supra} note 2, at 206.

\textsuperscript{354} \textit{Id.} at 138.

\textsuperscript{355} \textit{Id.} at 206. "The Committee recommends action by the Commission in concert with Member States aimed at defining a common attitude with regard to policy on double taxation agreements with respect to each other and also with respect to third countries (Phase I)." \textit{Id.}

\textsuperscript{356} Ruding Report, \textit{supra} note 2, at 379.

\textsuperscript{357} Convention with Respect to Taxes on Income and Property, Dec. 18, 1962, U.S.-Lux., 15 U.S.T. 2355 [hereinafter Luxembourg Treaty]. The limitation on benefits article states that

\textit{[t]he present Convention shall not apply to the income of any holding company entitled to any special tax benefit under Luxembourg Law of July 31, 1929, and Decree Law of December 27, 1937, or under any similar law subsequently enacted, or to any income derived from such companies by any shareholders thereof. In the event that substantially similar benefits are granted to other corporations under any law enacted by Luxembourg after the date of signature of the present Convention, the provisions of the present Convention shall not apply to the income of any such corporation or to any income derived from such corporation by any shareholder thereof. The expression 'substantially similar benefits' shall be deemed not to include tax reduction or exemption granted to any corporation in respect of dividends derived from another corporation, 25% or more of the stock of which is owned by the recipient corporation.}

\textit{Id.} art. XV. As of September 1995, the United States and Luxembourg have completed negotiations and initialed a comprehensive income tax treaty intended to replace this 1962 tax convention. Barth, \textit{supra} note 345, at 1046.
with the United States forms a legal entity in a tax haven jurisdiction with a favorable treaty with the United States. The legal entity avails itself of treaty benefits to which the investor was not directly entitled.\textsuperscript{358} The policy concern was that if residents of countries without income tax treaties with the United States already had effective access to treaty benefits, there was no incentive to enter into such a tax treaty and grant reciprocal concessions to the United States and its investors.\textsuperscript{359}

In 1981, the United States Department of Treasury issued a draft U.S. model income tax treaty which contained a limitation on benefits article.\textsuperscript{360} Since then, Treasury has attempted to restrict the availability of U.S. income tax treaty benefits during all subsequent income tax treaty negotiations with the inclusion of a limitation on benefits provision as one of the primary objectives.\textsuperscript{361} All treaties ratified by the United States Senate since 1980 have contained such a provision.\textsuperscript{362}

The comprehensive approach currently being taken, however, applies to all corporations organized in a treaty country regardless of whether they benefit from special measures in that country and regardless of whether the country operates as a tax haven.\textsuperscript{363} The objective of the comprehensive limitation on benefits provisions is to restrict source-country tax benefits to legal entities resident in the treaty country who are fully subject to residence taxation.\textsuperscript{364} This obsession


\textsuperscript{359} Id. at 152.


\textsuperscript{362} Id. at 26.


\textsuperscript{364} ALI-Treaties, \textit{supra} note 358, at 154. The qualifying tests of the standard limitation on
with treaty shopping has led to limitation on benefits articles that may be excessively detailed and complex, as well as difficult to administer.\(^{365}\)

The most poignant example of this complexity can be found in article 26 of the U.S.–Netherlands Treaty.\(^{366}\) This limitation on benefits article is twenty–three pages in length, longer than some tax treaties.\(^{367}\) To qualify for the benefits of the treaty, a Dutch company must comply with the requirements of a stock quotation test, an activities test, a headquarters company test, or a shareholder test.\(^{368}\) These tests do take into consideration, to a limited extent, shareholders and/or activities in other EC Member States.\(^{369}\) However, a company resident in another EC state is factored into the test only if it would qualify for treaty benefits if it were a Dutch resident and if the treaty between its country of residence and the United States would have offered the same benefits.\(^{370}\)

One resolution to the controversy over the compatibility of the treaty shopping rules with the Treaty of Rome is the negotiation of a single treaty with the entire EC.\(^{371}\) The adoption of such a treaty would produce significant benefits for the United States.\(^{372}\) Many of the treaties negotiated with the EC Member States are antiquated and do not include a comprehensive limitation on benefits article.\(^{373}\) The invest-
ment patterns in Europe are complicated because companies often raise their capital from multiple jurisdictions. This phenomenon will be exacerbated as the EC achieves its goal of a free capital market. Only an EC–wide double tax treaty can adequately address this situation. Furthermore, negotiation of such a treaty might be the catalyst necessary to return reluctant treaty partners to the bargaining table.

The United States could also bargain for the extension of the Parent–Subsidiary Directive to distributions and payments between United States and EC companies, given the fact that certain Member States have prohibited the application of the Directive where the ultimate parent is a non–EC resident. The United States could take this opportunity to address our treaty partners’ concerns over recent treaty overrides. United States constitutional law allows for conflicts between treaties and statutes to be resolved by the “later in time” rule which means that the more recently adopted rule prevails unless the statute or treaty provides otherwise. Thus, changes in U.S. law may override provisions of a treaty without the consent of the treaty partner. Many of the EC Member States are particularly sensitive to treaty overrides as their constitutions do not permit such a result. The U.S.–Netherlands Treaty addresses this problem by providing for consultations within six months in the event that the balance of benefits changes by reason of such a treaty override.

Administratively, an EC–wide tax treaty between the United States and the EC is a project very much worth pursuing. Former International Tax Counsel of the U.S. Treasury, Cynthia Beerbower, had designated forty percent of her staff’s time to negotiate treaties. Any time savings achieved by such a negotiation could be spent on regula-

374 See Adrian Ogle, Principles of International Tax: A Multinational Perspective 149 (Interfisc Publishing).
375 Risinger, supra note 372, at 22–23.
376 See Dieben, supra note 246, at 313.
377 Organization for Economic Cooperation and Development, Tax Treaty Override (1989). The term treaty override refers to situations where domestic legislation of a nation overrules provisions of a treaty. The legislation may contain a provision that the treaty is to be disregarded in certain circumstances, or that the domestic interpretation of the legislation may overrule a treaty. Id.
378 McIntyre, supra note 178, at 2–79; see, e.g., Whitney v. Robertson, 124 U.S. 190, 195 (1888); Reid v. Cover, 354 U.S. 1, 18 (1957).
379 McIntyre, supra note 178, at 2–79.
380 Id. at 2–79 n.306. Some countries, including Belgium, France, Germany, Greece and Spain, have constitutional arrangements that obstruct the override of treaties by legislative action. Id.
381 Cope, supra note 360, at 961.
382 New Treasury International Tax Counsel Discusses Priorities in Meeting with ABA Tax Section
tions projects and long-term planning regarding the U.S. system of international taxation. The Ruding Committee recommended coordination of tax treaty policies by the Commission but acknowledged that it would be simpler and cheaper for Member States and non-Member States to negotiate treaties concurrently with the Commission. 383

As a group, the EC Member States are not yet ready to yield the sovereignty necessary to negotiate a single treaty with the United States. Until the EC is granted the competence to represent the Community as is done in the area of external trade relations, the United States could advocate the conclusion of a multilateral tax treaty with the EC. The multilateral Nordic Income Tax Treaty between Denmark, Finland, Iceland, Norway, and Sweden could serve as a model. 384 This issue could be explored in the context of the EU–U.S. agreement to launch a joint feasibility study on the future of bilateral relations. 385 The Commission has proposed to extend topics for EU–U.S. summits to include macroeconomic and financial affairs and to involve U.S. Treasury, ECOFIN, and the Commission in the dialogue. 386 The Commission has also vowed to ensure that all bilateral tax treaties negotiated by the Member States are in strict accordance with the non-discrimination rules of the Treaty of Rome and the tax directives. 387

An alternative approach is to strive towards more uniformity in the negotiation of treaties with the EC Member States. 388 The Treasury Department is currently involved in active or ongoing negotiations with Denmark, Italy, Ireland, and Belgium. 389 The EC presents a unique situation given the level of coordination and information sharing 390

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383 Ruding Report, supra note 2, at 379.
387 COMMISSION RESPONSE, supra note 225, at 15.
388 Rosenbloom, supra note 365, at 77.
among the Member States and their thrust toward economic integration. Therefore, extraordinary efforts should be made to offer similar concessions to each countries’ foreign investors. This would relieve some concerns regarding treaty shopping between the EC Member States and would allow for the drafting of a simpler derivative benefits clause. For example, one of the derivative benefits provisions found in the Netherlands treaty grants treaty benefits to a Dutch joint venture company if three conditions are satisfied. The third condition, that the Dutch company is not a “conduit company,” was added to disqualify those joint ventures established to route U.S. interest, royalties, and other deductible payments to EC Member States like Italy, a country with which the United States has a less generous treaty provision regarding withholding taxes at source.

IV. Conclusion

To achieve a coherent system of international taxation, the United States must take note of how other countries tax international income. The EC is especially important not only because of the Member States that currently comprise the Union, but also because of the many countries that aspire to join. The tax systems of the Member States, as well as the evolving body of European tax law, were taken into consideration by the EFTA countries as they pursued tax reform and are being closely monitored by the Eastern European countries as they develop their tax systems. The tax policies pursued by this group will have important consequences for global economic conditions.

Complete harmonization of the EC’s corporate tax laws is neither likely nor necessary, but movement towards more uniformity is inev-

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391 In response to the Ruding Report, the Commission launched a comprehensive process of consultation of the tax authorities of the twelve Member States. See COMMISSION RESPONSE, supra note 225, at 2.

392 Netherlands Treaty, supra note 347, art. 26, para. 1(c)iii. The three conditions are as follows:
   (i) five or fewer publicly-traded Dutch companies own, in aggregate, at least 30% of the vote and value of the shares in the Dutch company;
   (ii) five or fewer publicly-traded companies that are resident in the United States or states that are members of the European Communities own at least 70% of the vote and value of the shares in the Dutch company; and
   (iii) the Dutch company is not a “conduit company”, i.e., a company that principally receives and pays out interest royalties and other deductible payments. Id.

393 Cope, supra note 360, at 969; see Netherlands Treaty, supra note 347, art. 26, para. 8(m). Having a model treaty for the EC Member States might give the United States more bargaining power to negotiate uniform withholding provisions.

394 See Kingson, supra note 22, at 1153.
The Commission will continue to urge the adoption of proposed directives such as the Loss Directive. These changes will logically lead to a reexamination of corporate tax rates, the tax bases, and the treatment of capital gains and losses. The thrust toward EMU will also facilitate and expedite the tax harmonization process. The adoption of a single currency will so intertwine the domestic economies that the adoption of a common corporate tax system should not be as difficult as it now appears. Business pressures and the fear of Community preemption may also naturally drive the Member States towards a more tolerable alignment of corporate tax systems. Because none of the EC countries relies on the corporate income tax as a major source of revenue, this process should not be as painful as VAT rate approximation.

Specifically, U.S. tax treaty policy should take into consideration the direct tax harmonization accomplished thus far and the proposals for the future. Although the negotiation of a single treaty with the EC would produce significant benefits for the United States both substantively and administratively, the EC Member States are not yet willing to transfer their sovereignty to conclude tax treaties to the Community. The alternative is to strive towards uniformity in the tax treaty negotiations currently underway with the Member States. An examination of the policies underlying the same-country exception of subpart F leads to the conclusion that, given appropriate safeguards, administrability, simplicity, and economic efficiency can be improved by treating the EC as a single country for this purpose.

395 See Frans Vanistendael, Additional Note to Ruding Committee Report: Some Basic Problems on the Road to Tax Harmonization (on file with author).