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Editorial

Fiscal degradation and the inter-nation allocation of tax jurisdiction

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Two main themes, which are obviously closely related, underlie most of the major current issues in international taxation: multinational enterprises and international investors are not paying their fair share of tax and, to the extent that they are paying tax at all, they are not paying it to the 'right' country. At a national level this concern is reflected in an increasingly aggressive approach to transfer pricing, and in the adoption or strengthening of thin capitalization rules and controlled foreign corporation rules. Internationally, the response has been more hesitant, but progress has been made in areas such as exchange of information and the negotiation of advance pricing agreements.

Within the European Community, too, the dangers of the erosion of the tax base - or 'fiscal degradation' as that process is sometimes called - are increasingly being recognized. The recent 'Monti Memorandum', on taxation in the European Union, identified three main challenges for Community taxation policy, two of which reflect relatively new concerns: in addition to promoting the proper functioning of the Single Market, EC tax policy should aim at the stabilization of Member States' tax revenues and at promoting employment. According to the document, the liberalization of capital markets within the Community, though generally a beneficial development, has increased the opportunities for tax avoidance and evasion and has helped to erode the tax base in many countries. This, in turn, has tended to result in a shift from capital taxation to labour taxation as countries struggle to preserve their revenues, which has, perhaps, had the effect of worsening the unemployment situation by increasing the cost of labour. The process of fiscal degradation, the document suggests, can only be halted by concerted action. Member States cannot alone protect their tax bases, and the apparent defence of national fiscal sovereignty has in reality brought about a real loss of sovereignty by virtue of tax erosion. What the Monti Memorandum largely fails to do, however, is to detail the actions necessary to halt that process, though further communications from the Commission are promised later this year. How the EC tackles the problem of fiscal degradation is obviously a matter of great interest, to countries outside as well as within Europe, since the problem is worldwide.

The starting-point, both within the Community and in the broader international tax community, ought to be the principle espoused by the Ruding Committee, namely to eliminate double taxation in cross-border activities, whilst ensuring taxation at least once. But that requires a measure of agreement upon how the tax base is to be shared among the states concerned. Existing international 'rules' as exemplified by the Organization for Economic Co-operation and Development (OECD) Model Convention, are somewhat unsatisfactory, principally because of the substitutability of debt and equity and because of the ability to conduct cross-border business either in the form of a branch or a subsidiary. Notions such as 'economic allegiance', or the 'benefit principle', are equally unable to provide satisfactory answers to the question of how tax jurisdiction should be shared between source and residence countries. Nor does recourse to the principles of 'capital export neutrality' and 'capital import neutrality' help a great deal. Both objectives are clearly desirable but, absent almost complete harmonization of tax systems and rates, they cannot both be achieved together. Opinions differ strongly as to the respective merits of the two principles, and of their respective methods of relieving double taxation, these being the credit and exemption methods. Given the high degree of mobility of portfolio investment capital, the credit method would seem to be necessary in order to prevent excessive tax competition and capital flight. By contrast, direct investment tends to be less mobile and less influenced by tax considerations, and the need to secure competitive neutrality between enterprises from different countries suggests that source-country taxation, with exemption in the residence country, is normally the more appropriate treatment. The choice is further complicated by the fact that whereas capital import neutrality requires taxation in the source country alone, capital export neutrality requires only that the total tax burden is determined by the residence country but says nothing as to the actual division of the tax base between the two countries.

Two further considerations seem relevant and should probably influence the choice. Capital-importing countries tend, on balance, to be poorer than those that export capital; thus considerations of inter-nation equity would seem to favour source-country taxation. A more compelling argument in favour of source-country taxation lies in the practical difficulty of taxing international capital income. In reality, the choice may be between source-country taxation and no taxation at all.

How should these considerations be reflected in concrete measures to be adopted within the EC and, hopefully, in the broader international community? A satisfactory international tax system should be neutral as between different forms of carrying on business (especially, in this context, between branches and subsidiaries), and as between equity and debt investment, otherwise investors will simply manipulate the system to their best advantage. It needs also to take account of the relevant differences between direct and portfolio investment.

How do existing EC measures and proposals match up to these requirements? In the case of direct investment, one of the situations has already been dealt with, more or less satisfactorily, by the Directive (90/435) on parent-subsidiary dividends. The tax base is allocated (substantially, at least) to the source country, and the elimination of dividend withholding tax promotes capital import neutrality. Ideally, capital import neutrality also requires that the exemption method be mandated in the residence country (and for branch profits as well as for direct dividends), but in practice it is in any event usually fairly simple to avoid any residual residence-country taxation. By contrast, the proposal to extend similar treatment (i.e. abolition of withholding tax) to inter-affiliate payments of interest and royalties seems, to this observer, to be a recipe for disaster. The opportunities for tax planning are too obvious to require mention. And where is the rationale for allocating income from direct equity investment wholly or mainly to the source country, and income from direct debt investment wholly to the country of residence? True, some sort of rough balance could be achieved by also adopting harmonized thin-capitalization rules, but this seems a very complex and clumsy way of achieving an appropriate sharing of the tax base. Far from eliminating withholding tax on intra-affiliate interest and royalties, the tax should be increased to the same level as the rate of corporate income tax, or - a more feasible approach, given existing treaty obligations - such payments should be made non-deductible and treated in the same way as dividends. That would simultaneously eliminate some of the most intractable transfer pricing problems.

Portfolio investment presents greater difficulties. Capital export neutrality requires the adoption of the credit method, and that the level of source-country taxation be low enough to leave room for the residual residence-country tax. But a relatively high level of source-country tax seems desirable in order to restrict tax evasion. In the case of equity investment, this is largely achieved by taxing the corporation's profits in the country of source. There is little justification for an additional dividend withholding tax in terms of inter-nation equity, and such a tax is likely to prevent capital export neutrality being achieved. Thus the appropriate response would seem to be to extend Directive 90/435 to apply to all dividends - as has been widely suggested. Further, capital export neutrality seems to require the residence country to grant a credit for the underlying source-country corporate income tax if it does so for its own corporate income tax (the solution recommended by the Ruding Committee).

Portfolio debt investment presents more intractable problems. A possible compromise (within the EC) between the desire to achieve capital export neutrality and the need to restrict evasion, would be the adoption of a minimum Community rate of corporate income tax (say, 30 per cent), with an interest withholding tax at the same rate. Such a solution would also fit well with the type of dual income tax system that is now being widely promoted. But due to existing treaty obligations it could not apply in external situations. It also fails to take account of the fact that a high proportion of international portfolio investment is conducted by tax-exempt entities and financial institutions. The reality is that there is now a 'world' interest rate, with interest withholding taxes simply being added to that rate to preserve the net return - and increase the cost of borrowing. This argues for zero withholding rates for portfolio interest, leaving the evasion problem to be dealt with by more effective supervision and exchange of information. For obvious reasons, this cannot be confined to the Member States of the Community.

An effective response to the problem of fiscal degradation will require substantial cooperation at the wider international level. Meanwhile, Europe must take the lead: as Signor Monti has said, for the EC 'inactivity is not a valid option'. Hopefully, it will start the process off on the right track.