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Tax Harmonisation and the Case of Corporate Taxation

Abstract

Tax harmonisation between countries has been frequently advocated but progress has tended to be slow and uncertain. This article suggest that the degree of harmonisation sought has often been vague and that more progress might be made if it were generally agreed how far the progress should go. The paper examines the case for tax harmonisation and its meaning - concluding that tax harmonisation is consistent with fiscal regional diversity. In Europe the principle of "subsidiarity" has been invoked to attempt to resolve conflict between overall harmonisation while retaining diversity among Member States. The European experience with corporate tax harmonisation is analysed and compared with progress between Australia and New Zealand. It is concluded that technological change will increase the importance of tax harmonisation and greater progress might be made if the aims of tax harmonisation were clearer, specific and modest. In particular it might be advantageous if the degree of harmonisation sought were limited and seen to be consistent with regional variation in taxation.

Keywords

tax, corporate taxation, harmonisation

Cover Page Footnote

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TAX HARMONISATION AND THE CASE OF CORPORATE TAXATION¹



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Tax harmonisation between countries has been frequently advocated but progress has tended to be slow and uncertain. This article suggests that the degree of harmonisation sought has often been vague and that more progress might be made if it were generally agreed how far the process should go. The paper examines the case for tax harmonisation and its meaning - concluding that tax harmonisation is consistent with fiscal regional diversity. In Europe the principle of "subsidiarity" has been invoked to attempt to resolve conflict between overall harmonisation while retaining diversity among Member States. The European experience with corporate tax harmonisation is analysed and compared with progress between Australia and New Zealand. It is concluded that technological change will increase the importance of tax harmonisation and greater progress might be made if the aims of tax harmonisation were clearer, specific and modest. In particular it might be advantageous if the degree of harmonisation sought were limited and seen to be consistent with regional variation in taxation.

1 INTRODUCTION

The issue of tax harmonisation has not always generated harmony. Corporate taxation has been one area experiencing particular difficulty and progress towards corporate tax harmonisation between Australia and New Zealand has been slow and uncertain. In Europe more determined efforts have been made over a longer period, but the result has still fallen far short of a harmonised corporate tax system. There are various possible reasons why this might be.

¹ The authors are very grateful to Ian Wallschutzky for helpful comments on an earlier draft.

For example, as Peggy Musgrave² pointed out, “business income taxes present more difficulties for the process of harmonisation...not only because they are heavily involved in all the [economic aims of harmonisation], but also because they are imposed on an internationally mobile factor”.

There is little doubt that the issue is a complex one and that difficulties have arisen because of a lack of clarity about what tax harmonisation actually involves and what it should and should not be expected to achieve. This article examines the topic more closely and with particular reference to corporate taxation. It is a large topic and is best dealt with in stages. The first question concerns the meaning of harmonisation. It will be shown in Section 2 that there are many possible definitions of tax harmonisation. The question is really about the desired degree of harmonisation rather than the achievement of some absolute definition. Although it may not be clear from much of the discussion to date, tax harmonisation usually means some form of partial harmonisation, rather than standardisation of tax systems. One possible approach which is examined below is the European response to national diversity within a harmonised system by using the legal concept of “subsidiarity”. The next question involves determining the most desirable degree of harmonisation and this can be tackled through a re-examination of the case for tax harmonisation. It is demonstrated that there are strong economic arguments for regional diversity within an economic area. However, it will be shown that the pressure for greater international co-operation in the field of taxation is likely to increase substantially in the future and hence the pressure for a greater degree of harmonisation. The analysis is then applied to corporate taxation, beginning in Section 4 by summarising different types of corporate taxation. Section 5 goes on to analyse the European experience with corporate tax harmonisation and describes the difficulties the process has faced. Section 6 examines the Australian/New Zealand situation. The conclusion from the analysis, together with the lessons from the European experience, is that Australian/New Zealand tax harmonisation might achieve greater success if it had clearer, more limited and agreed aims.

2 THE MEANING OF TAX HARMONISATION

2-1 Degrees of harmonisation

There are many definitions of tax harmonisation. At one extreme, they may be concerned with arrangements whereby the tax system of one country takes into account other tax systems in the form of double taxation agreements and

² Musgrave PB, “Harmonisation of Direct Business Taxes: A Case Study” in CS Shoup, *Fiscal Harmonisation in Common Markets*, Vol II, *Practice* (1967 Columbia University Press) at 216.

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bilateral tariff reductions. At the other extreme, they can refer to the complete standardisation of forms of taxation, tax bases and tax rates. An early definition by Dosser³ restricted tax harmonisation to “tax co-ordination among nations in the process of integration in a customs union or economic union” but, as Prest⁴ suggests, “co-ordination” is essentially a low-level meaning of harmonisation because it could be interpreted as no more than some sort of consultation process about organising tax systems in a similar sort of way. Rounds⁵ argues that harmonisation means tax reductions between states but which fall short of a uniform tax system. Peggy Musgrave⁶ supplied a more open definition, based on ends rather than on precise institutional arrangements, namely: “Fiscal harmonisation may be viewed as the process of adjusting national fiscal systems to conform with a set of common economic aims”. Nevertheless not all countries have the same set of economic aims. Hitiris⁷ took the view that there were two approaches to tax harmonisation - one which worked towards the same tax system across countries and the other where tax was acknowledged as a national economic instrument which might be used in different ways in different countries.

The solution to establishing a clearer framework for discussing harmonisation seems to be to take a more sophisticated view of the economics of the topic. The single-argument approach, that harmonisation is essential to ensure free trade, risks ignoring the fact that most countries are unwilling to let markets decide all economic issues. Indeed, depending on definitions, among OECD countries the public sector normally accounts for between a quarter and a half of all economic activity. The way forward, therefore, seems to be to balance the role of the market with that of the public sector in determining arrangements such as taxation.

The economic case for public sector activity has been exhaustively examined. For instance, Richard Musgrave’s classification⁸ of economic justifications for government intervention in a market economy fall into three areas - the “Allocation Branch”, the “Distribution Branch” and the “Stabilisation

³ Dosser D, *British Taxation and the Common Market* (1973 Charles Knight).

⁴ Prest, “Fiscal Policy” in P Coffey (ed), *Economic Policies of the Common Market* (1979 Macmillan) at 76.

⁵ Rounds, “Tax Harmonisation and Tax Competition: Contrasting Views and Policy Issues in Three Federal Countries” (1992) 22 *Publius: The Journal of Federalism* 91 at 92.

⁶ Musgrave PB, “Harmonisation of Direct Business Taxes: A Case Study” in CS Shoup, *Fiscal Harmonisation in Common Markets, Vol II, Practice* (1967 Columbia University Press) at 210.

⁷ Hitiris T, *European Community Economics* (3rd edn, 1994 Harvester Wheatsheaf).

⁸ Musgrave RA, *The Theory of Public Finance* (1959 McGraw-Hill).

Branch”.⁹ The Allocation Branch covers resource allocation - that is, the efficient production of the right amounts of goods and services. Markets left to themselves may fail in certain respects in this area, particularly in the area of “public goods” such as national defence, “external effects”, eg, pollution, “imperfect competition” including pure monopoly and “merit goods” which for various possible reasons might be underconsumed if markets were left to themselves. The Distribution Branch describes the policy of redistributing income either as cash or in the form of resources such as free or subsidised education and health. The Stabilisation Branch encompasses macroeconomic policies designed to contain inflation, unemployment, any balance of payments problems and to promote economic growth.

The point is that different groups of people might, perfectly rationally, choose to have different levels of public sector activity and redistribution. This, of course, is reflected in different levels of taxation in different countries. However, even within countries taxes are usually not completely harmonised in the sense that there is a completely uniform tax system within the country and it is common for some regional variation to reflect regional preferences and needs. There may even be different taxes in different areas. The whole topic is frequently referred to as “fiscal federalism”.

2-2 Fiscal federalism

There are many examples of regional fiscal variation. In the United States the different levels of fiscal jurisdictions include the federal government, fifty state governments, the District of Columbia and about 80,000 local jurisdictions. Much might be gained by examining the United States’ system.¹⁰ Australia, Canada and Germany provide further examples of three-level arrangements and the United Kingdom is an illustration of a two-tier system (parishes being too insignificant in this context).

The seminal work analysing how economic welfare might be increased by different local tax and public spending regimes was produced by Tiebout.¹¹ A great deal more has been done since then. Inman and Rubinfeld¹² review the literature on the design of tax policy in federalist economies and consider

⁹ For further discussion see Dosser, “Economic Analysis of Tax Harmonisation” in CS Shoup (ed) *Fiscal Harmonisation in Common Markets*, Vol I, *Theory* (1967 Columbia University Press).

¹⁰ Inman and Rubinfeld, “Fiscal Federalism in Europe - Lessons from the United States’ Experience” (1992) 36 *European Economic Review* 654.

¹¹ Tiebout, “A Pure Theory of Local Expenditures” (1956) 64 *Journal of Political Economy* 416.

¹² Inman and Rubinfeld, “Designing Tax Policy in Federalist Economies - An Overview” (1996) 60 *Journal of Public Economics* 307.

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different constitutional rules. Prudhomme¹³ examines some of the drawbacks of fiscal decentralisation and Alesina and others discuss some possible reconciliations between the gains from large fiscal units and an empirical observation of a tendency towards political separation.¹⁴ Several aspects of fiscal decentralisation are examined by Bird¹⁵ and particular issues include the deductibility of lower-level taxes from higher level liabilities,¹⁶ the effects on the overall size of the public sector¹⁷ and tax competition.¹⁸ Fiscal federalism also has implications for macroeconomic policy¹⁹ and optimal tax design.²⁰ So, the topic remains complex, but it is clear that descriptions of tax harmonisation should allow for the possibilities of regional tax variation. In a political context such differentiation between tax systems is very important. This has been very clear in the case of the European experience, where one of the major barriers to the attainment of fiscal harmonisation is the question of national sovereignty. As Weatherill and Beaumont²¹ put it: "Raising revenue is a cherished aspect of national sovereignty. Transfer of this power to the Community is a very visible and, to some, alarming manifestation of diminution in national sovereignty". Direct taxes have evolved over a long time and differ according to the political and social objectives of the countries concerned. Similarly, questions of administration, enforcement and compliance differ markedly and relate to social traditions and attitudes.²² This would seem to be one of the reasons why progress towards European tax harmonisation has been so cautious.

This was certainly reflected in the European legal framework. While Article 100a(1) EEC provided for qualified majority voting for measures over the

¹³ Prudhomme, "The Dangers of Decentralisation" (1995) 10 *World Bank Research Observer* 201.

¹⁴ Alesina, Perrotti and Spolaore, "Together or Separately - Issues in the Costs and Benefits of Political and Fiscal Unions" (1995) 39 *European Economic Review* 75.

¹⁵ Bird, "Threading the Fiscal Labyrinth - Some Issues in Fiscal Decentralisation" (1993) 46 *National Tax Journal* 207.

¹⁶ Kaplow, "Fiscal Federalism and the Deductibility of State and Local Taxes under the Federal Income Tax" (1996) 82 *Virginia Law Review* 413.

¹⁷ Persson and Tabellini, "A European State - Lessons from Existing Federations - Does Centralisation increase the size of Government?" (1994) 38 *European Economic Review* 765.

¹⁸ Bucovetsky, "Rent Seeking and Tax Competition" (1995) 58 *Journal of Public Economics* 337.

¹⁹ Allsopp, Davies and Vines, "Regional Macroeconomic Policy, Fiscal Federalism and European Integration" (1995) 11 *Oxford Review of Economic Policy* 126.

²⁰ Gordon, "An Optimal Taxation Approach to Fiscal Federalism" (1983) 98 *Quarterly Journal of Economics* 567.

²¹ Weatherill and Beaumont, *EC Law* (2nd edn 1995 Penguin) at 421.

²² Ogley, *Principles of International Tax: A Multinational Perspective* (1995 Intersc Publishing) at 44.

completion of the internal market, fiscal harmonisation was left out by Article 100a(2)²³ and unanimity remained necessary on tax matters under either Article 100 or Article 99.²⁴ “Thus each of the [then] 12 Member States effectively possesses a veto over measures for tax harmonisation”.²⁵

2-3 The concept of subsidiarity and harmonisation

In Europe, much of the discussion has been in terms of the principle of “subsidiarity”. This principle was not explicitly described in either the Treaty of Rome or the Single European Act, though it appeared implicitly in a provision inserted by the Single European Act, namely, that the “Community shall take action relating to the environment to the extent to which the objectives...can be attained better at Community level than at the level of the individual Member States”.²⁶ The Treaty on European Union broadened the provision so that it stated:

In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community.²⁷

Bernard²⁸ suggested that “subsidiarity provides us with a framework for the understanding of the relationship between the Community and its Member States”. As pointed out by González,²⁹ “subsidiarity is not proportionality” but possibly a different way of doing things. Although, the term “subsidiarity” has been used to challenge the expansion of Community activity, as Weatherill³⁰ points out, Article 3b cited above is concerned with the appropriate level at which things should be done. Brittan³¹ described it as

²³ “Paragraph 1 shall not apply to fiscal provisions...”: Art 100a(2).

²⁴ For example, Art 100 states that:

The Council shall, acting unanimously on a proposal from the Commission, issue directives for the approximation of such provisions laid down by law, regulation or administrative action in Member States as directly affect the establishment or functioning of the Common market.

²⁵ Easson, “Harmonisation of Direct Taxation in the European Community: From Neumark to Ruding” (1992) 40 *Canadian Tax Journal* 603.

²⁶ Article 130r(4) EC.

²⁷ Article 3b EC.

²⁸ Bernard, “The Future of European Economic Law in the Light of the Principle of Subsidiarity” (1996) 33 *Common Market Law Review* 633 at 665.

²⁹ González, “The Principle of Subsidiarity” (1995) 20 *European Law Review* 357.

³⁰ Weatherill S, *Cases and Materials on EC Law* (3rd edn 1996 Blackstone Press) at 509.

³¹ Brittan, “Institutional Developments of the European Community” (1992) *Public Law* 567 at 574.

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a “best level” test. It follows that taxation could be one area in which some actions can be “sufficiently achieved” by the Member States, particularly if their public sector needs and choices are different.

It is true that some commentators have indicated that subsidiarity might impede unification. Toth,³² eg, concluded that it will “weaken the Community and slow down the integration process” and Green³³ argues that subsidiarity is a concept which promises much and delivers little and is not, therefore, of much consequence to developments in the Community. Yet such views appear to discount the stresses and strains between central organisation and local circumstances. As Cass³⁴ suggests, subsidiarity is a principle which is still maturing, but it can help clarify the relationship between the Community and Member States and it has the potential to defuse conflict. It may make it easier for states to operate with a degree of autonomy within a co-operative framework. In other words, it might provide the flexibility to make a closer union possible, because it can accommodate a degree of heterogeneity. As Bernard³⁵ concludes, the “Union cannot avoid answering the calls for more decentralised decision-making. Subsidiarity permits this without calling into question the integrity of the Community legal order”. Some writers have gone on to relate subsidiarity to issues such as fiscal competition³⁶ and the co-ordination of indirect taxes in Europe.³⁷

The conclusion is that economic analysis suggests that tax harmonisation is more than simply a free trade issue. There is an economic case for fiscal diversity and this is at least partly reflected in political resistance to the adoption of a standard tax system across countries. In Europe, the argument has revolved around subsidiarity. In general, it would seem advantageous to be clear about issues of national sovereignty and independence, in order to be clear what sort of harmonisation is sought and the limitations within which it can be achieved. Progress towards harmonisation may then face much less resistance.

³² Toth, “The Principle of Subsidiarity in the Maastricht Treaty (1992) 29 *Common Market Law Review* 1105.

³³ Green, “Subsidiarity and European Union - Beyond the Ideological Impasse - An Analysis of the Origins and Impact of the Principle of Subsidiarity within the Politics of the European Community” (1994) 22 *Policy and Politics* 287.

³⁴ Cass, “The Word That Saves Maastricht? The Principle of Subsidiarity and the Division of Powers with the European Community” (1992) 29 *Common Market Law Review* 1107.

³⁵ Bernard, “The Future of European Economic Law in the Light of the Principle of Subsidiarity” (1996) 33 *Common Market Law Review* 633 at 665.

³⁶ Sinn, “How Much Europe? Subsidiarity, Centralisation and Fiscal Competition” (1994) 41 *Scottish Journal of Political Economy* 85.

³⁷ Smith, “Subsidiarity and the Co-ordination of Indirect Taxes in the European Community” (1993) 9 *Oxford Review of Economic Policy* 67.

3 THE CASE FOR TAX HARMONISATION

There are several arguments and factors to be taken into account in considering the case for tax harmonisation. Here they will be examined under the headings of economic efficiency, tax competition and administrative considerations.

3-1 Economic efficiency

The main economic arguments for tax harmonisation revolve around economic efficiency - that the production and distribution of goods and services should not be unduly distorted by tax considerations. If economic activity is impeded by all sorts of obstructions, including different tax arrangements in different areas, it is less likely to flourish. Moreover, if taxes are particularly high in one area, trade, labour and capital might migrate to lower tax areas for tax purposes rather than for sound economic reasons.

Furthermore, a country which discriminates against imports may find itself subject to retaliatory action from other countries. The outcome might be costly for all concerned, including the country which originally imposed restrictions or tariffs on imports.³⁸ Of course, the multilateral trade treaty and international trade organisation, the General Agreement on Tariffs and Trade (GATT) signed in 1947, has had considerable success in achieving its aim of promoting international trade through the reduction of tariffs, import quotas and other barriers to trade. Its work is being continued by the World Trade Organisation.³⁹

However, tax harmonisation should go further than the removal of tariffs and similar obstacles to trade, because many other tax differences between jurisdictions may also impede trade. In the Europe Union, Member States are specifically not permitted to use internal taxation to discriminate either directly or indirectly against products of other Member States,⁴⁰ since such taxation can be just as effective as tariffs in penalising other countries' products. For instance, in the so-called "spirits' cases" before the European Court, several countries were found in breach of this requirement - France for having favourable tax rates for cognac over whisky, Italy grappa over rum and Denmark aquavit compared with other spirits.⁴¹ Countries might also be tempted to add extra tax to goods which they do not produce themselves but

³⁸ For example, see Kindleberger and Lindert, *International Economics* (6th edn 1978 Irwin).

³⁹ Bhagwati, *Free Trade, "Fairness" and the New Protectionism; Reflections on an Agenda for the World Trade Organisation* (1995 Institute of Economic Affairs).

⁴⁰ Article 95 EC.

⁴¹ See Weatherill and Beaumont, *EC Law* (2nd edn 1995 Penguin) at 410.

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which still compete with domestic production. For example, in *Humblot*⁴² France imposed a disproportionately higher level of taxation on cars over a certain power rating - 16-CV. France did not produce cars with a power rating above this level and it was held by the European Court that the much higher rate of tax on those vehicles reduced the amount of competition faced by domestically produced cars and was therefore contrary to the principle of neutrality which is required of domestic taxation.

There are also wider economic pressures for greater tax harmonisation. The development of the "global economy"⁴³ is making it more difficult (or costly) for individual countries to pursue policies which are considerably out of line with practice elsewhere and a global view is often needed.⁴⁴ It is also clear that a technological revolution is under way⁴⁵ and the pace of change is also increasing. This has some important implications for taxation, in particular in the development of the internet and the world wide web.⁴⁶ Electronic commerce - the ability to undertake transactions involving the exchange of goods and services electronically - is a rapidly growing phenomenon. There are now both retail and wholesale catalogues of goods and services which are accessible on the world wide web. Many commercial items are suitable for trading over the internet, eg, computer software and recorded entertainment. On-line information, including research data bases, periodicals and some encyclopaedias are available, as are consulting and similar services. Financial transactions and stock trading now take place electronically around the world and there are apparently even internet casinos located outside restrictive jurisdictions. It is, of course, also becoming easier to avoid high tax jurisdictions.

An important result is the development of keener competition across markets. One of the major obstacles to what economists describe as "perfect competition" has been physical distance. Another obstacle has been limited information. Many enterprises have survived because they have been located sufficiently far from effective competition, or their customers have not been

⁴² Case 112/84 *Humblot v Directeur des Services Fiscaux* [1985] ECR 1367, [1986] 2 CMLR 338.

⁴³ See, eg, Terpstra V and Sarathy R, *International Marketing* (5th edn 1990 Dryden Press) ch 2, "Economic Environment: The World Economy".

⁴⁴ Yip, *Total Global Strategy: Managing for World Wide Competitive Advantage* (1997 Prentice Hall Canada).

⁴⁵ James, "A Strategic Analysis of the Future International Business Tax Environment" Paper to be given at the China International Business Symposium, Shanghai, May 1998.

⁴⁶ As many people are aware, the internet is a network of computer networks that enables computer users to share services and communicate with each other in ways that transcend national boundaries. The world wide web is the graphical hypertext part of the internet that incorporates images, video and audio elements as well as text. It can also contain embedded links to other web documents or information.

fully aware of rival goods and services. With technological developments of the sort described above, physical distance becomes less important in many markets and consumers have access to a great deal more information than they had previously. All of this means that many enterprises are likely to face greater competition than they have done in the past. In the international setting, trade rivalry has led to a number of developments. One of these is tax competition between countries in order to attract or keep economic resources and this is described in Section 3-2. Another consideration relates to administrative considerations and these are discussed in Section 3-3.

3-2 Tax competition

Tax competition may be defined as the “competition between different tax jurisdictions to encourage businesses and individuals to locate in their areas”.⁴⁷ At one extreme complete “tax holidays” may be granted whereby companies or individuals with particular skills are granted exemption or favourable tax treatment for a period following their move to a new country. There are two views of tax competition - one that it has beneficial effects, the other that the overall result is damaging.

The first argument is that tax competition has a beneficial effect in encouraging governments to keep tax rates down. It has also been suggested that tax competition is likely to encourage tax regimes to become similar. For example, in the European case the argument holds that in a single market no Member State will be able to maintain a tax regime which allows capital and tax revenues to be enticed away by more favourable regimes elsewhere.⁴⁸ It has been pointed out, therefore, that tax competition and harmonisation are not necessarily in conflict in many circumstances.⁴⁹

The other argument is that the alignment of tax systems may be impeded by tax competition.⁵⁰ This is because countries will have an incentive to adjust their tax systems to gain an advantage over their rivals and there will be a misallocation of resources as production may “gravitate towards countries with relatively high production costs but low taxes”.⁵¹ In addition this process can cause difficulties for countries in maintaining the integrity of their

⁴⁷ James, *A Dictionary of Taxation* (1998 Edward Elgar).

⁴⁸ For example, see Ernst and Young, *The Future of Corporate Taxation in the European Community* (1991 Kogan Page) at 41.

⁴⁹ Rounds, “Tax Harmonisation and Tax Competition - Contrasting Views and Policy Issues in 3 Federal Countries” (1992) 22 *Publius - The Journal of Federalism* 91.

⁵⁰ For example, see Coates, “Tax Competition among Jurisdiction with public and private employment” (1993) *National Tax Journal* 177.

⁵¹ Ogley, *Principles of International Tax: A Multinational Perspective*, (1995 Intersc Publishing) at 45.

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tax systems. With respect to value added tax, Fehr and others⁵² described possibilities which could favour low tax countries at the expense of their European partners. Kirchgassner and Pommerehne⁵³ found that individual income tax competition had some influence on the distribution of high income individuals across cantons. In Canada, Rounds⁵⁴ reports that some provinces have been threatening to move away from the nearly uniform system of income and corporate taxation in order to assist economic development. Furthermore, direct tax harmonisation has become a more significant issue since financial flows have been relieved of other controls,⁵⁵ which has been a policy aim in several parts of the world.

The problem has been recognised by many commentators and some international organisations. For example, in May 1996 the Ministers of Member Countries of the OECD asked the organisation to “develop measures to counter the distorting impact of harmful tax competition and financing decisions”. The solution is likely to involve international tax co-operation of some sort and this is likely to take the form of a greater degree of tax harmonisation.

3-3 Administrative considerations

There are many arguments and pressures for a greater degree of tax harmonisation for administrative reasons. One of the most widespread developments in this area has been the growth of double taxation agreements, estimated in 1991⁵⁶ to be approaching 900 with annual additions.⁵⁷ These have attempted to reduce some of the undesirable effects of separate tax jurisdictions,⁵⁸ in particular that the same source of income might be subject to tax twice over. As Williams⁵⁹ points out, if double tax relief is effective

⁵² Fehr, Rosenberg and Weigard, “Value-Added Taxation in the EC After 1992 - Some Applied General Equilibrium Calculations” (1993) 37 *European Economic Review* 1483.

⁵³ Kirchgassner and Pommerehne, “Tax Harmonisation and Tax Competition in the European Union - Lessons from Switzerland” (1996) 60 *Journal of Public Economics* 351.

⁵⁴ Rounds, “Tax Harmonisation and Tax Competition: Contrasting Views and Policy Issues in Three Federal Countries” (1992) 22 *Publius: The Journal of Federalism* 91.

⁵⁵ Marsh, “Taxation Impediments to Transnational Investment: Lessons from Europe” (1993) 10 *Australian Tax Forum* at 358.

⁵⁶ Williams, *Trends in International Taxation* (1991 International Bureau of Fiscal Documentation) at 86.

⁵⁷ Bartlett, “The Making of Double Taxation Agreements” [1991] *British Tax Review* 76.

⁵⁸ Skaar, “The Continental Shelf and Tax Treaties - A Case Study” [1993] *British Tax Review* 189.

⁵⁹ Williams, *Trends in International Taxation* (1991 International Bureau of Fiscal Documentation) at 99.

and genuinely has tax relief for the taxpayer as its objective, it should mean that taxpayers pay no more tax operating over international borders than they would if they operated in one state alone. This process clearly mitigates some of the adverse effects of a lack of tax harmonisation, but is not a complete solution to many problems.

Economic behaviour caused by tax differences may also have administrative consequences, particularly in tax avoidance. Saunders may have been exaggerating a little when he wrote, "ever since the advent of the earliest income tax legislation, taxpayers have regarded their liability to tax more as a challenge to be avoided than as a necessary contribution to their country's well-being".⁶⁰ There is plenty of scope for tax avoidance through profit shifting between different tax regimes. For example, "thin capitalisation" is used as a mechanism for financing foreign operations through debt rather than equity,⁶¹ and transfer pricing to manipulate the price at which goods and services are moved between associated entities, so shifting tax liability from high tax countries to low tax countries. Such practices "drive wedges between the pre and after tax rates of return hence distorting overseas investment decisions and ensure sub-optimal capital resource allocation both nationally and worldwide".⁶²

The technological developments mentioned above put further pressure on administrative tax harmonisation in order to combat tax avoidance and evasion. As we know, the internet was originally designed to reduce the damage to communications by nuclear attack, since there is no central computer which can be targeted. In the same way the internet poses enforcement problems for revenue agencies, as services and funds can flow in ways which are very difficult for revenue authorities to track.

Some of the tax implications of technological change have already become obvious, eg, with the introduction of the facility to transmit tax returns electronically to the revenue authorities, but this is only the start. The implications of the wider technological revolution have begun to be examined, eg, by the Department of the Treasury⁶³ in the USA and Wallschutzky⁶⁴ in Australia. One issue is that, in some ways, physical national boundaries are less relevant than they once were and there is the possibility that different countries will try to assert inconsistent taxing

⁶⁰ Saunders MR, *Tax Planning for Business in Europe* (1977 Butterworths) at v.

⁶¹ For further discussion see Sommerhalder, "Approaches to Thin Capitalisation" (1996) 36 *European Taxation* 82.

⁶² Groenwegen, *Public Finance in Australia* (1990 Prentice Hall 3rd edn) at 324.

⁶³ US Department of the Treasury, *Selected Tax Policy Implications of Global Electronic Commerce* (1996).

⁶⁴ Wallschutzky, "The Implications of Electronic Commerce for the Australian Tax System" Paper to be given at the Third International Conference on Tax Administration, University of New South Wales 1998.

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jurisdictions leading to uncertain and inconsistent taxation. It will be necessary to establish how existing tax systems are to be applied to international electronic commerce and it is hard to see how this can be done without international co-operation or harmonisation.

Tax law has evolved in a world where commercial events take place in clearly identifiable physical locations. Tax can be levied on the “source principle”, whereby a country levies tax on income arising within its jurisdiction, whether that income is for the benefit of residents or non-residents. Residence itself is also a basis of taxation. Usually taxpayers resident within a particular jurisdiction are taxed on a wider range of incomes than are taxpayers who are non-resident. In terms of indirect taxation, tax can be based on the “origin principle”, that goods or services should be taxed according to where they originate, or on a “destination” basis when taxation is levied on the basis of where they are consumed. With electronic commerce, transactions can take place on computer servers anywhere and in a sense can occur in some form of intangible “cyberspace”. It will not always be easy to see how such transactions fit into traditional concepts as “source”, “residence”, “origin” and “destination”.

One possibility, in particular, is that taxation based on the source of income is likely to prove more difficult to apply in the future. It may be that the emphasis will have to shift to taxation based on residence. This in turn may have implications for the migration of individuals and enterprises between countries and the effects of tax competition discussed above. It would seem that there are important issues of this sort that will require considerable international co-operation in the future. To some extent at least, an increase in the degree of formal tax harmonisation might prove to be advantageous. Indeed, McLure⁶⁵ goes so far as to say we may see a general agreement on taxes along the lines of GATT, given the difficulties in achieving the administrative co-operation necessary for residence based taxation.

4 CORPORATE TAXATION

The example discussed in this article is corporate taxation. To make some of the issues clear, it is necessary to describe the basic types of corporate taxation. This covers direct taxes on incorporated enterprises. Enterprises run by sole proprietors and partnerships are usually subject to personal income tax, but incorporated enterprises are more normally liable to a separate tax on company profits. Most countries adopt a corporate/shareholder taxation system, which provides for tax on both

⁶⁵ McLure, “Tax Policies for the XXIst Century” in International Fiscal Association, *Vision of the Tax Systems of the XXIst Century* (1997 Kluwer The Hague) at 63.

companies and their shareholders, largely in recognition of companies as separate entities, and also for practical administrative reasons.⁶⁶

Systems which tax both companies and shareholders on corporate profits (companies when profits are derived, and shareholders when profits are distributed as dividends) are referred to as classical systems. Such systems prevailed during the early half of the century. Recognition of the distortions or inefficiencies which the classical system causes has led to the increasing world-wide use of company tax systems, which mitigate this double taxation of company profits to some extent. Distortions include a bias to the retention of profits so as to prevent them being subjected to the second layer of taxation, bias to debt financing in preference to equity and biases relating to the form of organisation. There are thus indirect effects on the level of national savings and investment which arise as a result of distortions of pay out ratios, debt/equity ratios and the form of organisation through which business is conducted.⁶⁷

Systems which have evolved to mitigate the distortionary effects of classical company taxation include the split rate and imputation systems. The split rate system adopts different rates of corporation tax for retained and distributed company profits. In this way it mitigates the bias to retention evident under the classical system. Its effect depends on the differential between the company rate applicable to retentions and the shareholder rate applicable to distributed earnings, which usually varies across a range of shareholders. At the extreme, a zero rate on retentions is equivalent to a dividend deduction and therefore also eliminates the bias to debt financing, since dividends are treated in the same way as interest.⁶⁸

Imputation systems have increased in prominence in recent years.⁶⁹ They generally entail at least part of the tax paid by the corporation being imputed to shareholders and set against their liability to income tax on their dividends. In the United Kingdom, the current imputation system has the effect of offsetting the liability of shareholders on their dividends at the basic rate of income tax but not at the higher rate. The existence of a range of possible different forms of taxation of companies and shareholders is one of the reasons why European corporate tax harmonisation has not yet been achieved. However, it is not the only reason and the next section therefore examines

⁶⁶ Krever, "Companies, Shareholders and Tax Reform" (1995) 3 *Taxation in Australia* at 163/164.

⁶⁷ Cnossen, "Alternative Forms of Corporation Tax" (1983) 1 *Australian Tax Forum* (1983) at 261.

⁶⁸ Oats, "Taxing Corporations: Systems and Strategies" (1996) 4 *Taxation in Australia* Red Edn 138.

⁶⁹ Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights between Countries: A Comparison of Imputation Systems* (1996 IBFD Amsterdam).

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European progress towards harmonisation and corporate tax harmonisation in particular.

5 THE EUROPEAN EXPERIENCE

5-1 European tax harmonisation

Tax harmonisation in the European Union is part of a much wider programme of integration. The policy of establishing a common market and an economic and monetary union was to promote, among other things, “economic and social cohesion”.⁷⁰ The Treaty on European Union states explicitly that it “marks a new stage in the process of creating an ever closer union among the peoples of Europe in which decisions are taken as closely as possible to the citizen”.⁷¹ Economic prosperity was high on the agenda and this increased the pressure for tax harmonisation to avoid the risk that tax obstacles would obstruct trade.⁷² More generally, as Slot⁷³ has made clear, “harmonisation once looked upon by some observers as an Eurocratic idiosyncrasy has gradually and quietly moved to a central place in the Community”. It is now quite clear, however, that it is a long and difficult road.

In 1960, the European Commission set up a committee of tax and financial experts, under the chairmanship of Professor Fritz Neumark, to examine taxation and public expenditure with particular regard to those aspects which might distort the achievement of a common market. Its report⁷⁴ recommended at least some harmonisation of income tax, capital gains tax, corporate taxation and indirect taxes. It proposed a three-stage timetable for harmonisation. The first stage included turnover taxes as the area in need of the most urgent attention. This first stage was also to cover withholding taxes on dividends and interest, double taxation agreements and, if possible, excise duty structures. The second stage was the harmonisation of personal income taxes and corporate taxation. The third stage would complete the implementation of the recommendations, including a common information system and the establishment of a Community tax court. The Neumark Committee produced a fundamental set of proposals but, nearly four decades later, they are still a long way from being implemented in full.

⁷⁰ Article 2 EC (as amended by TEU).

⁷¹ TEU Art A.

⁷² Ogley, *Principles of International Tax: A Multinational Perspective* (1995 Interfisc Publishing) at 46.

⁷³ Slot, “Harmonisation” (1996) 21 *European Law Review* 378 at 397.

⁷⁴ *EEC Reports on Tax Harmonisation* (1963 International Bureau for Fiscal Documentation).

The Neumark Report was followed in 1966 by the Segre Committee's Report on the establishment of an integrated capital market within the community.⁷⁵ It dealt, inter alia, with the fiscal obstacles to the free movement of capital. The Committee concluded that tax considerations should not influence the choice of location of investments or transactions, nor should they influence an investor's choice between direct investment and investment through an intermediary.⁷⁶ Relevant recommendations of the Segre Committee included replacing bilateral double tax treaties with a multilateral community convention and the extension of credits for company tax paid to non-resident shareholders.

In 1967, following Neumark and Segre, the European Commission articulated the following objectives:

- (1) Liberalisation of capital movement, which in the long run would require alignment of national tax systems. Initially the Commission saw four matters requiring consideration, namely withholding tax on dividends and interest, reduction of double taxation on dividends, tax treatment of holding companies, and tax treatment of investments through financial intermediaries;
- (2) Removing obstacles to industrial combinations, including taxation; and
- (3) Approximation of the basis of assessment for company taxation.

In 1969, the Council adopted the directive on companies capital duties which required a harmonised capital duty on equity contributions to capital companies of between 1% and 2% of capital contributed. In 1973 that rate was established of 1%, and in 1985 provision was made for exemptions to be allowed, a measure described by one commentator as "deharmonisation".⁷⁷

In other detailed areas progress has been patchy and difficult. For example, a draft directive on the suppression of withholding tax on interest payments and fees paid between companies was finally withdrawn⁷⁸ by the Commission, after four years of discussion failed to reach sufficient agreement in the Council to proceed.⁷⁹ In other areas progress has taken a long time. For

⁷⁵ Commission of the European Communities, *Le Developpement d'un Marche European des Capitaux*, report of the Group of Experts established by the commission (1966 European Commission, Brussels).

⁷⁶ Easson, "Harmonisation of Direct Taxation in the European Community: From Neumark to Ruding" (1992) 40 *Canadian Tax Journal* 604.

⁷⁷ Ibid at 606.

⁷⁸ Commission Brief No WE/38/94 10 November 1994.

⁷⁹ "Eurobrief" (1994) 5 *European Business Law Review* 305.

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instance, as Hitiris⁸⁰ noted, directives on the taxation of cross-border merger and other activities of business were issued by the Community in July 1990, after 21 years of discussions.

The underlying theme of Devereux and Pearson's⁸¹ analysis is the distinction between the economic aims and the political feasibility of harmonisation. This may be a reflection that an appropriate degree of harmonisation, rather than complete harmonisation, is required as suggested above. As Mavraganis argues,⁸² "total harmonisation" of corporate taxation is not the aim. Instead, "partial harmonisation" should be the target and it should focus on those parts of corporate taxation which raise difficulties for the functioning of the European internal market. Again it seems that the establishment of clearer and more limited aims might achieve more progress towards harmonisation.

5-2 The harmonisation of corporate tax systems

There is experience of harmonisation of corporate taxes in other countries which may also be drawn upon. For instance, Daly and Weiner⁸³ examined corporate income taxation in three federal countries, Canada, Switzerland and the United States, with a view to the implications for tax harmonisation in Europe. Nevertheless, some of the issues are complex⁸⁴ and space limitations enable only the main features to be discussed here in the European context.

In relation to the harmonisation of corporate tax systems, European experience has not managed to maintain a consistent target. In 1962 the Neumark Committee⁸⁵ recommended to the Commission that a split-rate system should be adopted. In 1974 the Van den Tempel Report⁸⁶ examined the three systems, described in Section 4 above, and recommended the adoption of the classical system. However, the Commission's draft

⁸⁰ Hitiris T, *European Community Economics* (3rd edn, 1994 Harvester Wheatsheaf) at 125.

⁸¹ Devereux M and Pearson M, *Corporate Tax Harmonisation and Economic Efficiency* (1989 Institute for Fiscal Studies).

⁸² Mavraganis, "Corporate Income Tax Harmonisation in the Nineties" (1993) 47 *Bulletin of International Fiscal Documentation* 220 at 224.

⁸³ Daly and Weiner, "Corporate Tax Harmonisation and Competition in Federal Countries - Some Lessons for the European Community" (1993) 46 *National Tax Journal* 441.

⁸⁴ See, eg, Fuente and Gardner, "Corporate Tax Harmonisation and Capital Allocation" in G Kopits (ed), *Tax Harmonisation in the European Community* (1992 International Monetary Fund).

⁸⁵ Neumark Committee, *EEC Reports on Tax Harmonisation* (1963 International Bureau for Fiscal Documentation).

⁸⁶ Van den Tempel AJ, *Corporation Tax and Individual Income Tax in the EEC* (1971 Commission of the European Community).

directive⁸⁷ on the harmonisation of corporate taxation proposed the imputation system. Other commentators have also favoured this system. For example, a Federal Trust study group of experts, under the chairmanship of Sir William Goodhart, also recommended that all Member States should be required to move to an imputation system.⁸⁸

Such varied recommendations might reflect the reasons why different systems are operated across the European Union. Table 1 shows seven Member States with an imputation system in 1994/95 and four with a classical system. Of the countries joining the European Union in 1995, Finland introduced an imputation system in 1990 but Austria and Sweden have classical systems. This all adds up to eight imputation systems, six classical systems and Greece with a dividend deductible system. In a wider perspective of federal countries it might be noted that the United States has a classical system and Australia and Canada have imputation systems.

Table 1 Corporate Tax Systems in the European Union in 1994/95

Country	System	Corporation tax rate	Tax credit as % of dividend	Tax credit as % of underlying CT
Belgium	Classical	40	-	-
Denmark	Classical	34	-	-
France	Imputation	33.3	50	69.05
Germany	Imputation	45 and 30	42.86	100.00
Greece	Dividend deductible	35	-	-
Ireland	Imputation	40	33.3	50.00
Italy	Imputation	52.2	56.25	51.51
Luxembourg	Classical	44	-	-
Netherlands	Classical	35	-	-
Portugal	Imputation	36	28.13	50.00
Spain	Imputation	35	10	18.75
UK	Imputation	33	25	50.76

Source: S James and C Nobes, *The Economics of Taxation: Principles, Policy and Practice* (6th edn 1997 Prentice Hall) at 297.

⁸⁷ Commission of the European Community, *Draft Directive Concerning the Harmonisation of Systems of Company Taxation and of Withholding Tax on Dividends*, OJ no C253. COM(75) 392 final, 1975.

⁸⁸ Ernst and Young and Federal Trust, *The Future of Corporate Tax in the European Community* (1991 Kogan Page) at 86.

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Within the European Union, progress has not always been in the same direction. Two of the states moved to an imputation system and then moved back to a classical system - Belgium had an imputation system from 1963 to 1989 and Denmark from 1987 to 1991. Nor are all the systems the same. For instance, France, Ireland, Portugal and Spain have partial imputation systems similar to that in the United Kingdom. However, Germany has a system of full imputation. Some progress might be noted, perhaps, in that before 1977 a split-rate system was operated in Germany and also in Austria and Portugal until 1989.

There are other differences in the tax bases and administrative rules governing the operation of corporation tax across Member States. One major dimension is that harmonisation involves not just changing corporate tax rules, but also the whole way business accounts are kept. Stitt⁸⁹ suggests there is little point in trying to harmonise corporate tax systems until there is greater agreement on how book profits should be determined. In continental Europe, few adjustments are made to “book” figures in arriving at taxable income. As a result, accounting principles in many countries have been heavily influenced by tax considerations to an extent that is almost unknown in the United Kingdom.

It has also been pointed out that the degree of enforcement varies across the European Union, with “enterprises being given a considerable degree of discretion over the taxes they pay in some cases”.⁹⁰

In addition to the proposal on corporate tax harmonisation, in 1976 the directive on mutual assistance in direct taxation was proposed and adopted in 1977. Of the three other proposals submitted to the Council, the directive establishing an arbitration procedure to avoid double taxation was eventually adopted in 1990. The other two proposals, regarding the taxation of transactions in securities and the carryover of business losses, remain to be adopted. In 1990 two new directives were adopted, the Parent Subsidiary directive and the Merger directive, and in December of that year a committee of experts was established under the chairmanship of Dr Onno Ruding to examine the role of direct taxation in the Community. The Ruding Committee⁹¹ noted that corporate tax was a growing factor in investment decision-making in Europe as other barriers to the location of investment were being dismantled. It concluded that some of the differences in corporate taxation were distorting the internal market and considered that “it is unlikely

⁸⁹ Stitt, “International Tax: Avoiding Parochialism” [1997] *British Tax Review* 19 at 35.

⁹⁰ Gardner, “Taxes on Capital Income: A Survey” in G Kopits (ed), *Tax Harmonisation in the European Community* (1992 International Monetary Fund) at 56.

⁹¹ Commission of the European Community, *Report of the Committee of Independent Experts on Company Taxation 1992* (“Ruding Report”).

that such differences will be reduced much further through independent action by Member States".⁹²

Essentially, the Ruding Report was concerned with two main areas. These were proposals to reduce tax discrimination against cross-border investment and proposals for the harmonisation of tax bases and tax rates, with a minimum tax rate of 30 per cent. However, the harmonisation proposals did not recommend immediate action or a system to be adopted as a basis for harmonisation.

5-3 Reduced discrimination against cross border investment

The main aim of corporate tax harmonisation is to reduce, if not remove, distortions arising as a result of cross border investment. The most serious impediment to cross border investment is the imposition of withholding taxes on dividends. As between related companies, the Parent Subsidiary directive should deal with the problem. In the long run, the intention is to extend the directive to all inter-company interest, dividend and royalty payments, that is to remove both domestic withholding tax provisions and the treaty articles which impose such taxes within the Community.

The Ruding Committee recommended that Member States work towards a common policy in respect of double tax treaties both between Member States and with third countries. It also recommended that those Member States providing relief from double taxation on domestic profits, through imputation or similar mechanisms, extend these benefits to profits earned in other Member States. Given the difficulties in achieving this apparently simple goal between Australia and New Zealand, which have very similar imputation systems, it will presumably be even more difficult to achieve in a European context where imputation systems vary more markedly. Easson notes that "the next logical step from a harmonised tax treaty policy toward third countries would be the negotiation of new treaties at the community level, treating the community as a single territory for tax purposes".⁹³

5-4 Harmonisation of bases and rates

At present there are considerable differences between the tax regimes of various Member States which will result in significant compliance costs for enterprises seeking to conduct business in other Member States.⁹⁴ Harmonisation of the tax base was the subject of a preliminary draft proposal issued by the Commission in 1988. The difficulties in achieving

⁹² Ibid at 201-202.

⁹³ Easson, "Harmonisation of Direct Taxation in the European Community: From Neumark to Ruding" (1992) 40 *Canadian Tax Journal* at 638.

⁹⁴ Ogley, *Principles of International Tax: A Multinational Perspective* (1995 Interfisc Publishing) at 49.

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harmonisation, given different approaches to such issues as depreciation both in term of rates and assets eligible for tax depreciation claims, treatment of losses, trading stock valuations and provisions, may be insurmountable. Given, however, that subsidiarity is the prevailing principle, harmonisation of tax base may no longer be considered desirable.

Harmonisation of rates would certainly seem to be an easier task. The Ruding Committee recommended a minimum rate which would, in the first instance, force Greece to change its system. The later imposition of a maximum rate would see countries forced to choose between a classical system and an imputation system. It seems that harmonisation of rates and systems should be dealt with together, since, on the assumption of the existence of tax competition, countries choosing a classical system would find themselves disadvantaged in attracting investment in relation to those with imputation systems.

5-5 Harmonisation of imputation systems

Jurisdictions which operate imputation systems usually grant relief only in respect of domestic taxes. This is sometimes referred to as a prejudice problem, which discriminates against cross border investment. The Ruding Committee recommended that Member States utilising imputation systems and other forms of relief from double taxation, extend the benefits to corporate profits derived in other Member States. It did not, however, recommend the extension of tax credits to non-resident shareholders, presumably on the basis that to do so would conflict with source country entitlement.

The denial of imputation credits to non-resident shareholders and in respect of foreign profits also distorts investment flows. The failure to provide imputation credits for foreign profits creates a bias against corporations investing overseas and also a disincentive for investors to invest in foreign companies.

In the European context, the Commission's 1975 draft recommended a clearing system whereby imputation credits allowed in the shareholder's state of residence for foreign taxes would then be recovered from the state in which the corporation was resident. This proposal was officially withdrawn in 1990, and the Ruding Committee's approach to this issue differs considerably. It treats the company tax paid as properly creditable in the shareholder's state of residence on the same basis that underlying foreign tax credit is granted to corporate shareholders in most jurisdictions.

6 AUSTRALIAN AND NEW ZEALAND CORPORATE TAX HARMONISATION

6-1 Closer economic relations

As in Europe, Australia and New Zealand have attempted to move towards freer trade. In 1983 they negotiated the Closer Economic Relations (CER) Agreement, with the aim of strengthening “the relationship between Australia and NZ by free trade between the two countries, involving elimination of barriers to trade and the development of a single market”.⁹⁵ The tax systems of the two countries are similar in many respects, particularly in the form of the system of company and shareholder taxation. Both operate an accounting system to determine the amount of company tax to be imputed to shareholders and both allow only credit for domestic company tax. However, they are sufficiently different to create biases in investment flows and therefore barriers to free trade. Marsh notes⁹⁶ that the failure of both New Zealand and Australia to recognise trans-Tasman imputation credits distorts the effective tax rate faced by investors undertaking investment in the other country. Taxation issues, however, have not figured prominently in negotiations, although some commentators⁹⁷ consider it critical to the success of the Agreement, an issue which deserves closer attention. Indeed, the CER Agreement makes little reference to taxation and, in the 1988 review, a Memorandum of Understanding on harmonisation of business law similarly made no mention of taxation laws, nor did the 1990 Report of the Steering Committee, established to co-ordinate the task of harmonising business laws and regulatory practices.⁹⁸

In 1992, a review of CER was undertaken and tax impediments to trade and investment were finally placed on the agenda for further consideration. To date, however, nothing concrete has come of this, not even during the 1993 re-negotiation of the double tax treaty between the two countries, which would have provided an ideal opportunity to examine the question of corporate tax harmonisation. Indeed, the reciprocal recognition of imputation credits was ruled out by the then Prime Minister of Australia in a visit to New Zealand in May 1993.⁹⁹

⁹⁵ Shewan J and Heffernan J, “Company Taxation and Harmonisation Issues for Australia and New Zealand” Bureau of Industry Economics Dividend Imputation Policy Forum (1993 AGPS) at 258.

⁹⁶ Marsh, above n 55 at 372.

⁹⁷ Shewan and Heffernan, above n 95 at 257.

⁹⁸ Ibid at 259.

⁹⁹ Bengé M, “The Australian Full Imputation Reform” in Head and Krever (eds), *Company Tax Systems*, (1996 Australian Tax Research Foundation Conference Series No 18) at 185.

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Shewan and Heffernan¹⁰⁰ are of the view that failure to grant reciprocal imputation credits is a major problem in the context of CER and runs contrary to the principle of capital export neutrality which dictates that tax liability should not differ based on the source of profit, domestic or foreign. By not allowing imputation credits for foreign tax, capital export neutrality is not achieved and the double taxation of corporate profits remains for foreign source income. Although the impact of taxation on investment decisions is downplayed in many quarters, there is a significant cost in trans Tasman investment which Shewan and Heffernan suggest “can be a dominant factor in determining the location of new plants”.¹⁰¹

6-2 Barriers to imputation co-ordination

Australian investment into New Zealand is greater than the reverse, but the extent of the differential is not entirely clear. Deutsch and Cooper¹⁰² describe it as significant, but Bengel¹⁰³ suggests that based on verbal advice from the Australian Bureau of Statistics there is not, in fact, a major asymmetry in bilateral capital flows between the two countries. Even if there is an imbalance, it need not preclude action on a reciprocal recognition of imputation credits. Deutsch and Cooper¹⁰⁴ suggest that Australia could allow a lesser benefit for New Zealand tax paid than vice versa to compensate.

The impact of any alignment of imputation systems on the respective corporate tax rates in each country is not clear. Deutsch and Cooper¹⁰⁵ suggest that there may be a tendency for the source country to increase its company tax rate, in line with the personal tax rate for shareholders in the residence country, so as to deny the residence treasury access to the differential. This may be offset at the present time by the worldwide trend to reduction in corporate tax rates.

The question of how corporate tax preferences granted in the source country should be treated is also a concern. In the case of both Australia and New Zealand, the imposition of withholding tax on dividends from untaxed profits

¹⁰⁰ Shewan J and Heffernan J, “Company Taxation and Harmonisation Issues for Australia and New Zealand” Bureau of Industry Economics Dividend Imputation Policy Forum (1993 AGPS) at 264.

¹⁰¹ Ibid at 264.

¹⁰² “Taxation and Imputation in the Asia Pacific Context” Bureau of Industry Economics Dividend Imputation Policy Forum (1993 AGPS) at 219.

¹⁰³ “The Australian Full Imputation Reform” in Head and Krever (eds), *Company Tax Systems*, (1996 Australian Tax Research Foundation Conference Series No 18) at 188.

¹⁰⁴ Deutsch and Cooper, “Taxation and Imputation in the Asia Pacific Context” Bureau of Industry Economics Dividend Imputation Policy Forum (1993 AGPS) at 219.

¹⁰⁵ Ibid at 241.

has the effect of recapturing the preferences in the source country, but this could easily be altered and suggests the need for a co-ordinated approach to company tax base definition.¹⁰⁶

As the European experience demonstrates, identical tax laws are an unrealistic goal in the face of national sovereignty and to eliminate completely tax induced barriers to trade and investment would entail duplication of tax laws, rates and bases which is clearly not possible. The objectives of CER would, however, be served if the tax impediments can be mitigated so as not to pose a material barrier to free trade between the countries.¹⁰⁷ In the context of base co-ordination, the less than enthusiastic embrace of mutual recognition by the Australian government is in part the result of the failure of the New Zealand tax system to tax capital gains. It seems that the Australian Treasury is concerned that this will open up avoidance opportunities. Another concern of the Australian government is apparently the fear that pressure will be brought to bear by other treaty partners to enter similar arrangements, a position which could not be sustained.¹⁰⁸

6-3 Options for harmonisation of imputation systems

There is no question that the imputation systems in both Australia and New Zealand discriminate against foreign investment and impede the two way investment between the two countries.

There are several methods by which two countries with imputation company tax systems can provide for reciprocal credit. The simplest is to recognise the tax payments in the other jurisdiction for domestic imputation purposes. Deutsch and Cooper¹⁰⁹ describe this as the "Recognition Model" and note the recent adoption of a similar process on a unilateral basis by Singapore. Here the tax paid in the source country is allowed as a credit against the shareholder's tax liability in the residence country. This method has been suggested as appropriate for Australia and New Zealand in the context of CER. It is apparently the preferred option of the New Zealand Treasury.

Under an alternative proposal, described as the "Transfer Model", a refund of tax could be made by the foreign government to the shareholder to be taxed in the residence country. This would appear to be the preferable approach from the Australian point of view.¹¹⁰

¹⁰⁶ Ibid at 244.

¹⁰⁷ Shewan J and Heffernan J, "Company Taxation and Harmonisation Issues for Australia and New Zealand" Bureau of Industry Economics Dividend Imputation Policy Forum (1993 AGPS) at 257.

¹⁰⁸ Ibid at 267.

¹⁰⁹ Ibid at 220.

¹¹⁰ Ibid at 238.

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Although it would be possible to incorporate the elimination of tax impediments to investment in the double tax treaty between the two countries, the dangers in terms of re-negotiations with other treaty partners would seem to be significant, and it is more likely that a separate bilateral agreement would be the appropriate vehicle for achieving it. Indeed Bengé¹¹¹ suggests that, if the recognition were confined to fully franked dividends, it could be justified as an extension of the CER agreement without causing demands for equal treatment from other treaty partners.

Shewan and Heffernan¹¹² note that:

the early effects of CER have been to expand the Australasian market, providing new business opportunities to residents in both countries. However, it is important that the Agreement not be seen to stop there. In the context of a rapidly developing Asian and global market, Australasian companies are paying increasing attention to investing further afield. CER is relevant to this outward focus, providing both a larger domestic base to act as a springboard and hopefully ensuring that the regulatory framework in each country, and collectively, is conducive to combining forces to exploit investment opportunities further afield.

Harris¹¹³ advocates the application of a composite tax principle under which non-residents are taxed on the basis of source at a flat rate and residents are taxed on the basis of residence at traditional progressive rates in deference to the desire for wealth redistribution. Source income taxation would be competitive so encouraging efficient global resource allocation. He suggests that it may be possible for a block of countries with imputation systems to move towards the composite principle and so neutralise the effects of their imputation systems, with the aim of regional efficiency in resource allocation while retaining a large amount of national autonomy.

7 CONCLUSIONS

Tax harmonisation in general and for corporate taxation in particular is not an easy process. However, with a technological revolution under way and its major tax implications such as future difficulties in using source as a basis of taxation, international co-operation and a higher degree of tax harmonisation

¹¹¹ Bengé M, "The Australian Full Imputation Reform" in Head and Krever (eds), *Company Tax Systems*, (1996 Australian Tax Research Foundation Conference Series No 18) at 185.

¹¹² "Company Taxation and Harmonisation Issues for Australia and New Zealand" Bureau of Industry Economics Dividend Imputation Policy Forum (1993 AGPS) at 282.

¹¹³ Harris, "Neutralizing the Imputation Systems" (1997) 3 *Asia Pacific Tax Bulletin* 164-177.

should be further up the political agenda. It is possible that the advantages of harmonisation have not yet been fully appreciated. It might also not be widely realised that a satisfactory degree of tax harmonisation does not necessarily preclude significant regional fiscal disparity. The lack of progress towards harmonisation in Europe and between Australia and New Zealand might indicate that a different approach would be preferable.

If the best solution is some particular degree of harmonisation, rather than complete standardisation of taxes, then there is a strong case for making this clear and establishing the ultimate target more precisely. If participating countries could agree on the extent to which harmonisation was sought, and their degree of autonomy was guaranteed, progress might be much more rapid and substantial.

In an Antipodean context, harmonisation of corporate taxation does not seem to be high on the agenda, despite significant similarities in approach to corporate and shareholder taxation in Australia and New Zealand, which would seem to make alignment potentially easier than in Europe. The recalcitrance seems to be associated with the Australian government's concern with revenue losses resulting from New Zealand's failure to tax capital gains. Marsh notes that the CER agreement is hampered by the same difficulty faced in the EU, namely the fear of loss of fiscal autonomy. There are possible solutions to this, eg, the composite tax principle advocated by Harris may allow for a degree of harmonisation without the need to compromise national tax autonomy. More generally, as in Europe, the key to successful progress might lie in the clarification of precisely what degree of harmonisation is desired overall and can be agreed between all the participants.