TAX FOUNDATION

Tax Foundation and
Ernst & Young

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

February 1995

By Tracy Kaye
Associate Professor of Law
Seton Hall University School of Law
Ernst & Young Visiting Professor

About the Tax Foundation

As the size of government continues to grow, so too does the need for reliable information about its cost and scope. Since 1937, the Tax Foundation has been monitoring tax and fiscal activities at all levels of government: federal, state and local. In that year, civic-minded businessmen envisioned an independent group of researchers who, by gathering data and publishing information on the public sector in an objective, unbiased fashion, could counsel government, industry and the citizenry on public finance.

More than 50 years later, in a radically different public arena, the Foundation continues to fulfill the mission set out by its founders. Through newspapers, radio, television, and mass distribution of its own publications, the Foundation supplies objective fiscal information and analysis to policymakers, business leaders, and the general public.

The Tax Foundation's research record has made it an oft-quoted source in Washington and state capitals, not as the voice of left or right, not as the voice of an industry or even of business in general, but as an advocate of a principled approach to tax policy, based on years of professional research.

Today, farsighted individuals, businesses, and charitable foundations still understand the need for sound information on fiscal policy. As a nonprofit, tax exempt 501(c)(3) organization, the Tax Foundation relies solely on their voluntary contributions for its support.

The Ernst & Young/Tax Foundation Visiting Professorship

The Ernst & Young/Tax Foundation Visiting Professor Program is founded on the need to encourage quality tax policy research and to make this research available to a broad audience of tax policy makers and analysts in Washington, D.C., and around the country.

Professors are appointed to the Ernst & Young/Tax Foundation Visiting Professor program for a year, during which time they are expected to publish research through the Tax Foundation and take part in Tax Foundation programs to the extent their schedules and opportunities permit.

The Tax Foundation would like to congratulate Professor Tracy Kaye of Seton Hall University for having been selected as an Ernst & Young Visiting Professor for 1993.

The Tax Foundation would like to thank Ernst & Young for its generous support of this important program.

Tax Foundation and
Ernst & Young

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

February 1995

By Tracy Kaye
Associate Professor of Law
Seton Hall University School of Law
Ernst & Young Visiting Professor

* * *

Tax Foundation
1250 H Street, N.W.
Suite 750
Washington, DC 20005
202-783-2760

Table of Contents

I. European Community Tax Harmonization

A. Introduction

Just as the U.S. Congress is most productive the last few months of the legislative session, so too, the European Community (EC) made most of its progress on tax harmonization[1] to date in the last few years before the 1992 deadline. Actually, the term tax harmonization is a misnomer. Only by abandoning the concept of full tax harmonization and substituting the concepts of "coordination"[2] and "approximation,"[3] has there been any agreement on direct taxation matters.[4] This new approach incorporates the principle of subsidiarity; Member States should determine their own tax arrangements, except to the extent that major distortions would occur.[5]

The goal of the Treaty of Rome was to create a single, integrated European Market.[6] In order to realize this goal, the physical barriers to trade, the border controls, had to be removed. Taxation plays a role because tax rate differences, such as those with respect to the value-added taxes of the twelve Member States, were a primary reason for the border controls in the first place. Direct taxes play a role with respect to the free movement of capital.

This article examines the status of tax harmonization in the European Community and the implications of the actions taken thus far as well as the future actions that will be necessary to complete the process. To understand the reasons for the initial slow pace of the legislation, it is necessary to establish the historical background and legal basis for tax legislation in the European Community. It is also helpful to understand the legislative process and the participants involved in enacting EC tax legislation. Furthermore, in order to understand the difficulties in reaching agreement on tax legislation, the article examines the current structure of the Member States' varied systems of taxation. The article discusses the recent agreements with respect to direct taxation and the implications of these agreements to the European Community. Finally, the article analyzes the implications of European tax harmonization for U.S. tax policy.

B. History of the European Economic Community

The Treaty of Rome established the European Economic Community in 1958.[7] The original Member States were Belgium, France, Germany, Italy, Luxembourg, and the Netherlands. The United Kingdom, Ireland, and Denmark joined in 1973, Greece in 1981, and Spain and Portugal in 1986.[8] The objective of the Treaty of Rome 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.[9]

To create such a market, the Treaty contemplated the removal of obstacles to the free movement of goods, persons, services, or capital between Member States.[10] Approximation of indirect taxes is necessary for the free movement of goods and the harmonization of direct taxes, particularly corporate taxes, is essential to the free movement of capital. 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.[11] 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.[12] 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.[13]

Articles 95 through 99 of the Treaty discuss the harmonization of indirect taxes. For example, Article 95 states that members may not use internal taxes to discriminate against products coming from other Member States. Article 220 contains the only explicit reference to direct taxes and states that members "shall enter into negotiations" to eliminate double taxation.[14] However, it is understood that Article 100 of the Treaty provides the 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."[15]

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.[16] Then 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.[17] The White Paper contained a comprehensive list of 300 measures that the Commission deemed necessary to complete the internal market.[18] 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 relating to an arbitration procedure, parent companies and subsidiaries, mergers, divisions, and contribution of assets, and taxes on transactions in securities were included in the timetable for completing the internal market.[19]

The Single European Act (SEA)[20] was signed by the twelve Member States in 1986 and amended the Treaty of Rome providing for institutional reform, European political co-operation, and formal extension of the scope of the Treaty of Rome to five new policy areas.[21] Article 13 of the Act incorporated the objective of an internal market into the Treaty of Rome[22] and set December 31, 1992, as the target date for completion of the internal market.[23] The internal market is defined as "an area without internal frontiers in which the free movement of goods, persons, services, and capital is ensured."[24]

The Maastricht Treaty on European Union (TEU) was concluded in December 1991 and ratified by all twelve Member States by October 13, 1993.[25] The TEU became effective on November 1, 1993, and creates the European Union (EU), "founded on the European Communities, supplemented by the policies and forms of cooperation established by this Treaty."[26] It commits most of the Member States to follow a particular route to economic and monetary union.[27] One goal of the TEU is the achievement of a single European currency for many Member States by the year 2000.[28] Article 3b formally incorporates the general principle of subsidiarity (making decisions at the lowest practicable level of government) into the Treaty of Rome.[29] The TEU also makes various changes to the EC institutions.[30] 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.[31] This Article allows Member States to continue to deny the benefit of imputation tax credits to foreign shareholders.[32]

C. Formation of European Community Tax Legislation

The Treaty of Rome established an institutional system enabling the Community to enact legislation that is equally binding on all its members.[33] There are three Community institutions involved in the process of producing 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.[34]

The Council consists of representatives of the twelve Member States, usually the ministers responsible for the subject matter under discussion.[35] For example, the Finance Ministers meet with respect to tax and other economic matters and are known as the Economy and Finance Council (ECOFIN).[36] The foreign ministers are usually responsible for major overall policy decisions and the Presidency of the Council rotates between the ministers at six-month intervals.[37] The Council is the principal lawmaker of the Community, although it can only act on a proposal from the Commission except in a few narrowly defined areas. But it also has the power to request that the Commission undertake studies on particular questions and submit proposals for legislation.[38]

The Commission consists of seventeen members who are appointed by mutual agreement between the member governments for what was a four-year term.[39] These Commissioners are required to act in complete independence of the governments and the Council and for the good of the Community.[40] Each Commissioner is assigned one or more portfolios and becomes the political head of one or several Directorates-General.[41] In 1989, the Commission set up a post solely concerned with tax harmonization. Mrs. Christiane Scrivener was the first such Commissioner for taxation.[42]

The Commission formulates Community policy and is responsible for making proposals to the Council and drafting the detailed measures needed for their implementation. It must also ensure that the Treaties and Community law are respected and applied, acting on any infringements. This includes referring matters to the Court of Justice, if necessary.[43]

The European Parliament consists of 567 members, directly elected every five years. The most recent election was held in June 1994.[44] The current breakdown of the seats is as follows: Germany has 99; France, Italy, and the United Kingdom each have 87; Spain has 64; the Netherlands has 31; Belgium, Greece, and Portugal each have 25; Denmark has 16; Ireland has 15; and Luxembourg has 6 seats.[45]

The EEC Treaty defined the role of the European Parliament as advisory and supervisory.[46] However, the legislative role of the Parliament has been steadily increasing. For example, Parliament's role was enhanced by the cooperation procedure introduced in the Single European Act.[47] The cooperation procedure provides the European Parliament two opportunities to comment on certain draft legislation but is generally not relevant to legislation with respect to indirect or direct tax harmonization.[48] Parliament's role was further expanded by the Treaty on European Union.[49]

The Economic and Social Committee was established by the EEC[50] and

EURATOM[51] treaties to involve various economic and social interest groups in the establishment of the Common Market. The Committee has 189 members who represent employers, employees, and other interests. The members are appointed by 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 amendment of national legislation.[52]

Community law is comprised of basic legislation which includes the treaties and the protocols to the treaties 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 take implementing action.[53] The principal types of secondary Community legislation are regulations, directives, decisions, recommendations, and opinions.[54]

Regulations have general application and are binding in their entirety on all Member States without any further action by individual states.[55] Regulations are promulgated either by the Council or the Commission.[56] In practice, most regulations are made by the Commission. Although the vast majority of the regulations relate to agriculture, there is a draft regulation setting out a proposed statute for a European company.[57]

Directives 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.[58] They are proposed by the Commission and adopted by the Council. Directives are the legislative instruments most commonly used for harmonizing the Member States' legislation.[59] 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.[60] When a Member State does not implement the directive into national law, the question arises as to whether the directive has direct effect.[61] The Court of Justice observed that "a Member State which 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."[62] The test is whether the provisions of the directive are unconditional and sufficiently precise such that they can be relied upon as against an incompatible national provision.[63] "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."[64]

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.[65] Recommendations and opinions are not legally binding upon the Member States. They are issued by both the Commission and the Council with respect to specific subjects on which advice has been sought.[66]

The following example of the consultation procedure, which still applies to tax harmonization legislation, outlines the steps taken pursuant to Article 99 of the Treaty of Rome to adopt a major directive such as the Sixth Directive on Value-

Added Tax (VAT).[67] Minor or uncontroversial directives would likely omit some steps.[68]

1. After deciding on the need for a directive, the Commission appoints independent experts to prepare a detailed report on the scope and content of such a directive. For example, the Neumark Committee Report (published in 1963) provided a wide ranging assessment of the ways in which a common tax system should develop and proposed the adoption of a VAT system.[69]

2. Based on the report, the Commission prepares a preliminary draft of the directive.

3. The preliminary draft is sent to the Member States' governments. A working party consisting of experts from each Member State is organized.

4. The preliminary draft is also shared with the appropriate EC professional organizations for comment.

5. The Commission prepares and proposes a final draft directive based on the guidance of the Commission working party and the comments received from professional organizations. This directive is then submitted formally to the Council and published for information in the *Official Journal*.

6. The European Parliament considers the proposed directive and publishes its advisory opinion that either accepts, rejects, or suggests amendments to the proposal.[70]

7. The Commission may amend the proposed directive to incorporate any changes suggested by the advisory opinions.

8. The Council then examines the proposed directive and, if approval is unanimous, it is adopted.[71]

The Single European Act modified the EEC Treaty by adding Article 100a to provide for majority voting in many instances such as the alteration or suspension of duties relating to common customs tariff, legislation regarding the free movement of capital and services, and the harmonization of national standards.[72] However, a unanimous vote is still required for the harmonization of indirect and direct taxation.[73] This explains, in part, why progress in the direct taxation area has been so slow.[74]

D. Enforcement of European Community Tax Legislation

The Commission must ensure that the Treaties and Community law are respected and applied. 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.[75] If the Member State fails to comply with the request, the Commission may refer the infringement to the European Court of Justice.[76] The Commission may also bring suit against a Member State in the Court, when the Commission believes that the country has failed to enact or enforce EC directives.[77]

The Court of Justice's rulings are binding on the Member States. For example, in 1978 the Court delivered judgments requiring several Member States to revise their tax policies that favored domestically produced spirits to the detriment of imported products.[78] 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.[79] The Maastricht Treaty strengthened the enforcement powers of the Court.[80] The Court of Justice may impose fines on any Member State that refuses to comply with a Court ruling where it has infringed Community law.[81]

The European Court of Justice is composed of thirteen judges, each appointed for a renewable six year term, and is assisted by six Advocates General.[82] 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."[83] The Court has jurisdiction to examine the validity of all acts adopted by the Council and the Commission, including regulations, directives, and decisions.[84] These appeals can be brought on the grounds of: lack of competence; infringement of an essential procedural requirement, the Treaty of Rome, or any rule of law relating to its application; or abuse of power.[85]

To ensure the uniform interpretation of Community law, the European Court of Justice renders legally binding preliminary rulings in cases where any question of Community law arises, at the request of any court or tribunal of a Member State.[86] 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 of the relevant question of Community law.[87] Although the judgment is only binding on the court or tribunal requesting the preliminary ruling, other tribunals or courts frequently follow the precedent set by the ruling.[88]

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 countries have extremely wide variations not only in their tax rates but also in their basic approach to taxation. Tables 1, 2, and 3 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 countries in 1991. 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 75 percent of their tax revenues from personal income taxes, social security taxes, and consumption taxes in 1991. With the exceptions of Luxembourg and Italy, corporate taxes play a very minor revenue raising role. All member countries but Greece appear to rely most heavily on direct taxes[89] as the predominant source of revenue, whereas Greece relies predominantly on indirect taxes.[90] 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 countries and the EEC as a whole. 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 1991, the tax ratios ranged from a high of 48.5 percent in Luxembourg to a low of 34.7 percent in Spain, almost a 14 percentage point spread. The common denominator, however, is that the residents of the EC countries are very heavily taxed. Note for comparison purposes that U.S. federal tax revenues

Table 1.
Sources of Tax Revenue as a Percentage of Total Tax Revenue, 1991

	Corporate Income	Personal Income	Social Security	Property Taxes	Consumption Taxes	Other Taxes
Belgium	6.0	30.3	35.4	2.5	25.6	-
Denmark	3.3	53.4	3.0	3.7	33.3	0.2
France	4.5	13.5	43.8	5.8	27.1	3.4
Germany**	4.3	27.1	39.1	2.8	26.7	-
Greece	4.5	12.5	30.4	3.8	45.5	-
Ireland	5.9	32.3	15.1	4.6	40.7	-
Italy	9.6	26.4	33.0	2.5	28.1	-
Luxembourg	15.5	22.2	29.2	7.6	25.4	-
Netherlands	7.3	26.2	37.1	3.6	25.4	0.4
Portugal	8.4	17.8	27.4	2.4	41.9	0.5
Spain	7.7	23.4	35.6	5.1	28.2	-
U.K.	8.9	28.5	17.8	8.2	32.7	4.0
EEC	7.2	26.1	28.9	4.4	31.7	0.7

Source: Based on Revenue Statistics of OECD Member Countries, 1965-1992, Tables 7, 11, and 13. Paris, 1993.

Table 2.
Total Tax Revenue as a Percentage of Gross Domestic Product

	1965	1986	1991	1992*
Belgium	31.2	47.2	44.9	45.4
Denmark	29.9	50.8	48.3	48.9
France	34.5	44.0	44.2	43.7
Germany	31.6	37.7	39.2	40.0
Greece	22.0	36.9	38.3	-
Ireland	26.0	38.8	37.5	38.0
Italy	25.5	36.0	39.7	42.4
Luxembourg	30.6	48.1	48.5	-
Netherlands	32.5	44.8	47.0	46.7
Portugal	18.4	33.4	35.6	37.8
Spain	14.7	30.6	34.7	35.9
U.K.	30.4	37.4	36.0	35.8
EEC	27.3	40.5	41.2	-

*Table 112, Estimates of revenues as percentage of GDP (to the extent available).
** Germany's numbers are unified as of 1991.

Source: Based on Revenue Statistics of OECD Member Countries, 1965-1992, Table 3. Paris, 1993.

Table 3.
Selected Taxes as a Percentage of Gross Domestic Product

	Direct Taxation Taxes on Income and Profits			Indirect Taxation Taxes on Goods and Services		
	1965	1987	1991	1965	1987	1991
Belgium	8.6	18.7	16.4	11.6	11.7	11.5
Denmark	13.7	29.1	28.6	12.1	17.4	16.1
France	5.5	8.0	8.0	13.2	13.0	12.0
Germany	10.7	13.0	12.3	10.4	9.7	10.5
Greece	2.0	6.5	7.6	10.7	17.8	17.4
Ireland	6.7	14.7	14.3	13.7	16.5	15.3
Italy	4.5	13.0	14.3	10.1	9.5	11.1
Luxembourg	11.0	20.9	18.3	7.6	12.0	12.3
Netherlands	11.6	13.0	15.7	9.3	12.3	11.9
Portugal	4.5	6.1	9.9	8.1	15.5	14.9
Spain	3.9	9.2	10.8	6.0	10.0	9.8
U.K.	11.3	13.7	13.5	10.0	11.6	11.8
EEC	7.8	13.8	14.1	10.2	13.1	12.9

Source: Based on Revenue Statistics of OECD Member Countries, 1965-1992,Tables 8 and 24, Paris, 1993.

equaled 29.8 percent of GDP in 1991.

The trend since 1965 has, for the most part, been increased taxation. Total tax revenues as a percentage of GDP have increased over 15 percentage points in countries like Denmark, Greece, Luxembourg, Portugal, and Spain. However, since 1986, with the exceptions of Italy, Germany, Greece, Portugal, and Spain, tax ratios are leveling off or slightly declining and the spread is narrowing. In 1986, the tax ratios ranged from a high of 50.8 percent in Denmark to a low of 30.6 percent in Spain, over a 20 percentage point spread. By 1991, Luxembourg had the highest tax ratio of 48.5 percent and Spain's tax ratio had increased to 34.7 percent, narrowing the spread between the EC countries to 13.8 percentage points. Within the EC, Belgium, Denmark, France, Germany, Italy, Luxembourg, and the Netherlands would be considered high-tax countries (tax ratios 40 percent and above) and Greece, 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 EC countries.[91] There has also been an increased demand for income redistribution through the budget leading to increased public outlays of varying degrees for transfer programs for the unemployed, elderly, sick, etc.[92]

Table 3 illustrates this income redistribution theory. Most of the growth in tax revenues has been from increased taxes on income and profits. This source of revenue is generally considered to be more progressive than taxes on goods and services. With the exception of Germany, every EC country's taxes on income and profits grew by at least two percentage points, with Denmark growing by a phenomenal 14.9 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. In Greece and Portugal, the percentage point increases in taxes on goods and services exceeded that of taxes on income and profits.

As illustrated by Tables 1 and 3, 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 28.6 percent, and the lowest, Greece at 7.6 percent, has broadened greatly since 1965 (21.0 percentage points versus 11.7 percentage points). This phenomenon is not as significant in the case of indirect taxation. In 1991, Greece had the highest indirect tax ratio at 17.4 percent and Spain the lowest ratio at 9.8 percent. This compares to Ireland's indirect tax ratio of 13.7 percent and Spain's at 6.0 percent in 1965. Thus, while the gap has slightly narrowed, there has not been a significant decrease 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.

F. Direct Taxation

1. The Directives

The scope of EC direct taxation legislation is much more limited than indirect taxation 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.[93] The goal of such legislation 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."[94]

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 had called for the adoption of an imputation system with a single corporate tax rate to range between 45 and 55 percent, an income tax credit on grossed-up dividends, and uniform dividend withholding rates of 25 percent. Too ambitious an undertaking, this draft languished. The European Parliament argued that it was senseless to harmonize corporate tax rates and the tax treatment of dividends when such extreme differences in the calculation of taxable corporate income remained.[95]

In July 1990, the Council reached agreement 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");[96] 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");[97] and 3) a transfer price arbitration procedure ("Arbitration Convention").[98] By withdrawing the draft directive of 1975[99] and concentrating on measures deemed essential by the White Paper for Completing the Internal Market by December, 1992, the Commission made progress after years of stagnation.[100]

The Parent-Subsidiary Directive evolved from a Commission proposal submitted to the Council in 1969.[101] It provides generally that there should be no withholding tax on dividends from a 25 percent or greater subsidiary to its parent company established in another Member State.[102] The Member State of the parent company must either exempt the dividends from corporate tax or allow a credit for any tax paid by the subsidiary on the applicable profits from which the dividend is paid.[103] Thus, this Directive will go far towards guaranteeing the neutrality of the tax law with respect to investment decisions.[104]

In most cases, there will be no double taxation when a company decides to set up a subsidiary in another Member State. However, the Parent-Subsidiary Directive does not extend across borders the benefit of the imputation systems that integrate corporate and shareholder taxation in several member countries.[105] In this situation, the effect of the Directive is to allow the source country to collect a single, full level of tax from the distributing subsidiary.[106] So, in many situations, cross-border tax structures will remain biased.[107]

Member States were required to enact legislation to put the Directive into effect by January 1, 1992, although Germany, Greece, and Portugal were given extensions with respect to the zero withholding tax requirement.[108] Every Member State has implemented the Directive. Italy, the last to enact implementing legislation, did so through a legislative decree on March 5, 1993 which provided for the rules to apply retroactively to profits distributed on or after January 1, 1992.[109] Like most Member States, Italy adopted the exemption method[110] so that 95 percent of the profits distributed by EC subsidiaries are not included in the taxable income of the Italian parent.[111] In order to qualify for this tax treatment: 1) the parent must have held a minimum of 25 percent of the subsidiary's capital for at least a continuous year when the distribution is made; 2) the subsidiary must be 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.[112]

The Parent-Subsidiary Directive allows for the adoption of an anti-avoidance regime.[113] Some commentators are concerned about the lack of harmonization with respect to the anti-avoidance rules.[114] 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.[115]

The Mergers Directive also originated from a 1969 proposed Directive.[116] The Mergers Directive seeks to remove barriers to the free and unimpeded flow of capital by deferring gains at the corporate level in a merger, division, transfer of assets, or exchange of shares[117] involving corporations from multiple EC countries under certain conditions.[118] These rules are roughly comparable to the U.S. tax rules governing tax-free reorganizations.[119] Unfortunately, the Mergers Directive applies to specified cross-border transactions within the Community, many of which cannot yet be legally implemented because progress in the tax field has actually outpaced developments in the company law area.[120] This Directive must be supplemented by commercial law changes introduced by the draft of the Tenth Company Law Directive before many of the mergers and divisions contemplated by the Directive are permitted under many of the domestic company laws.[121] However, transfers of assets and exchanges of shares, also within the scope of the Directive, generally are already possible as all Member States except for Greece have domestic laws which permit and recognize cross-border transfers of assets and exchange of shares.[122] The conditions for the tax free or tax deferral treatment of such transactions vary slightly from country to country.

Except for Belgium, Germany, Greece, and the UK, all other EC countries have implemented the Mergers Directive.[123] However, provisions in each country's tax laws vary as to the conditions for the tax free or tax deferral treatment of the transactions (mergers, divisions, transfers of assets, or exchanges of shares). Laws presently exist in Belgium, Germany, and the UK permitting mergers but only between domestic entities. Cross-border mergers as set forth by the Directive are not legally possible or recognized in these countries. Similarly, divisions are not recognized in these countries. Greece is the furthest from implementing the Mergers Directive because it has no tax or company laws covering cross-border transactions as set forth by the Directive.[124]

The final measure in the package dealing with transnational cooperation between firms is an arbitration procedure designed to eliminate the double taxation from adjustments by one tax authority that are not accompanied by a corresponding adjustment by the other Member State tax authority. The Community has realized that optional provisions of bilateral agreements are insufficient to prevent such double taxation.[125] The Arbitration Convention establishes a mandatory arbitration procedure upon failure of agreement between the competent authorities 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.[126] This commission then has six months to deliver its opinion which the competent authorities must implement within the next six months.[127] This Convention has been ratified by the legislature of each Member State[128] and is effective on January 1, 1995.[129]

Also during 1990, the Commission proposed two directives with respect to cross-border loss relief[130] and the elimination of withholding taxes on inter-company royalties and interest payments.[131] 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 the two methods of relief. The first method is known as the credit method and 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.[132]

The second 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 second method must be chosen for losses of a subsidiary and is known as the re-incorporation method.[133] In March 1992, the European Parliament issued its opinion on the Loss Directive. The draft directive is under consideration by the Council but negotiations are progressing very slowly.[134]

The proposal regarding the limitation of the withholding tax on interest and royalties paid between affiliated EC companies is similar to the Parent-Subsidiary Directive and requires that Member States exempt cross-border interest and royalty payments made between parents and subsidiaries from withholding taxes.[135] In March 1991 and February 1992, the Economic and Social Committee and the European Parliament respectively adopted favorable opinions on this proposal.[136] Pursuant to the recommendations of the Parliament, the Commission amended the proposed directive to expand the definition of included interest and royalty payments.[137] Although the EC finance ministers began discussions in 1991, they have been unable to adopt this Directive.[138] At a meeting held in April 1994, Commissioner Scrivener threatened to withdraw the proposal if the Council did not adopt it by year-end.[139]

The Parent-Subsidiary Directive's most immediate effect is an appreciable reduction in the tax burdens of the affected companies. The Mergers Directive will apply immediately to 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 revised draft of the proposed regulation for a European Company Statute.[140] Finally, the Arbitration Convention involves the affected company in the proceedings at an early stage, unlike double taxation conventions, so that there should be significant savings realized from the time restrictions.[141]

Besides the establishment of substantive rules, these directives and the proposed directives have and will have an important indirect influence on the interpretation of treaties.[142] Most tax treaties following Article 3(2) of the OECD Model Treaty refer to the domestic law of the state that applies the Convention when it is necessary to interpret an undefined term. The directives, once enacted, become part of the domestic law of the EC member state, thus, any definition of terms found in these directives will apply to specify a tax treaty rule.[143]

2. The Ruding Committee Report

Progress in the direct taxation area has come about because of the Commission's adoption of a more flexible approach. This new approach is to promote convergence, approximation, and cooperation rather than harmonization.[144] In keeping with this new approach, in December 1990, Mrs. Scrivener established a committee of independent experts chaired by Mr. Onno Ruding, the former Dutch Finance Minister, to identify future proposals on company taxation after 1992.[145] The Committee's mandate was to evaluate the need for greater harmonization of business taxation in the European Community.[146] On the basis of its mandate, 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?[147]

On March 18, 1992, the Ruding Committee presented its report to the Commission. The Committee noted that there were major differences in the corporate tax systems, tax rates, and tax bases utilized by each Member State.[148] Based on a simulation study and an empirical survey, the Committee concluded that there are clear differences in the tax burden on the domestic companies of each Member State and that there is overall discrimination against foreign investors.[149] 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.[150]

The Report contains a three phase schedule for implementing the corporate tax measures that the Committee deemed necessary to achieve a true internal market.[151] The priorities were: 1) removing the discriminatory and distortionary features of each country's tax system that impede cross-border business investment 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 maximum transparency of any tax incentives granted by a Member State.[152]

Phase I proposals were considered urgent and were to be implemented by the end of 1994. These proposals predominantly refine proposed and adopted Community measures.[153] Phase II includes proposals with respect to the harmonization of the tax base. Phase III contains further harmonization rules for the tax base keyed to common accounting rules and an integration proposal.[154] The Committee linked the timing of these proposals to the development of the European Monetary Union (EMU). Thus, Phase II should be implemented during the second phase of EMU and Phase III is envisaged as being implemented concurrently with the completion of the EMU.[155]

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 within the Community because of the implementation of the Parent-Subsidiary Directive. To further this progress, the Committee recommended a substantial reduction in the 25 percent participation threshold prescribed in the Directive and an extension of its scope to all enterprises subject to corporate income tax, regardless of their legal form.[156] In order to ensure a sufficient level of taxation at source, the Committee recommended that the Commission propose a uniform withholding tax of 30 percent on dividend distributions by EC-resident companies to non EC-resident taxpayers.[157] The Committee urged that the Member States adopt the proposed Interest and Royalty Directive,[158] and the proposed Loss Directive,[159] and ratify the Arbitration Convention as soon as possible.[160] Finally, the Committee urged Member States to conclude comprehensive bilateral income tax treaties between themselves and to work in concert with the Commission to develop a common policy on double taxation agreements with respect to third countries.[161]

The Committee recommendations with respect to corporate tax harmonization concern the Member States' systems of integration, 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."[162] The Ruding Committee did not recommend that Member States with imputation systems extend imputation credits to non-resident shareholders as this step would not be in accordance with the principles of source-country treatment. However, the Committee did recommend 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.[163] The Committee acknowledged that, although it was unlikely that all Member States would be willing to accept the same type of corporate integration system in the near future, their goal for Phase III was for the Commission and the Member States to determine the most appropriate corporate tax system for the Community.[164]

In the area of tax rates, the Committee recommended that the Commission prepare a directive prescribing a minimum statutory corporate tax rate of 30 percent and that all Member States adopt a maximum statutory corporate tax rate of 40 percent during Phase II.[165] As harmonization of the corporate rates make 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.[166] In addition, they recommended that the Commission issue detailed proposals on items such as depreciation, intangibles, leasing, and stock valuations for Phases I and II.[167]

The Commission released a communication on June 24, 1992 that set out the Commission's initial reactions to the Committee's conclusions and recommendations.[168] Generally speaking, the Commission was very supportive of the recommendations for proposals to eliminate the double taxation of cross-border flows.[169] With respect to the Committee's recommendations on corporate tax harmonization, however, the Commission was more restrained.[170] 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."[171]

Specifically, the Commission considered the extension of the scope of the Parent-Subsidiary Directive and the Mergers Directive to be desirable and necessary.[172] In July, 1993, the Commission proposed a directive that would extend the scope of the Mergers Directive and the Parent-Subsidiary Directive to all enterprises subject to corporate tax.[173] The proposed Directive also amends the Mergers Directive to require a holding of a minimum of 25 percent of the subsidiary's capital in order to be consistent with the Parent-Subsidiary Directive.[174] The Parent-Subsidiary Directive is amended to take into account taxes levied by the lower-tier subsidiaries when using the imputation method.[175]

The Commission also endorsed the suggestion of establishing appropriate procedures for transfer price adjustments by Member States and of proposing a common approach to the definition and treatment of thin capitalization.[176] 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.[177] The Commission concurred with the Committee's goal of neutrality of treatment as between foreign-source and domestic-source dividends, but was concerned about the condition of reciprocity. The Committee's recommendation limits the benefit to Member States applying imputation systems and tax relief systems.[178]

G. 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 tax harmonization. The proposed Interest and Royalty Directive is often on the ECOFIN agenda, but there has been no resolution thus far.[179] In part this can be explained by a pre-occupation 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 has been consumed with making the new system work.[180] Furthermore, the Maastricht Treaty required the Council to adopt recommendations establishing broad guidelines regarding the economic policies of the Member States and the Union in preparation for monetary union.[181]

The Ruding Committee presented evidence that the average EC 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 percent as compared to 0.7 percent for a similar project carried out domestically.[182] The Committee attributed this difference to withholding taxes on cross-border intercorporate dividend payments, to use by some Member States of the credit rather than the exemption method to relieve cross-border double taxation, to differences in corporate tax rates, and to withholding taxes on cross-border intercorporate interest payments.[183] The 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.[184] 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 be eroded regardless as the Member States' economies are increasingly integrated.[185] The thrust toward economic and monetary union, 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 base is inevitable. The differences in the corporate tax systems of the 50 states in the U.S. provide evidence that complete harmonization of corporate tax laws is not necessary. However, if the goal of accelerated economic unification is to be achieved, 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.

II. Implications of EC Direct Tax Harmonization on U.S. Tax Policy

The twelve Member States comprise a single market of approximately 350 million people, but the future EU could include Scandinavia, Austria, and much of Eastern Europe.[186] The European Economic Area (EEA) Agreement commenced January 1, 1994.[187] The EEA Agreement surpasses the North American Free Trade Agreement (NAFTA) in terms of establishing 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.[188] Although it is not full EU membership, the EEA Agreement allows for the free movement of goods, persons, services, and capital throughout the 17 countries and creates a common market of 370 million consumers.[189] In the spring of 1994, the EC Council finished negotiations with Austria, Sweden, Norway, and Finland so they could accede to the Union on January 1, 1995.[190] The Austrians voted in a national referendum to accept the terms of EU membership and similar referendums passed in Finland and Sweden but not Norway.[191]

To achieve a coherent system of international taxation, the U.S. must take note of how other countries tax international income.[192] The European Union (EU) is especially important not only because of the twelve Member States that currently comprise the EU 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.[193] For example, Sweden enacted major tax reform in 1990 that included provisions that resemble the Parent-Subsidiary Directive and Mergers Directive.[194] The Eastern European countries are also closely monitoring the tax systems of the twelve Member States as well as the evolving body of EC tax law as these countries develop their tax systems.[195] The tax policies pursued by this entire group will have important implications for economic conditions in the EU and in the U.S.

In the international trade arena, the current trend is the formation of regional trading blocs.[196] In 1992, the United States, Canada, and Mexico agreed to the terms of NAFTA in order to create a trade area in which goods and services are exchanged free of tariffs and other trade restrictions.[197] In general, NAFTA does not address the subject of taxation except to specify that taxation questions will be governed by the applicable tax conventions in effect between the NAFTA countries.[198] It is logical to presume, however, that as cross-border activity increases, the NAFTA countries will increasingly feel pressure to attempt some harmonization of their respective tax systems. Valuable lessons can be learned from the tax harmonization experience of the EC.

A. U.S. Tax Treaty Policy Implications

The sovereignty to conclude bilateral tax treaties has not been transferred from the Member States to the EC.[199] Presently, the U.S. has ratified tax treaties with eleven of the twelve Member States.[200] The most recent treaty ratified with an EC Member State, the U.S.-Netherlands Income Tax Treaty, was signed on December 18, 1992[201] and has generated some controversy with respect to the limitation on benefits article (also known as an anti-treaty shopping clause).[202] The issue is whether the limitation on benefits article of this treaty is compatible with Articles 6, 52, and 58 of the Treaty of Rome.[203] Some commentators argue that excluding Dutch companies with EC parents from treaty benefits conflicts with the freedom of establishment under the Treaty of Rome.[204] The bilateral tax treaties between the U.S. and Germany, France, Italy, Belgium, and Spain present similar issues.[205]

The Ruding Committee noted that although multilateral relations between Member States with respect to withholding taxes are becoming increasingly harmonized because of the Parent-Subsidiary Directive, this is not true for Member States' relations with non-Community countries. The Member States continue to negotiate bilateral treaties with third countries that exclude cross-border dividend, interest, and royalty payments from treaty protection in the case of treaty shopping.[206] The Committee stated that treaty provisions such as the anti-treaty shopping clauses negotiated by the U.S. may not be compatible with the fundamental principles of Community law as far as residents of other Member States are concerned.[207] 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, interest, and royalties) and avoiding conflicts with the Treaty of Rome.[208] 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.[209]

Anti-treaty shopping clauses have become an integral part of U.S. treaty policy. The U.S.-Luxembourg Treaty was the first U.S. tax treaty to incorporate such a provision.[210] In 1981, the U.S. Department of Treasury issued a draft U.S. model income tax treaty which contained a limitation on benefits article.[211] Since then, the 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 of benefits provision as one of the primary objectives.[212] All treaties ratified by the U.S. Senate since 1980 have contained such a provision.[213]

The Treasury was initially responding to the situation where a foreign investor who resides in a country without a treaty with the U.S., forms a legal entity in a tax haven jurisdiction with a favorable treaty with the U.S. The legal entity avails itself of treaty benefits to which the investor was not directly entitled.[214] The policy concern was that if residents of countries without income tax treaties with the U.S. already had effective access to treaty benefits, there was no incentive to enter into such a tax treaty and grant reciprocal concessions to the U.S. and its investors.[215]

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.[216] 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.[217] This obsession with treaty shopping has led to limitation on the benefits articles that may be excessively detailed and complex, as well as difficult to administer.[218] The treaty negotiations with the Netherlands took years and much of the controversy revolved around the limitations on benefits article.[219]

The most poignant example of this complexity can be found in Article 26 of the U.S.-Netherlands Treaty. This limitation on benefits article is 23 pages—longer than some tax treaties.[220] 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.[221] Partially because of the Netherlands' concerns over compatibility with the Treaty of Rome,[222] these tests take into consideration to a limited extent shareholders and/or activities in other EC Member States. 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 U.S. would have offered the same benefits.[223]

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.[224] The adoption of such a treaty would produce significant benefits for the U.S.[225] Many of the treaties negotiated with the EC Member States are antiquated and do not include a comprehensive limitation on benefits article.[226] Other issues could also be addressed such as the extension of the Parent-Subsidiary Directive and the proposed Interest and Royalty Directive to distributions and payments between U.S. and EC companies.[227]

The U.S. could also take this opportunity to address our treaty partners' concerns over recent treaty overrides.[228] U.S. 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.[229] Thus, changes in U.S. law may override provisions of a treaty without the consent of the treaty partner.[230] Many of the EC Member States are particularly sensitive to treaty overrides as their constitutions do not permit such a result.[231] The 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.[232]

Administratively, a multilateral tax treaty between the U.S. and the EC is a project very much worth pursuing. The former International Tax Counsel of the U.S. Treasury, Cynthia Beerbower, had designated 40 percent of her staff's time to be spent negotiating treaties.[233] 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 third countries to negotiate treaties concurrently with the Commission.[234] The Treasury is currently involved in active or ongoing negotiations with Portugal, Denmark, Luxembourg, France, Italy, and Belgium.[235] As a group, the EC Member States are not yet ready to negotiate a single treaty with the U.S. The Commission has, however, 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.[236]

An alternative approach is to strive towards more uniformity in the negotiation of treaties with the EC Member States.[237] The European Community presents a unique situation given the level of coordination and information sharing[238] among the Member States and their thrust toward economic integration.[239] 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.[240] 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 through EC countries like Italy, with which the U.S. has a less generous treaty provision regarding withholding taxes at source.[241]

B. Implications for Subpart F

The provisions of Subpart F also need to be reexamined in light of the tax harmonization developments in the EC. Generally, a U.S. shareholder of a foreign corporation will not be taxed on that foreign corporation's earnings until those earnings are distributed, which may occur in any subsequent tax period, if ever.[242] This delay in the payment of U.S. tax until the earnings are repatriated is referred to as deferral.[243] 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. However, if the foreign corporation's effective rate of foreign tax is less than the U.S. rate, its U.S. shareholders may enjoy substantial benefits from deferral.[244]

To deny the tax deferral advantages of certain investments, Congress has enacted complex rules that require immediate recognition of income to U.S. shareholders from certain foreign corporations irrespective of whether there is an actual distribution. These rules, contained in Subpart F and first enacted in 1962, endeavor to impose current shareholder taxation on certain undistributed income earned through a foreign corporation.[245]

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, except for certain income derived by foreign subsidiaries in less developed countries.[246] 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.[247] Those opposed to this proposal argued that the deferral of U.S. tax on the income of U.S.-controlled foreign corporations was necessary to achieve capital import neutrality, to enable U.S. companies to compete effectively in foreign markets.[248] Congress compromised by eliminating deferral for certain 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.[249]

Two requirements must be met for Subpart F to apply. First, the U.S. taxpayer must own at least ten percent of the foreign corporation's voting stock.[250] Such a taxpayer, a ten percent shareholder, is known as a "U.S. shareholder."[251] Second, U.S. shareholders must own more than fifty percent of the foreign corporation's voting power or value.[252] A corporation that satisfies these requirements is known as a "Controlled Foreign Corporation" (CFC).[253] Its "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, as well as any increase in earnings invested in specifically defined U.S. property.[254]

Subpart F income[255] primarily includes foreign base company income such 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.[256] In defining foreign base company income, Congress was primarily concerned with the income of a subsidiary established to market products and which has 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 in which 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.[257] This is known as the same-country exception.

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.[258] 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."[259]

Congress has always provided an exception from the Subpart F rules for foreign subsidiaries not established in tax haven countries.[260] As enacted in 1962, income could be excluded from Subpart F if it were established that the CFC did not substantially reduce taxes.[261] The exception was revised by the Tax Reform Act of 1969[262] so that it was necessary to establish that reducing taxes was not a significant purpose of earning the income through the CFC.[263] In 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 90 percent of, or no more than 5 percentage points less than, the rate of tax applicable in either the country of manufacture or the country of destination of the goods.[264] For services income, reference was made solely to the tax rate in the country in which the services were performed.[265]

Section 954(b)(4) as amended by the Tax Reform Act of 1986[266] now provides that 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 90 percent of the highest U.S. corporate tax rate is exempt from Subpart F taxation.[267] This is referred to as the high-tax exception. 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.[268]

The rationale for requiring a comparison between the foreign tax paid and the U.S. tax rate is unclear.[269] 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 tax consequences if the CFC is incorporated at the destination of the sale regardless of the tax rate in that jurisdiction.[270] 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.[271] 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 foreign 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.[272] 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.[273]

U.S. 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 countries.[274] 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.[275] 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.[276]

In response to these concerns, Congressman Gibbons (D-FL), Acting Chairman of the House Ways and Means Committee, introduced legislation in the 101st, 102nd, and 103rd Congresses.[277] For example, proposed bill HR 1401, which was introduced on March 18, 1993, would amend §954(b) so that the Member States are treated as a single country for purposes of the Subpart F rules.[278]

In testimony submitted to the Ways and Means Committee in June, 1993, the Treasury opposed this legislation stating "although the EC is moving towards economic integration, the lack of direct tax harmonization creates inappropriate tax planning opportunities."[279] 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.[280] 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.[281] The Treasury was concerned about the myriad of deduction and credit rules and enterprise zones that result in low taxes for certain industries in certain locations providing unwarranted tax avoidance opportunities.[282]

In general, EC countries are not considered low-tax countries.[283] However, some Member States have special tax regimes for specific locations that offer significantly reduced tax rates or other tax incentives such as accelerated depreciation.[284] A number of Member States such as Belgium, France, Ireland, and Luxembourg, for example, 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.[285]

The Ruding Committee shared the U.S. Treasury's concern that the growing mobility of capital increases the temptation for EC Member States to attract capital from each others' jurisdictions by offering lower effective tax rates and special tax schemes designed to attract internationally mobile business.[286] As economies become increasingly globally integrated, the competition for investment will become more intense.[287] Nevertheless, the Committee concluded there was no convincing evidence that tax competition would lead to a serious erosion of corporate tax revenues.[288] As a safeguard against such competition, the Community has proscribed the amount of State aid that can be paid to companies[289] and the Commission has a competition department that must approve tax law changes.[290] Also, as a historical matter, since 1986 every Member State except for Italy and Spain has reduced its corporate tax rates,[291] yet corporate tax revenues as a percentage of GDP and of total tax revenues have risen.[292] 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.[293]

The same-country exception from Subpart F allows for deferral so long as the CFC is organized and operated in its natural business locus. Thus, the question is whether the EC can be considered such a natural business locus. The EC does not have a single corporate income tax system but neither do many federal governments 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 the association of completely sovereign cantons with the goal of maintaining the traditions, languages, and customs of each of these cantons.[294] 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.[295]

The national government of Switzerland relies predominantly on indirect taxes while the 26 cantons and approximately 3,000 communes earn most of their revenues from direct taxation.[296] Specifically, the cantons of Switzerland raise approximately 12.6 percent 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.[297] Each canton has its own income tax act and these tax acts are in some cases quite diverse.[298] For example, while the classical system prevails in Switzerland, three cantons operate a split-rate system whereby a lower rate of tax is levied on distributed earnings than on retained earnings.[299]

There is progress towards 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. However, the cantons are allowed eight years to change their cantonal laws, only after which the law becomes self-executing.[300] The model tax law provides a mandate for working towards uniform definitions of tax entities, the tax base, and taxpayers and rules for tax dispute resolution.[301] 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.[302] Currently, combined cantonal and communal corporate income tax rates range from 9.9 percent to 29.6 percent.[303] Note that EC corporate income tax rates range from 10 percent to 45 percent.[304]

The Swiss cantons freely compete for business investment through tax rate reductions and tax concessions designed to encourage regional development.[305] 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.[306] 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.[307] But the amount of tax diversity within Switzerland is illuminating with respect to the question of whether the EC can 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.[308] Adoption of this statute only requires a qualified majority[309] but Germany, Ireland, and the UK remain opposed.[310] Movement may occur in 1995 as a result of the enlargement of the EU as the qualified majority necessary for adoption will change.[311]

Similarly, in many cases European companies are unable to consolidate their separate country subsidiaries because corporate law does not provide for such mergers.[312] France, Italy, Portugal, and Spain, however, are the exceptions where it appears that mergers of subsidiaries into a new or existing European company 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.[313] 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.[314]

There are changes in the way European companies are doing business. Centralized warehouses and the consolidation of operations are allowing these companies to become more efficient.[315] The new VAT system for intra-community trade became effective January 1, 1993 and in general, the transition went more smoothly than anticipated.[316] Enough progress has been made to ensure that the Community begins to reap the financial rewards that were promised by EC 92. Of the 282 measures in the White Paper, only 18 have not been approved by EC members.[317] The push towards economic and monetary union 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.[318] U.S. companies are unable to reallocate capital within an EC holding company structure efficiently[319] and may not be able to avoid foreign dividend withholding taxes. 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.[320]

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.[321] This income would not be considered foreign base company sales income because the manufacturing took place outside the U.S. Similarly, many of the EC special tax regimes are targeted at services income which are 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 also argues that other regional trading blocs should be treated as a single country if the EC receives such treatment, thus unravelling Subpart F.[322] Single country treatment of other economic regions is justified once they have established an institutional structure comparable to that of the EC 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 harmonization. Although there is not a compelling case for treating the EC as a single country at this time, given the work that remains on the harmonization of direct taxes, corporate law, and monetary union, the tax policy goals of administrability, simplicity, and economic efficiency argue for such treatment.[323]

III. Conclusion

To achieve a coherent system of international taxation, the United States must take note of how other countries tax international income.[324] The European Community is especially important not only because of the twelve Member States that currently comprise the Community, but also because of the many countries that aspire to join. The tax systems of the twelve Member States, as well as the evolving body of EC tax law, are being closely monitored by the EFTA countries as they pursue tax reform and 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 inevitable. 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, tax bases, and the treatment of capital gains and losses.[325] The thrust towards economic and monetary union 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. And as 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 U.S. 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 half of 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.

Endnotes

1 Full harmonization means the establishment of identical tax bases, rates, systems, etc., throughout the European Community as a result of action at the Community level by the Commission or other agencies of the Community such as the European Court of Justice. COMMISSION OF THE EUROPEAN COMMUNITIES, REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION 19 (1992) [hereinafter Ruding Report].

2 Coordination refers to any action in the form of directives, conventions, recommendations, guidelines, etc., taken by the Commission or an EC Member State to affect the tax practices of the member countries. *Id.*

3 Approximation means the establishment of a range of possibilities for the Member States to choose from — choices outside that range are not allowable. Marlin Risinger, Address at the National Tax Association Tax Institute of America 4 (Oct. 12, 1992).

4 The EC Commissioner for taxation, Mrs. Christine Scrivener, issued a communication in 1990 setting forth guidelines on company taxation and the measures the Commission thought necessary to establish and further develop the internal market. In this communication, Mrs. 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. COMMISSION OF THE EUROPEAN COMMUNITIES, COMMISSION COMMUNICATION TO PARLIAMENT AND TO THE COUNCIL - GUIDELINES ON COMPANY TAXATION SEC (90) 601 final [hereinafter GUIDELINES ON COMPANY TAXATION].

5 *Id.* at 2. Subsidiarity, as now defined in the Maastricht Treaty, is 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. Treaty on European Union,

Feb. 7, 1992, art. G(5), 1 CMLR 719 [hereinafter TEU].

[6] TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY, Mar. 25, 1957, art. 1, 298 U.N.T.S. 3 [hereinafter Treaty of Rome]. The term EEC Treaty will be used to refer to the original treaty prior to any amendments. This Treaty established the European Economic Community in 1958.

[7] Treaty of Rome, *supra* note 6, art. 5. The TEU formally renamed the European Economic Community the European Community (EC). TEU, *supra* note 5, art. G(1). The TEU also established the European Union (EU), but only the EC has international legal status.

[8] NOEL, WORKING TOGETHER: THE INSTITUTIONS OF THE EUROPEAN COMMUNITY 5 (1993).

[9] *See* Treaty of Rome, *supra* note 6, art 2. For example, the creation of a customs union, the first step towards a common market, was completed by 1968. As a result, trade increased among the original six Member States from $6.8 billion in 1958 to $60 billion in 1972. EUROPEAN COMMISSION DELEGATION TO THE UNITED STATES, THE EUROPEAN UNION: A GUIDE 12 (1994) [hereinafter EU GUIDE].

[10] Treaty of Rome, *supra* note 6, arts. 54, 100a.

[11] FORWARD 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.

[12] Jonathan Schwarz, *Survey of World Taxation*, FIN. TIMES, May 20, 1994, at III; *see* 1994 O.J. (L 39) 22; *see also infra* note 66 and accompanying text for an explanation of the authority of a recommendation.

[13] Coopers & Lybrand, *Direct Taxation*, EC COMMENTARIES, May 5, 1994, at §5.1 [hereinafter *Direct Tax*].

[14] Treaty of Rome, *supra* note 6, art. 220.

[15] Treaty of Rome, *supra* note 6, art. 100; *see also* EUROPEAN DOCUMENTATION, TAXATION IN THE SINGLE MARKET 6 (1990) [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 the 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 6, arts. 52, 58. Article 73b is intended to ensure the free movement of capital by providing that Member States shall abolish restrictions on the movement of capital belonging to residents of another Member State. Treaty of Rome, *supra* note 6, 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 6, art. 221, see also Michael Daly and Joann Weiner, *Corporate Tax Harmonization and Competition in Federal Countries: Some Lessons for the European Community?*, XLVI NAT'L TAX J. 441, 460 n.33 (Dec. 1993).

[16] Commission of the European Communities, *Report from the Commission to the Council on the Scope for Convergence of Tax Systems in the Community*, S. 1/80 BULL. OF THE EUR. COMMUNITIES 13 (1980).

[17] Cnossen, *supra* note 11, 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 and meets at least twice a

year, at the end of each Member State's six-month presidency of the Council. EU Guide, *supra* note 9, at 9.

[18] Robert H. Aland, *Europe 1992, Tax Planning for U.S. Multinationals*, 68 Taxes 1072, 1073 (Dec. 1990). The original 300 measures were subsequently reduced to 282. The measures were divided into three categories: measures to remove physical barriers; measures to remove technical barriers; and measures to remove fiscal barriers. *Id.* at 1074.

[19] White Paper, *supra* note 17, at 38.

[20] Single European Act, 1987 O.J. (L 169) 1, 4 [hereinafter SEA].

[21] A.G. Toth, 1 The Oxford Encyclopaedia of European Community Law 482 (1990).

[22] SEA, *supra* note 20, art. 13 (adding a new Article 8a to the EEC Treaty); *see also* Taxation in the Single Market, *supra* note 15, at 5. The internal market can be thought of as a stepping stone towards a common market which is the objective outlined in art. 2 of the Treaty of Rome. Johan Brands, *Comment: Trade-Off Between Subsidiarity and Neutrality*, in Taxation of Cross-Border Income, Harmonization, and Tax Neutrality under European Community Law 35, 36 n.52 (1994).

[23] Aland, *supra* note 18, at 1073.

[24] SEA, *supra* note 20, art. 13.

[25] *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,* The Economist, Oct. 23, 1993, at 15 [hereinafter *Maastricht Recipe*].

[26] TEU, *supra* note 5, art. A; *see also* EU Guide, *supra* note 9, at 3; *European Union Closer to Making Single Currency for 12 Member States*, Sacramento Bee, Jan. 2, 1994, at A12.

[27] *Europe's Monetary Future: From here to EMU*, The Economist, Oct. 23, 1993, at 25.

[28] Patrick Oster, *Europe Finds Economic Unity Elusive Dream; Protectionism, Regulation Slow Efforts to Create Single Market*, Wash. Post, Jan. 23, 1994, at h01.

[29] Treaty of Rome, *supra* note 6, art. 3b. *See supra* note 5 and accompanying text for further explanation of the subsidiarity principle.

[30] *See infra* notes 35-49 and accompanying text.

[31] Treaty of Rome, *supra* note 6, art. 73d.

[32] Germany, France, Italy, Ireland, and the UK currently alleviate the economic double taxation of benefits through imputation credit methods. Ruding Report, *supra* note 1, at 194; *see infra* note 96 and accompanying text; *see also* Daly, *supra* note 15, at 460 n.31.

[33] European Documentation, European Unification: the Origins and Growth of the European Community (1990) [hereinafter European Unification].

[34] George Bermann et. al., Cases and Materials on European Community Law 50 (1993); David Freestone & J. Scott Davidson, The Institutional Framework of the European Community 55-90 (1988); Trevor Clayton Hartley, The Foundations of European Community Law 8-47 (2d ed. 1988).

[35] European Unification, *supra* note 33, at 26; *see* Freestone & Davidson, *supra* note 34, at 67; *see also* Hartley, *supra* note 34, at 14. The TEU has renamed the Council the Council of the European Union. EU Guide, *supra* note 9, at 8.

[36] See *Lobbying,* in Single European Market Reporter 2-A, 2-4 (Baker & McKenzie, Oct. 1989).

[37] Bermann, *supra* note 34, at 51; Freestone & Davidson, *supra* note 34, at 67; Hartley, *supra* note 34, at 14. The Danish Presidency of the Council ended

on June 30, 1993 and Belgium held the presidency through December 31, 1993. Stephen Nisbet, *Belgium Take Over EC Presidency*, REUTER FINANCIAL WIRE, July 1, 1993, *available in* LEXIS, WORLD Library, REUFIN File. Greece held the presidency through June 30, 1994. *EC: Greece Assumes Council Presidency for the First Half of 1994*, AGENCE EUROPE, Dec. 31, 1993, *available in* LEXIS, WORLD Library, TXTNWS File. Germany, France, and Spain will hold the presidency in that order for the three six-month terms through 1995. Tom Buerkle, *Spaniard Trips up Dutchman in Race for EC's Top Post*, INT'L HERALD TRIBUNE, June 8, 1994.

[38] Treaty of Rome, *supra* note 6, art. 145; *see also* BERMANN, *supra* note 34, at 51-52; FREESTONE & DAVIDSON, *supra* note 34, at 69-70.

[39] The Commission will have 20 members once the Community is enlarged to 15 Member States and from January 1995 will be appointed to 5-year terms coterminously with the European Parliament. *Institutional Implications of Norwegian 'No' Vote*, THE REUTER EUROPEAN COMMUNITY REPORT, December 1, 1994, available on LEXIS, WORLD LIBRARY, REUEC File.

[40] EUROPEAN UNIFICATION, *supra* note 33, at 29; *see* Treaty Establishing a Single Council and a Single Commission of the European Communities (Merger Treaty), 1965, art. 10(2); *see also* BERMANN, *supra* note 34, at 57; FREESTONE & DAVIDSON, *supra* note 34, at 57; HARTLEY, *supra* note 34, at 8-9.

[41] FREESTONE & DAVIDSON, *supra* note 34, at 59-60; HARTLEY, *supra* note 34, at 10.

[42] KPMG, 1992 GETTING READY - A BRIEFING FOR TAX PROFESSIONALS app. 3 (1989).

[43] EUROPEAN UNIFICATION, *supra* note 33, at 29; *see also* Treaty of Rome, *supra* note 6, art. 155; BERMANN, *supra* note 34, at 292; FREESTONE & DAVIDSON, *supra* note 34, at 60-66; HARTLEY, *supra* note 34, at 11-13.

[44] EUROPEAN UNIFICATION, *supra* note 33, at 29; BERMANN, *supra* note 34, at 65; Tyler Marshall, *EU Voters Turn Against Established Parties; Europe: Governments in Britain, France and Spain Receive Sharp Rebukes*, LOS ANGELES TIMES, June 13, 1994, at A7, B1.

[45] NOEL, *supra* note 8, at 5; *see also* BERMANN, *supra* note 34, at 64; Marshall, *supra* note 34, at A7 The proposed number of seats in the enlarged European Parliament is 626, affording Austria 21 seats, Finland 16, and Sweden 22. *EU Enlargement: Implications of Norwegian "No" Vote*, EUROPEAN REPORT, December 7, 1994, available on LEXIS, WORLD LIBRARY, EURRPT File.

[46] Treaty of Rome, *supra* note 6, art. 137; BERMANN, *supra* note 34, at 64; FREESTONE & DAVIDSON, *supra* note 34, at 71. The TEU introduced a new article 138b to the Treaty of Rome. This new article permits Parliament to ask the Commission to submit legislative proposals. Furthermore, the 1992 TEU actually gives Parliament a form of co-decision on certain types of legislation while retaining the cooperation procedure or the consultation procedure for others. BERMANN, *supra* note 34, at 63-68; Treaty of Rome, *supra* note 6, art. 189b. *See infra* note 49 for a description of the co-decision procedure.

[47] SEA, *supra* note 20, art. 6; *see also* BERMANN, *supra* note 34, at 66; FREESTONE & DAVIDSON, *supra* note 34, at 76-78; HARTLEY, *supra* note 34, at 32-34.

[48] HARTLEY, *supra* note 34, at 32-33. Under the cooperation procedure, the Council must adopt a common position by a qualified majority. This position is then referred to the Parliament for a second reading after which one of the following transpires:

1) the Parliament adopts the position or fails to make a decision, in which case

the Council must adopt the common position; or

2) the Parliament rejects the position in which case it may only be adopted by unanimous vote of the Council; or

3) the Parliament proposes amendments to the position, in which case the Council can adopt the amended proposal by qualified majority if the Commission supports the amendments or the Council can adopt the amended proposal by unanimous decision if the Commission opposes the amendments.

KMPG, *supra* note 42, at 8, 12.

[49] The TEU creates a third legislative process, the co-decision procedure as outlined in new article 189b of the Treaty of Rome. The co-decision procedure will apply widely, in particular to the harmonization directives, although not with respect to indirect or direct tax harmonization. This new process will essentially give Parliament veto power over legislation in policy areas such as the environment, research and development, culture, education, vocational training, and youth. BERMANN, *supra* note 34, at 89-90. For example, Parliament can definitively end the legislative process by rejecting the common position agreed to by the Council. Pierre Mathijsen, *The Power of the Co-Decision of the European Parliament Introduced by the Maastricht Treaty*, 8 TUL. EUR. & CIV. L. F. 81, 85-86 (1993).

[50] Treaty of Rome, *supra* note 6, art. 4(2).

[51] 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 tasked with the development of a common structure for nuclear energy. UNITED STATES DEPARTMENT OF STATE, EUROPEAN COMMUNITY, BACKGROUND NOTES 3 (1990).

[52] BERMANN, *supra* note 34, at 83-84 n.4; FREESTONE & DAVIDSON, *supra* note 34, at 85-86; HARTLEY, *supra* note 34, at 36-37.

[53] PRICE WATERHOUSE, EUROPEAN COMMUNITIES 17 (1987).

[54] Treaty of Rome, *supra* note 6, art. 189.

[55] Treaty of Rome, *supra* note 6, art. 189. Article 189 expressly provides that regulations are directly applicable. *Id.*

[56] The TEU amended Article 189 of the Treaty of Rome to read: "In order to carry out their task and in accordance with the provisions of this Treaty [TEU], the European Parliament acting jointly with the Council and the Commission shall make regulations, issue directives, take decisions, make recommendations, or deliver opinions." Treaty of Rome, *supra* note 6, art. 189.

[57] Amended proposal for a Council Regulation on the Statute for a European Company, 1991 O.J. (C 176) 1; PRICE WATERHOUSE, *supra* note 53, at 20; *see infra* note 308 and accompanying text for a discussion of the regulation on the European Company Statute.

[58] Treaty of Rome, *supra* note 6, art. 189. Directives can never be directly applicable. 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. BERMANN, *supra* note 34, at 180.

[59] PRICE WATERHOUSE, *supra* note 53, at 18.

[60] Treaty of Rome, *supra* note 6, art. 189.

[61] According to the *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. BERMANN,

supra note 34, at 166 and 181. Case 26/62, Van Gend en Loos v. Nederlandse Administratie der Belastingen, 1963 E.C.R. 1.

[62] Case 8/81, Becker v. Finanzamt Munster - Innenstadt, 1982 E.C.R. 53 (holding that the Sixth VAT Directive was directly effective since Germany had not yet implemented the directive).

[63] BERMANN, *supra* note 34, at 184.

[64] 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).

[65] Treaty of Rome, *supra* note 6, art. 189; *see also* NOEL, *supra* note 8, at 7.

[66] PRICE WATERHOUSE, *supra* note 53, at 12.

[67] 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. Treaty of Rome, *supra* note 6, art. 99.

[68] PRICE WATERHOUSE, *supra* note 53, at 18.

[69] KPMG, *supra* note 42, at app. 1.

[70] The Economic and Social Committee must also be consulted for any legislation deriving from Article 100. FREESTONE & DAVIDSON, *supra* note 34, at 84-86. *See supra* note for explanation of cooperation procedure and *supra* note 49 for explanation of co-decision procedure.

[71] PRICE WATERHOUSE, *supra* note 53, 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 directives for the approximation of direct taxes under Article 100. *Id.* at 5.

[72] SEA, *supra* note 20, art. 18.

[73] *Id.*

[74] Risinger, *supra* note 3, at 2.

[75] A.P. LIER ET AL., TAX AND LEGAL ASPECTS OF EC HARMONIZATION 18 (A.P. Lier ed., 1993).

[76] EUROPEAN UNIFICATION, *supra* note 33, at 29. 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, *supra* note 75, at 19.

[77] Roger M. Poor, *The European Community's "Project 1992"- Background and Outlook For The United States*, ECON. DEV. REV. 7, 9 (Fall 1989).

[78] PRICE WATERHOUSE, *supra* note 53, at 62-63.

[79] KPMG, *supra* note 42, at app. 1.

[80] Treaty of Rome, *supra* note 6, art. 171.

[81] EUROPEAN DOCUMENTATION, EUROPEAN UNION: EUROPE ON THE MOVE at 18 (1994) [hereinafter EUROPEAN UNION].

[82] EUROPEAN UNIFICATION, *supra* note 33, at 33.

[83] EUROPEAN DOCUMENTATION, THE ABC OF COMMUNITY LAW at 35 (1991) [hereinafter COMMUNITY LAW]; *see* Treaty of Rome, *supra* note 6, art. 164.

[84] LIER, *supra* note 75, at 19. The Court of Justice does not opine on validity of recommendations or opinions. *Id.*

[85] *Id.*

[86] COMMUNITY LAW, *supra* note 83, at 37; *see also* Treaty of Rome, *supra* note 6, art. 177.

[87] LIER, *supra* note 75, at 20.

[88] *Id.* at 21.

[89] 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 classifica-

tion is in accordance with the system of National Accounts, United Nations, 1968.

[90] 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.

[91] *See e.g.*, ALAN T. PEACOCK AND JACK WISEMAN, THE GROWTH OF THE PUBLIC EXPENDITURES IN THE UNITED KINGDOM 26-27 (1961); Richard Goode, *The Tax Burden in the United States and Other Countries, in* FINANCING DEMOCRACY: THE ANNALS OF THE AMERICAN ACADEMY OF POLITICAL AND SOCIAL SCIENCE 89 (1968); KEN C. MESSERE, TAX POLICY IN OECD COUNTRIES: CHOICES AND CONFLICTS 119 (1993); *see generally* RICHARD A. MUSGRAVE, FISCAL SYSTEMS (1969); THE UNDERGROUND ECONOMY IN THE UNITED STATES AND ABROAD (Vito Tanzi ed., 1982).

[92] Sijbren Cnossen, *Tax Structure Developments, in* TAX COORDINATION IN THE EC 19, 22 (Sijbren Cnossen ed., 1987).

[93] Treaty of Rome, *supra* note 6, art. 100; TAXATION IN THE SINGLE MARKET, *supra* note 15, at 25.

[94] Christiane Scrivener, Address to the Members of the European Commission, Paris, (Feb. 1990), *reprinted in* TAXATION IN THE SINGLE MARKET, *supra* note 15, at 25.

[95] Cnossen, *supra* note 92, at 39.

[96] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable to parent companies and their subsidiaries in different Member States, 1990 O.J. (L 225) 6 [hereinafter Parent-Subsidiary Directive].

[97] Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanging shares concerning companies of different Member States, 1990 O.J. (L 225) 1 [hereinafter Mergers Directive].

[98] Convention 90/436/EEC on the elimination of double taxation in connection with the adjustments of transfers of profits between associated undertakings, 1990 O.J. (L 225) 19 [hereinafter Arbitration Convention].

[99] *See* GUIDELINES ON COMPANY TAXATION, *supra* note 4, at 10.

[100] Roger H.A. Muray, *European Direct Tax Harmonization-Progress in 1990*, EUR. TAX'N 74-85 (Mar. 1991).

[101] TAXATION IN THE SINGLE MARKET, *supra* note 15, at 25.

[102] Parent-Subsidiary Directive, *supra* note 96, art. 5. Imputation taxes such as the precompte in France, imposta di congualio in Italy, equalization tax (Ausschuttungsbelastung) in Germany, and advance corporation tax (ACT) in Ireland and the UK are still allowed. These taxes ensure that all dividends paid out for which there is a shareholder tax credit have actually been subject to domestic corporate tax. Ruding Report, *supra* note 1, at 54; *see* Parent-Subsidiary Directive, *supra* note 96, art. 7.

[103] Parent-Subsidiary Directive, *supra* note 96, art. 4. The Directive is limited 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.* at art. 2. *See infra* note 173 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. *Id.* at art. 3.

[104] Muray, *supra* note 100, at 75; *see also* TAXATION IN THE SINGLE MARKET, *supra* note 15, at 26.

[105] Ruding Report, *supra* note 1, at 195-196. Luxembourg and the Nether-

lands 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. The other Member States provide relief for this double taxation at either the corporate level, the shareholder level, or both levels. Germany levies a lower tax rate on dividend distributions and Greece allows a partial or full deduction for dividend payments. 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.* at 194; *see infra* note 163 for Ruding Committee recommendations.

[106] Risinger, *supra* note 3, 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). Because of the nondiscrimination clause of Germany's tax treaties, the benefit of the split rate cannot be denied to foreign shareholders. *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 5 percent withholding tax until mid-1996, provided it continues to grant a rate reduction for distributed profits of at least 11 percentage points. *Id.* at 20.

[107] Muray, *supra* note 100, at 78.

[108] Parent-Subsidiary Directive, *supra* note 96, 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%. *Id.* at 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. *Id.* at art. 5, para. 2. Note, Greece abolished dividend withholding tax for years after June 30, 1992. Peter Cussons, *The Parent-Subsidiary and Merger Directives*, 2 BRIT. TAX REV. 105, 108 (1993). Portugal may withhold 15% on dividends until 1997 and 10% until 2000. Parent-Subsidiary Directive, *supra* note 96, art. 5, para. 4.

[109] Simona Bellettini, *Parent-Subsidiary Finds Home in Italy*, 4 INT'L TAX REV. 36 (Apr. 1993).

[110] The UK and Germany adopted the credit method. However, German tax treaties with other Member States exempt dividends received by a German company from certain treaty partner resident companies. Augusto Fantozzi and Andrea Manganelli, *Parent-Subsidiary Directive Changes EC Corporate Operations*, 4 J. INT'L TAX'N 349, 351 (Aug. 1993).

[111] The Parent-Subsidiary Directive permits a Member State to disallow expenses relating to the subsidiary holding not to exceed 5% of the profits distributed by the subsidiary if expenses are fixed at a flat rate. Parent-Subsidiary Directive, *supra* note 96, art. 4, para. 2. Thus, the maintenance of a tax charge on 5% of the profits complies with the Directive. Bellettini, *supra* note 109, at 36.

[112] *Id.*

[113] Parent-Subsidiary Directive, *supra* note 96, art. 1, para. 2.

[114] Augusto Fantozzi and 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).

[115] Gilbert Tixier and Dominique Berlin, *France*, 1 EC TAX REV. 24, 25

(1993).

[116] Taxation in the Single Market, *supra* note 15, at 26.

[117] Mergers Directive, *supra* note 97, 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 percent 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 percent of the nominal value of the accounting par value of the securities issued in exchange. *Id.; see also* Aland, *supra* note 18, at 1075 n.29.

[118] John F. Chown, *The Mergers Directive - Some Broader Issues*, Intertax, Oct. 1990, at 409-10; *see* Mergers Directive, *supra* note 97, art. 4.

[119] Aland, *supra* note 18, at 1075; *see* I.R.C. § 368.

[120] Muray, *supra* note 100, at 77.

[121] Helmut Becker, *Europe 92 and Taxation*, Intertax, Oct. 1990, at 408; *see* Proposal for a Tenth Council Directive based on Article 54(3)(g) of the Treaty Concerning Cross-Border Mergers of Public Limited Companies, 1985 O.J. (C 23) 11 [hereinafter Tenth Council Directive]. This Directive would enable cross-border legal mergers and divisions to the extent not already provided for under current domestic law and is also known as the Tenth Company Law Directive. Cussons, *supra* note 108, at 111.

[122] Muray, *supra* note 100, at 78-79; *see infra* notes 173-174 and accompanying text for discussion of proposed amendments to the Mergers Directive.

[123] *Consolidated Commentary on the Present Status of Implementation of the Tax Directive on Mergers, Divisions, Transfers of Assets and Exchanges of Shares in all Member States of the European Union,* EC Tax Notes (Supp.), Oct. 1993 - Apr. 1994, at 4-22 [hereinafter *Consolidated Commentary]*.

[124] *Consolidated Commentary, supra* note 123, at 10.

[125] Taxation in the Single Market, *supra* note 15, at 27.

[126] Arbitration Convention, *supra* note 98, art. 7, para. 1.

[127] *Id.* at art. 11, para. 1; *see also* Muray, *supra* note 100, at 76.

[128] Patrick L. Kelly, *EU Arbitration Convention Ratified by all Member States*, 94 Tax Notes Int'l 152-156 (August 8, 1994).

[129] European File, Tax Law and Cross-Border Cooperation Between Companies 6 (1991) [hereinafter European File]. The convention will initially be effective for five years. The signatory countries will meet again prior to the conclusion of the time period to decide upon extension or any other modifications. Kelly, *supra* note 128, at 153.

[130] 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].

[131] Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States, 1991 O.J. (C 53) 26 [hereinafter Interest and Royalty Directive].

[132] Loss Directive, *supra* note 130, arts. 6 and 7; *see also* Coopers & Lybrand, *supra* note 13, at § 3.6.

[133] *Id.*; *see also* Loss Directive, *supra* note 130, art. 9.

[134] Coopers & Lybrand, *supra* note 13, at § 3.6.

[135] Interest and Royalty Directive, *supra* note 131, art. 4.

[136] Coopers & Lybrand, *supra* note 13, at § 3.5.

[137] Amended Interest and Royalty Directive, 1993 O.J. (C 178) 15.

[138] Nigel Tutt, *EC Finance Ministers Discuss Easing Withholding Tax on Interest*, TAX ANALYSTS' DAILY TAX HIGHLIGHTS AND DOCUMENTS, 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 (June 18, 1993).

[139] Coopers & Lybrand, *supra* note 13, at §3.5.

[140] EUROPEAN FILE, *supra* note 129, at 15; *see* Terence L. Blackburn, *The Societas Europea: The Evolving European Corporation Statute*, LXI FORDHAM L. REV. 695, 772 (1993).

[141] EUROPEAN FILE, *supra* note 129, at 16.

[142] VOGEL, *supra* note 199, at 13.

[143] *Id.* at 14.

[144] Mrs. Christiane Scrivener, Address at Kangaroos Group's Annual Conference in Hamburg: "What kind of taxation for 1992 and beyond?" (Nov. 12, 1990) (available in EC Commission office in Washington, D.C.).

[145] The Committee was set up pursuant to the Commission Communication "Guidelines on Company Taxation." GUIDELINES ON COMPANY TAXATION, *supra* note 4, at 148. Other members included Mr. de Buitleir, 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), Mr. Radler (German tax professor) , and Mr. Vanistendael (Professor at the Catholic University of Leuven, Belgium). Ruding Report, *supra* note 1, at 7.

[146] *Id.* at 11.

[147] *Id.*

[148] *Id.* Chapter 3 of the report provides an overview of the tax base, the nature of the corporation 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 1994, EC Member States impose corporate tax rates that range from 33% in Luxembourg and the UK to 45% in Germany with a 10 percent tax rate for manufacturing and certain internationally traded service income available in Ireland. The rate quoted for Germany applies to retained profits. ERNST & YOUNG, WORLDWIDE CORPORATE TAX GUIDE 154 (1994).

[149] Ruding Report, *supra* note 1, at chs. 4 and 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 consider-

ations on location decisions.

[150] *Id.* at chs. 7 and 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* Franz Vanistendael, *The Ruding Committee Report: A Personal View*, 13 FISCAL STUD. 85, 89 (May 1992).

[151] Ruding Report, *supra* note 1, at ch. 10.

[152] *Id.* at 13.

[153] *Id.* at ch. 10. Phase I proposals were 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 150, at 91.

[154] Ruding Report, *supra* note 1, at ch. 10.The Ruding Committee calls for the introduction of a common corporate income tax system with source-country-entitlement as a feature during the final step of Economic and Monetary Union. Seven of the eight Committee members endorsed a corporate tax system of shareholder relief developed by Radler and Blumenberg. *Id.* at 439-460. However, as Mr. Messere dissented, this proposal was not incorporated into the report. *Id.* at 461-463; *see also* Jens Blumenberg, *Germany*, 2 EC TAX REV. 116, 118 (1993).

[155] Ruding Report, *supra* note 1, at 13. The second stage towards economic and monetary union (EMU) began January 1, 1994. The third stage for EMU is to start January 1, 1999 at the latest. Dr. Brigitte Knobbe-Keuk, *The Ruding Committee Report - An Impressive Vision of European Company Taxation for the Year 2000*, 1 EC TAX REV. 22, 24 (1992).

[156] Ruding Report, *supra* note 1, at 203. The Committee's recommendation for Phase II was to extend the Directive to all other enterprises subject to income tax. *Id.*

[157] *Id.* at 203-204.

[158] 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 204-205.

[159] For Phase II, the Committee recommended that the Member States allow full vertical and horizontal offsetting of losses within groups of enterprises at the national level and full Community-wide loss-offsetting within groups of enterprises for Phase III. *Id.* at 206.

[160] *Id.* at 205. *See supra* notes 119-120 and accompanying text.

[161] *Id.* at 206.

[162] *Id.* at 207.

[163] *Id.* at 207-208.

[164] *Id.* at 208-209.

[165] *Id.* at 209-210.

[166] *Id.* at 212.

[167] *Id.* at 212-218.

[168] COMMISSION OF THE EUROPEAN COMMUNITIES, COMMISSION COMMUNICATION TO THE COUNCIL AND TO THE EUROPEAN PARLIAMENT SUBSEQUENT TO THE CONCLUSIONS OF THE RUDING COMMITTEE INDICATING GUIDELINES ON COMPANY TAXATION LINKED TO THE FURTHER DEVELOPMENT OF THE INTERNAL MARKET SEC (92) 1118 final [hereinafter COMMISSION RESPONSE].

[169] *Id.* at 10.

[170] *Id.* at 9-10.

[171] Press Release *accompanying* COMMISSION COMMUNICATION TO THE COUNCIL AND TO THE EUROPEAN PARLIAMENT SUBSEQUENT TO THE CONCLUSIONS OF THE RUDING COMMITTEE INDICATING GUIDELINES ON COMPANY TAXATION LINKED TO THE FURTHER DEVELOPMENT OF THE INTERNAL MARKET at 2.

[172] COMMISSION RESPONSE, *supra* note

168, at 13.

[173] Commission of the European Communities, Proposal for a Council Directive amending Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanging shares concerning companies of different Member States and Proposal for a Council Directive amending Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable to parent companies and their subsidiaries in different Member States, COM (93) 293 final.

[174] *Id.* at art. 2.

[175] Dirk Schelpe, *Two New Proposals for a Directive Amending the 'Merger' and 'Parent-Subsidiary' Directives*, 4 EC TAX REV. 204 (1993). On April 19, 1994, the European Parliament approved this proposed directive adding its own amendment that would alter the definition of subsidiary. The proposal awaits final approval from the Council. *Parliament Backs Proposals on Mergers*, 6 EUROWATCH (May 2, 1994) *available in* LEXIS, WORLD Library, ALLWLD File.

[176] COMMISSION RESPONSE, *supra* note 168, at 13-14.

[177] *Id.* at 16.

[178] *Id.* at 17-18.

[179] *EC: Agenda of ECOFIN Council on Monday*, AGENCE EUROPE, Dec. 11, 1993, *available in* LEXIS, WORLD Library, TXTNWS File [hereinafter *Agenda of ECOFIN*]. Draft compromises have been negotiated with respect to the issue of the scope of the Directive and exemptions for Ireland, Greece, and Portugal in order to ease the financial impact on these countries. *Id.* The Council has agreed that this Directive should apply to interest and royalty payments between all enterprises of different Member States and not just payments between parent companies and subsidiaries. Schelpe, *supra* note 175, at 201.

[180] 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.

[181] *Agenda of ECOFIN*, *supra* note 179. To prepare for monetary union, the Member States must meet targets of low inflation and sound public finances. *Europe Moves Closer to Single Currency*, ST. PETERSBURG TIMES, Jan. 2, 1994, at 9A.

[182] John Goldsworth, *EC Commission Reviews Ruding Committee Report, Suggests Member State Consultation*, 5 TAX NOTES INT'L 177 (July 27, 1992).

[183] Daly, *supra* note 15, at 460 n.23.

[184] Ruding Report, *supra* note 1, at ch. 4.

[185] Daly, *supra* note 15, at 457.

[186] Maastricht Recipe, *supra* note 25. 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*, THE ECONOMIST, May 1, 1993, at 54. In April 1994, Poland and Hungary formally applied for membership. EU GUIDE, *supra* note 9, at 5. Membership applications were previously received from Turkey, Malta, and Cyprus. Vincent John Ella, *The Visegrad Countries of Central Europe — Integration or Isolation?*, 2 MINN. J. GLOBAL TRADE 229 (Summer 1993). Article 0 sets forth the procedure for countries to accede to the EU. TEU, *supra* note 5, art. 0.

[187] John Turro, *European Economic Area Agreement To Enter Into Force January 1*, 7 TAX NOTES INT'L 1618 (Dec. 27, 1993).

[188] *Europe Moves Closer to Single Currency*, *supra* note 181, at 9A.

[189] Turro, *supra* note 187, at 1618. The EEA Agreement also extends the rules on competition and state aids.

[190] Craig R. Whitney, *Parliament Vote in Europe Shows Rightward Trend*, N.Y. TIMES, June 13, 1994, at A1, B6.

[191] *See* Marshall, *supra* note 44, at A7.

[192] Charles Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151, 1153 (1981).

[193] Cussons, *supra* note 108, at 105.

[194] Leif Muten, *Swedish Parliament Accepts Tax Program*, 8 TAX NOTES INT'L 23 (Jan. 3, 1994).

[195] *See* SEMINAR PROCEEDINGS: EC'92 AND ITS IMPLICATIONS FOR GLOBAL COMPETITIVENESS 9 (Tracy A. Kaye ed., 1992) [hereinafter SEMINAR PROCEEDINGS].

[196] *See generally* THE GROWTH OF REGIONAL TRADING BLOCS IN THE GLOBAL ECONOMY IX (Richard S. Belous and Rebecca S. Hartley eds., 1990).

[197] North American Free Trade Agreement, *drafted* Aug. 12, 1992, *revised* Sept. 6, 1992, U.S.-Mex.-Can., 32 I.L.M. 605 (entered into force Jan. 1, 1994) [hereinafter NAFTA].

[198] NAFTA art. 2103(l). There are, however, certain exemptions. Bilateral treaties are in effect between the U.S. and Canada, the U.S. and Mexico, and Canada and Mexico.

[199] 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. This authority would be extended to interest and royalties paid and to withholding tax on interest following the adoption of the respective directives. However, the EC does not have authority to negotiate and conclude a double taxation convention that would cover the whole range of income taxation. KLAUS VOGEL, TAXATION OF CROSS-BORDER INCOME, HARMONIZATION, AND TAX NEUTRALITY UNDER EUROPEAN COMMUNITY LAW 15 (1994). 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 §3.6.1 (1993).

[200] Andre Fogarasi et. al., *Current Status of U.S. Tax Treaties*, 23 TAX MGMT INT'L J. 95 (1994). The exception is Portugal. The U.S. and Portugal have signed an income tax treaty and protocol on September 15, 1994. However, the accord still has to be ratified by each country. News Digest, *U.S. and Portugal Sign Income Tax Treaty and Protocol*, 9 TAX NOTES INT'L 966 (September 26, 1994). In addition, the U.S. is renegotiating its tax treaty with Luxembourg. *See United States: Developing Country Model*, WORLD TAX REPORT, June 1994, *available in* LEXIS, WORLD Library, WLDTAX File. The U.S. signed a new income tax treaty with France on August 31, 1994. JOHN TURRO, *U.S. Signs Tax Treaty With France and Protocol with Canada; Signature of Swedish Accord Expected*, 9 TAX NOTES INT'L 711-712 (September 5, 1994).

[201] Convention for the Avoidance of Double Taxation, Dec. 18, 1992, U.S.-Neth., art. 37, S, TREATY DOC. NO. 6, 103rd Cong., 1st Sess. (1993), *reprinted in* 32 I.L.M. 462 (1993) [hereinafter Netherlands Treaty]; *see* Jean-Louis D. Chicha and Jeffrey A. Johnson, *The New U.S.-Netherlands Tax Treaty: Understanding the International Tax Planning Implications*, 6 TAX NOTES INT'L 1509 (June 21, 1993).

[202] Netherlands Treaty, *supra* note 201, art. 26. Only residents and nationals of a treaty country are entitled to benefits under a tax treaty. 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. This practice is referred to as treaty shopping. The United States has included in its recent tax treaties, a limitation on benefits article, designed to prevent persons without sufficient nexus to the treaty countries from obtaining the benefits of the treaty. Michael McIntyre, THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES 2-72 (2d ed. 1992).

[203] Dirk van Unnik and Maarten Boudesteijn, *The New U.S.- Dutch Tax Treaty and the Treaty of Rome*, 2 EC TAX REV. 106 (1993). Article 7 of the Treaty of Rome prohibits any discrimination on grounds of nationality. Treaty of Rome, *supra* note 6, at 17. According to Article 52, any company incorporated under the laws of any EC country must be able to establish itself in any other EC country under the same conditions as a local company. *Id.* at 37-38. Article 58 explicitly provides the right of freedom of establishment to corporations. *Id.* at 40.

[204] Van Unnik, *supra* note 203, at 107; *see*, e.g., Rijkele Betten, *Fundamental Aspects of EC Measures Regarding Company Law and Direct Taxation*, IV EUR. TAX'N 289 (Sept. 1991) *and* Helmut Becker and Otmar Thommes, *Treaty Shopping and EC Law*, EUR.TAX'N 173 (June 1991).

[205] Martin Du Bois, *EC Commission Outlines Cautious Corporate Tax Plan*, WALL ST. J., June 19, 1992, at 2; *see also* Ruding Report, *supra* note 1, at 138. Vogel asserts that Article 28 of the US-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 199, at 15. The European Commission is examining this question. *See* Written Question [from the European Parliament] No. 2046/90 of Mr. Gijs de Vries and answer by Commissioner Scrivener on February 11, 1991, 1991 O.J. (C 79) 28.

[206] Ruding Report, *supra* note 1, at 206.

[207] *Id.* at 138.

[208] *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)." *Id.*

[209] Ruding Report, *supra* note 1, at 379.

[210] Convention with Respect to Taxes on Income and Property, Dec. 18, 1962, U.S.-Lux., 15 U.S.T. 2355, T.I.A.S. No. 5762 [hereinafter Luxembourg Treaty]. The limitation on benefits article states that"[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 percent or more of the stock of which is owned by the recipient corporation." *Id.* at art. XV.

[211] U.S. Department of Treasury, Proposed Model Convention Between the

United States and ____ For the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, art. 16 (1981) *reprinted in* 1 Tax Treaties (CCH 1993) [hereinafter U.S. Model Treaty]. This model was withdrawn in July 1992. *Treasury Announces Review of Model Income Tax Treaty*, TREASURY NEWS, July 17, 1992. Treasury is currently updating the model treaty to reflect changes in treaty policy, significant changes made to the international provisions of the Internal Revenue Code, and changes in the OECD Model Tax Convention. Charles Cope, *U.S. Income Tax Treaties: Notes and Comments on Some Present and Future Policies*, 8 TAXES 955, 956 (Dec. 1993).

[212] William P. Streng, *"Treaty Shopping": Tax Treaty "Limitation of Benefits" Issues*, 15 HOUSTON J. OF INT'L LAW 1, 7 (1992).

[213] *Id.* at 26.

[214] AMERICAN LAW INSTITUTE, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION II: PROPOSALS ON UNITED STATES INCOME TAX TREATIES 151 (1992) [hereinafter ALI - Treaties].

[215] *Id.* at 152.

[216] *Id.* at 153. Supplementary Protocol Modifying and Supplementing the Convention Between the United States of America and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Brussels on July 9, 1970, Dec. 31, 1987, U.S.-Belg., art. 12 *reprinted in* 1 TAX TREATIES para. 1340 (CCH 1993); Convention With Respect to Taxes on Income and Property, July 28, 1967, U.S.-Fr., art. 24, *reprinted in* 2 TAX TREATIES para. 3003 (CCH 1993); Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, Aug. 29, 1989, U.S.-F.R.G., art. 28, *reprinted in* 2 TAX TREATIES para. 3249 (CCH 1993).

[217] ALI - Treaties, *supra* note 214, at 154. The qualifying tests of the standard limitations on benefits provision are meant to ensure that at least to a significant extent, one level of tax is imposed by the residence jurisdiction. *Id.* at 155.

[218] H. David Rosenbloom, *International Tax Policy: Agenda for the Nineties - Toward a New Tax Treaty Policy For a New Decade*, 9 AM. J. OF TAX POL'Y 77, 92 (1991).

[219] Chicha, *supra* note 201, at 1509.

[220] Netherlands Treaty, *supra* note 201, art. 26; *see* John Turro, *U.S. and Netherlands Sign Tax Treaty; Limitation-on-Benefits Article Breaks New Ground*, 5 TAX NOTES INT'L 1471 (Dec. 28, 1992).

[221] Maarten Ellis and Rob Fulke, *Limitation-on-Benefits Article from the Dutch Perspective*, 5 TAX NOTES INT'L 1474 (Dec. 28, 1992).

[222] Memorandum of Understanding Regarding Income Tax Treaty, Dec. 18, 1992, U.S.-Neth., art. XI, *reprinted in* 1 TAX TREATIES (CCH 1993), at 36,438.

[223] Ellis, *supra* note 221, at 1474.

[224] Van Unnik, *supra* note 203, at 115.

[225] Marlin Risinger, *U.S. Tax Treaty Policy and the EC Directives on Parent/Subsidiary Distributions*, 1992 85TH ANNUAL CONF. ON TAX'N PROC. 19, 23.

[226] The United States Tax Treaty with the United Kingdom was signed on December 31, 1975, with Ireland on September 13, 1949, with Denmark on June 17, 1980, and with Greece on February 20, 1950. Fogarasi, *supra* note 200, at 95. None of these treaties includes a limitation on benefits article. *Id.* The treaty with Luxembourg was signed on December 18, 1962 and contains a limitation on benefits article designed only to protect against the use of special investment holding companies. *Id.* The

U.S. is currently renegotiating its tax treaties with France and Luxembourg. WORLD TAX REPORT, *supra* note 200.

[227] Risinger, *supra* note 225, at 22-23.

[228] ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TAX TREATY OVERRIDE (1989). The term treaty overrides 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 the domestic interpretation of the legislation may overrule a treaty. *Id.*

[229] McIntyre, *supra* note 202, at 2-79; *see, e.g.,* Whitney v. Robertson, 124 U.S. 190, 195 (1888) and Reid v. Cover, 354 U.S. 1, 18 (1957).

[230] *Id.*

[231] McIntyre, *supra* note 202, 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.*

[232] Cope, *supra* note 211, at 961.

[233] *New Treasury International Tax Counsel Discusses Priorities in Meeting with ABA Tax Section Committee,* 8 TAX NOTES INT'L 201 (Jan. 24, 1994).

[234] Ruding Report, *supra* note 1, at 379.

[235] Cope, *supra* note 211, at 955; *see infra* note 191.

[236] Commission Response, *supra* note 168, at 15.

[237] Rosenbloom, *supra* note 218, at 77.

[238] The EC Member States are implementing the directives on banking and exchange of information. Cope, *supra* note 211, at 964; *see* Council Directive of 19 December 1977 (77/799/EEC); Second Council Directive of 15 December 1989 (89/646/EEC); Council Directive of 10 June 1991 (91/308/EEC).

[239] 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 168, at 2.

[240] Netherlands Treaty, *supra* note 201, 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 percent 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 percent 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.*

[241] Cope, *supra* note 211, at 969; *see* Netherlands Treaty, *supra* note 201, art. 26, para. 8(m).

[242] 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. 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 U.S. 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 202, at §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.*

[243] H.R. Rep No. 1447, 87th Cong., 2d Sess., 55-58 (1962). *See also* BRIAN ARNOLD, THE TAXATION OF CONTROLLED FOREIGN CORPORATIONS 83 (1986).

[244] JOINT COMM. ON TAXATION, PROPOSAL RELATING TO CURRENT U.S. TAXATION OF CERTAIN OPERATIONS OF CONTROLLED FOREIGN CORPORATIONS (H.R. 2889 - AMERICAN JOBS AND MANUFACTURING PRESERVATION ACT OF 1991) AND RELATED ISSUES, 102d Cong., 1st Sess. 44 (Comm. Print 1991) [hereinafter U.S. Taxation of CFCs].

[245] The Revenue Act of 1962, Pub. L. No. 87-834, § 12, 76 Stat. 960, 1006-1027, *reprinted in* 1962 U.S.C.C.A.N. 1128, 1185-1211 (codified as amended in scattered sections of 26 U.S.C.). Sections 951-964 of the Internal Revenue Code are collectively known as Subpart F. These provisions are Subpart F of part III of subchapter N of Chapter II of subtitle A of the Internal Revenue Code of 1986.

[246] Message of the President Relative to Our Federal Tax System, April 20, 1961, *reprinted as* H.R. Doc. No. 140, 87th Cong., 1st Sess., 6-7 (1961).

[247] *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. Taxation of CFCs, *supra* note 244, 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. 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. U.S. Taxation of CFCs, *supra* note 244, at 37. Neither of these two situations exists 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 Pareto optimal. Vogel, *supra* note 199, at 22.

[248] AMERICAN LAW INSTITUTE, INTERNATIONAL ASPECTS OF UNITED STATES INCOME TAXATION I, PROPOSALS ON UNITED STATES TAXATION OF FOREIGN PERSONS AND OF THE FOREIGN INCOME OF UNITED STATES PERSONS 173 (1987) [hereinafter ALI - I]. "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 244, 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 244, at 37-38.

Arguments for capital import neutrality may be found in RICHMAN, *supra* note 247, at 8-9; Mitsuo Sato and Richard M. Bird, *International Aspects of the Taxa-*

tion of Corporation and Shareholders, 22 INT'L MONETARY FUND STAFF PAPERS 384, 407 (1975).

[249] S. Rep. No. 1881, 87th Cong., 2d Sess., 3381-3382 (1962). "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 243, at 57-58.

[250] I.R.C. § 951(b) (CCH 1993).

[251] *Id.*

[252] I.R.C. § 957(a) (CCH 1993).

[253] *Id.* Such a corporation is commonly referred to as a CFC.

[254] I.R.C. § 956(a) (CCH 1993). 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 1993).

[255] I.R.C. § 952(a) (CCH 1993). Subpart F income also includes certain insurance income, international boycott income, foreign bribe income, and unfriendly country income. *Id.*

[256] I.R.C. § 954 (d)(1) (CCH 1993).

[257] S. Rep. No. 1881, *supra* note 249, at 3387.

[258] I.R.C. § 954(e)(1) (CCH 1993). Such services include technical, managerial, engineering, or similar services. *Id.*

[259] S. Rep. No. 1881, *supra* note 249, at 3387.

[260] The term tax haven is subject to varying interpretations. *See U.S. Taxation of CFCs, supra* note 244, 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 (January 12, 1981).

[261] I.R.C. § 954(b)(4) (CCH 1962).

[262] Pub. L. No. 91-172, 83 Stat. 487 (1969).

[263] I.R.C. § 954(b)(4) (CCH 1969) as amended by §909(a) of the Tax Reform Act of 1969.

[264] Treas. Reg. § 1.954-1(b)(3) & (4)(iii)(a) (1972).

[265] *Id.*; *see also* Treas. Reg. § 1.954-1(b)(4)(iii)(b) (1972).

[266] Pub. L. No. 99-514, 100 Stat. 2085 (1986).

[267] § 954(b)(4), as amended by the Tax Reform Act of 1986, § 1221(d). Currently, the highest corporate rate pursuant to § 11 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%). *See* BORIS I. BITTKER AND LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION 56-68 (2d ed. 1991).

[268] JOINT COMM. ON TAXATION, 99th Cong., 2d Sess., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 983 (Comm. Print

1987) [hereinafter BLUEBOOK].

[269] ALI - I, *supra* note 248, 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).

[270] *Id.*; *see* Treas. Reg. § 1.954-3(a)(3)(iv) example 2 (as amended in 1983).

[271] ALI-I, *supra* note 248, at 260.

[272] *Id.* at 291.

[273] *Id.* at 290. "...it 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.

[274] EC Member States impose corporate tax rates that range from 33% in Luxembourg and the UK to 45% in Germany (as of January 1994). The rate quoted for Germany applies to retained profits. ERNST & YOUNG, *supra* note 148. Ireland, however, has a 10% tax rate for manufacturing and certain internationally traded services income. Ruding Report, *supra* note 1, at 50 and 64. Luxembourg, 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. DANIEL SANDLER, PUSHING THE BOUNDARIES: THE INTERACTION BETWEEN TAX TREATIES AND CONTROLLED FOREIGN COMPANY LEGISLATION 6-7 (1994); *see also supra* note 260.

[275] *See* SEMINAR PROCEEDINGS, *supra* note 195, 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.*

[276] *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. 631 (statement of J. Michael Farren, Vice President of External Affairs Xerox Corporation).

[277] Similar legislation was introduced by Senators Roth and Moynihan in the 102nd Congress. Senator Roth's bill would have treated the EC as a single country for Subpart F purposes and would have adjusted the effective tax rate for the high-tax exception to 80%. S. 1733, 102nd Cong., 1st Sess. (1991). Senator Moynihan's bill solely adjusted the high tax exception. S. 1653, 102nd Cong., 1st Sess. (1991).

[278] H.R. 1401, 103rd Cong., 1st Sess. (1993).

[279] *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 (statement of Leslie B. Samuels, Assistant Secretary of Department of Treasury).

[280] Letter from Asst. Sec. of Treasury Gideon to Chairman Rostenkowski (Mar. 15, 1990) [hereinafter Gideon letter].

[281] *Id.* at 3.

[282] *Id.* at 4.

[283] *See supra* note 274.

[284] Ruding Report, *supra* note 1, at 53. Some examples are the Shannon Free Airport Development 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.*

[285] *Id.* Some examples are the

Belgium Coordination Centers, the Dublin International Financial Services Centre, and the Luxembourg Societe de Participations Financieres (SOPARFI). *Id.*

[286] *Id.* at 143.

[287] *Id.* at 165.

[288] *Id.* at 200-201.

[289] *Id.* at 160.

[290] SEMINAR PROCEEDINGS, *supra* note 195, at 19.

[291] MESSERE, *supra* note 91, at 327.

[292] Ruding Report, *supra* note 1, 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 3% of GDP in 1991 and 7.2% of total revenues. OECD, REVENUE STATISTICS OF OECD MEMBER COUNTRIES 1965-1992 80 (1993) [hereinafter OECD Table].

[293] Ruding Report, *supra* note 1, at 154.

[294] Daly, *supra* note 15, at 444.

[295] Ruding Report, *supra* note1 , at 397.

[296] *Id.*

[297] OECD Table, *supra* note 292, at 74.

[298] Daly, *supra* note 15, at 442.

[299] Ruding Report, *supra* note 1, at 401.

[300] Daly, *supra* note 15, at 447.

[301] Ruding Report, *supra* note 1, at 408.

[302] Daly, *supra* note 15, at 447.

[303] *Id.* at 448. The tax rates depend on the return on equity of the corporation. Peter Dieben, *Eurocompatability of the Swiss Tax System*, 6-7 INTERTAX 313, 316 (July 1993).

[304] ERNST & YOUNG, *supra* note 148.

[305] Daly, *supra* note 15, at 448.

[306] *Id.* at 449.

[307] *Id.* at 445.

[308] Oster, *supra* note 28, at h01. The proposed regulation on the European Company statute and the accompanying directive on workers representation are designed to allow freedom of establishment in the single market. Amelia Torres, *Belgium Tries to Get Qualified Majority on European Company*, THE REUTER EUROPEAN COMMUNITY REPORT, *available in* LEXIS, WORLD Library, REUEC File. The Statute provides four ways of forming a European Company: merger, formation of a holding company, formation of a joint subsidiary, or conversion of a public limited company. Amended Proposal for a Council Regulation on the Statute for a European Company, 1991 O.J. (C 176).

[309] The regulation is based on Article 100a and therefore only requires a qualified majority in the Council for adoption.

[310] The UK 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 308.

[311] John Robinson, *Tax and the Single European Company*, EC TAX NOTES, Oct. 1993-Apr. 1994, at 3. When Austria, Finland, and Sweden join the EU, the qualified majority blocking vote will increase. This will dilute the UK, Ireland, and Germany "veto" on this issue. See *Id.*

[312] SEMINAR PROCEEDINGS, *supra* note 195, 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 108, at 111.

[313] *See supra* note 122 and accompanying text.

[314] Robinson, *supra* note 311, at 2.

[315] Oster, *supra* note 28, at h03.

[316] Albert J. Radler, *Where Does Tax Harmonization Stand Today?*, 4 EC TAX REV. 198, 199 (1993).

[317] *Id.* at 2.

[318] H. Onno Ruding, *U.S. Tax Policy Is Hurting U.S. Multinationals Operating in the EC,* 5 J. INT'L TAX'N 4 (Jan. 1994). 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. Reg. §1.367(a) -3T(g).

[319] Dividends between related companies organized in different countries are treated as Subpart F income.

§ 954(c)(3); *see* Ruding, *supra* note 1.

[320] Dieben, *supra* note 303, at 313; *see also supra* notes 113-115 and accompanying text.

[321] *See* SEMINAR PROCEEDINGS, *supra* note 195, 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.*

[322] Gideon letter, *supra* note 280, at 4.

[323] Taxpayers recordkeeping burden would be reduced for purposes of tax return filing, the tracking of previously taxed income, and determining the credibility of foreign taxes under §960. 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. U.S. DEPARTMENT OF THE TREASURY, INTERNATIONAL TAX REFORM: AN INTERIM REPORT 10 (Jan. 1993).

[324] *See* Kingson, *supra* note 192, at 1153.

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