# A CORPORATE BASE AS A BASIS OF A FIFTH COMMUNITY RESOURCE?[*]

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## Abstract

Given the European Budgetary needs, to tax corporations in the E.U. as a possible fifth Community resource has a strong rationale. The use of direct taxation in Community revenue makes a good balance with the present use of indirect taxation. Among direct taxes corporate taxation is a clear first choice for this purpose. This paper discusses which would be the best common indicator of corporation's contributive capacity in the E.U.

Current national income tax bases show a lack of harmonization and a corresponding lack of equity among countries. The same is true of the accounting profit and loss. The net wealth of corporations is disregarded for mainly economic reasons. A different view may be taken, however, with regard to the taxation of the flow of funds of corporations. The flow of funds concept -especially the "R" and "S" bases- deserve further study.

**Keywords:** E.U., fifth Community resource, corporate taxation, accounting profit and loss, net wealth of corporations, taxation of the flow of funds of corporations.

# A CORPORATE BASE AS A BASIS OF A FIFTH COMMUNITY RESOURCE?

## 1. Introduction

Given the European Budgetary needs, to tax corporations in the E.U. as a possible fifth Community resource[1] has a strong rationale. The use of direct taxation in Community revenue makes a good balance with the present use of indirect taxation. Since indirect taxation falls mainly on consumption, relatively poorer countries of the E.U. contribute relatively more in terms of their G.N.P. than richer countries do. At the same time, the flexibility of the base of a direct tax may render greater advantages in policy terms than those of an indirect tax. Among direct taxes corporate taxation is a clear first choice for these purposes, since personal income and wealth taxes are too diverse in nature and content in the E.U., and the Commission has clearly declared that the harmonization of personal income tax is not currently intended.

The national corporate income taxes may be an appropriate vehicle to collect this possible fifth Community resource, making use of the administrative capacities of each member State. There should be only one return per member country and the possible Community tax should be based on elements easily obtained from the information needed for national tax purposes. Another idea is that the fifth Community resource may be deductible from national corporate tax liabilities, or considered as a deductible expense to compute national taxable profits.

With all the aforementioned in mind, we plan to discuss in this paper which would it be the best common indicator of corporation's contributive capacity in the E.U. It is clear that for a tax to become a new Community resource, it has to have a sufficiently harmonized tax base so that countries' contributions can be homogeneously compared and be equitable. The first indicator to be studied is obviously the present national income tax base.

Given the differences among corporate taxes of member countries (or even among regions within countries) and the difficulties of short or medium term harmonization, an alternative approach is to try to define a "common European corporate tax base", with the least possible changes from current corporate taxes. Since the main differences in corporate taxes arise from the definition of the taxable base -corrections of the accounting result- and from the tax allowances applicable, an obvious indicator of a "common European corporate tax base" is the accounting result to which an European tax rate might be applied. To use the profit and loss account as an indicator of the corporations' contributive capacity to the Community has clear advantages since it is both easy to understand and to comply with by tax payers and to control by tax administrations.

Since the use of the accounting result as a "common European corporate tax base" will also be proved as difficult, we shall study other indicators of contributive capacity related to current accounting practices of the corporations in Europe. A final recapitulation and conclusion will end the paper.

## 2. The corporate income tax base as the basis of a fifth Community resource

A necessary condition for the base of corporate income tax to be appropriate as the basis of a fifth Community resource is a certain degree of uniformity in the definition and structure of the tax base in the Union countries (apart from a level of uniformity in the determination of the accounting result which discussion is postponed to the following section).

Although not necessarily as a direct result of the harmonization efforts made by the Community institutions, there is a certain degree of similarity among european corporate income taxes. This is the effect of a tax competition process which has originated a spontaneous harmonization of parts of the tax legislation in E.U. countries.

A review of european corporate income taxes highligts the following:

a) The countries have spontaneously opted mainly for an imputation system. There is still one country that applies a classical system and, above all, there are great differences in the specific way in which the imputation system is applied, meaning that the degrees of correction of the double taxation of dividends are very varied, also taking the rest of the systems applied for the same purpose into account (reduced tax rates, two-rate system, tax credit)[2].

b) There is coincidence in basing corporate income tax on net income, rather than alternative concepts like the flow of funds or economic profit which are tax ideas for the future of national tax systems. However, the criteria for delimiting the computable income and deductible expenses that allows net income to be quantified differ.

c) Corporate income tax is a tax levied by the central authorities but there are States where there are also municipal taxes on corporate income which must also be considered in order to quantify and compare the total tax burden borne by companies in different countries.

d) There is a general trend towards defining corporate income tax as a proportional tax with a single rate for distributed profits and reserves. However, countries still exist with slightly progressive tariffs and Germany has a two-rate system.

e) Regarding tax rates, we have noted what we could consider one of the most general trends of all those we have detected. It is the progressive reduction of rates in the European Union countries. In spite of this, it is important to draw attention to the significant difference between the nominal rate of countries like Finland and Sweden (28%) and Italy (53.2%).

f) In all E.U. countries the straight-line depreciation/amortisation method is admitted and in most of them a constant percentage declining-balance method. However, the differences in the depreciation/amortisation rates permitted may lead to very varying tax savings. In addition, with regard to the declining balance method, the conditions required of the assets in order for it to be applied and the way in which the constant percentage is quantified differ. The sum of the digits declining-balance method is also admitted in a number of cases.

g) All the countries coincide in defining the depreciation/amortisation base as the historical cost of acquisition or production, without applying any consistent system to correct the effect of inflation. To the extent that inflation rates differ between countries, the consequences for the effective tax burden will be very diverse.

h) Accelerated depreciation/amortisation is a generally-applied incentive. However, the requirements for its application and the specific accelerated rate are very different, even within the same country, for the different cases where it may be applied.

i) Stocks, like fixed assets, are valued at the historical cost of acquisition or production. With regard to the system for determining unit costs, the method applied for tax purposes is usually required to coincide with that which is applied for accounting purposes. Furthermore, there has been a trend towards a progressive acceptance of the LIFO system as a way of correcting the effects of inflation, even though this system is not yet admitted in all countries.

j) Capital gains are usually taxed when they are realised, not under a separate tax but integrated into corporate income tax at the ordinary tax rates, with no distinction between those generated in the short or long term. There are, however, exceptions to these general rules. For example, France taxes capital gains at special rates and gives them different tax treatment depending on the term over which they are generated.

k) Although systems to correct the effects of inflation are not usually applied in calculating capital gains, there are countries where such systems are used.

l) Among the incentives relative to capital gains, the deferral of capital gains in the event of reinvestment stands out. There are, however, differences in the criterion for its application and the term and time sequence of the deferral. Furthermore, there are discrepancies in other cases of exemption of capital gains.

m) In general, capital losses are treated as ordinary losses. However, in some cases they are subject to restrictions on offsetting, which vary between countries.

n) Another of the most general trends shown by the reforms carried out over recent years has been the extension of the term for carrying losses forward and the progressive, although still tentative, admission of loss carrybacks. Therefore, attention should be drawn to the significant differences that still exist between the 5 years carry forward term of some countries and the unlimited carryforwards of others and, above all, the fact that most countries do not yet admit the carrybackwards.

o) All the countries establish incentives in order to promote investment. There are, however, extraordinary differences between the measures applied.

These stylized features of current european corporate income taxation show that, in spite of the trend towards alingment noted in various components of the tax, there is still a significant degree of diversity among E.U. countries. These divergences, mainly in the definition of the corporate income tax base are confirmed by international reports, like the Ruding Report (1992).

Therefore, the use of present corporate income tax bases of member countries as the basis of a fifth Community resource present problems of insufficient harmonization and a lack of equity in the corresponding generation of revenue. The main differences in the corporate taxable income of member countries arise from elements such as:

- the depreciation/amortization acceptable for tax purposes and, especially, the use of accelerated depreciation/amortization (these are time differences giving rise to financial effects)

- tax incentives to promote investment or to stimulate areas or activities. These may be implemented in the tax base in the form of deductions or, principally, accelerated depreciation schemes, or as tax credits

- the tax treatment of capital gains and losses (valuation, inflation adjustments and deferral or exemption)

- the possibilities of tax loss set-off (number of years, carry forward or backwards)

- the valuation of stocks

- divergences in the formation of the profit and loss account, which will be studied below.

The "tax competition" process of alignment of corporate income taxes in the E.U. that has developed over recent years has not been able, due to its own nature, to establish a sufficiently harmonized tax base to be used as the basis of a fifth Community resource. Any further "spontaneous" alignment of corporate tax legislation among member countries is not foreseeable in "tax competition" terms, since the main divergences listed above correspond to elements with which countries compete to attract direct investments. A process of cooperative harmonization -with the approval of directives- would be necessary to eliminate the tax divergences listed above.

The latter may be a good objective by itself. The prevalence of the source criterion in the practice of international taxation of corporations leads, if one wants to reach a minimum level of neutrality in the international allocation of investment, to a convergence in corporate income tax rates and bases in the E.U., along the lines indicated, for example, by the mentioned Ruding Committee Report. Otherwise, tax competition between States makes it difficult to collect taxes on capital and generates inefficiency in the location of investment (not to mention the problems of the existence of tax heavens, the difficulties of the rules on international tax transparency and of the exchange of information, or the use of transfer pricing).

A complete application of the residence principle in international corporate taxation would avoid the need for tax harmonization, but the situation of present tax systems, with the exemption of interest, at origin, in practice, the deferral of taxation in the residence state of profits allocated to reserves and the limitation of foreign tax credits, proves the residence principle impossible and harmonization attractive. The differences in effective tax rates on capital income are great, distorting economic decisions, and it is absurd to encourage them further by opposing the convergence of tax systems. However, the significant political problems that arise in the convergence solution and the existence of strong supporters of maintaining the tax competition between the States make it difficult, at least in the short run, to have a greater coordination of corporate income taxes in Europe in respect of both the tax base and rates.

## 3. The profit and loss account as the basis of a fifth Community resource

The profit or loss shown in the profit and loss account is a relative magnitude which depends on the characteristics of the accounting model used and the specific rules arising therefrom. It will also be affected by the way in which it is applied in practice. The study of the profit and loss account has been one of the basic lines of accounting research due to its heterogeneous nature, since it depends on a very wide-ranging set of magnitudes which may not always be quantified on the basis of objective criteria.

Both the components of the profit and loss account and the aforementioned quantification thereof may be and, in fact are, very different under the various accounting systems. These systems may be classified into two broad groups, known as the continental group and the Anglo-Saxon group. Both of them coexist in the European Union.

If the profit and loss account is to serve as the basis of a fifth Community resource, a condition is the existence of a sufficient degree of harmonization of the said account to be used for european-wide tax purposes. Such degree of harmonization does not exist among E.U. countries. This, without doubt, is a consequence of the alternatives contained in the 4th Directive and of the institutional differences and characteristics of accounting in different countries.

The main divergences in the determination of the accounting profit or loss of corporations of different member countries may arise from:

- differences in straight-line depreciation rates or in the use of declining balance methods, which, in fact, are also explicit divergences in terms of the corporate income tax base.

- the valuation of assets and, therefore, the determination of certain expenses of the corporation. Examples in this area are: R&D, goodwill, capitalization of financial expenses, lease agreements with purchase options, provisions or the valuation of stocks.

- differences in the recording of income in the case of long-terms contracts, for example building contracts.

- options in the recording of foreign currency transactions.

- consolidated profit and loss account in the event that a corporation group exists.

It is obviously clear that all these divergences are also present, implicitly, in the lack of homogenity of corporate income tax bases of member countries. In this sense, and since these bases show further divergences, the comparison between the accounting profit or loss and corporate income tax bases is favorable to the former, which, however, is also unsatisfactory, as it stands today, as a basis of a fifth Community resource.

If we distinguish within the profit or loss account other partial margins, such as:

- the operating profit or loss margin
- the financial profit or loss margin
- the profit or loss on ordinary activities, which contains the two previous margins, and
- extraordinary results

it is also clear that all these concepts are affected by the mentioned lack of harmonization and since, at the same time, any differences in the classification of items for one or other margin (i.e. capitalization or not of financial costs or ordinary/extraordinary items) are compensated in the profit and loss account, the global account is preferable to any of its margins.

One further question is whether the existing accounting divergences might be made more acceptable because of the time profile of such differences. At this respect, however, only if one is prepared to assume that:

- a good part of the accounting divergences that arise among Community countries are time differences which will be offset in the future, which is a rather unconvincing assumption,

- differential inflation will be small and interest rates reduced in the future, and

- an effort towards a more complete accounting harmonization may be possible,

the accounting profit or loss, before the national corporation tax charge, might be defended as a reasonable basis for a fifth Community resource on an individual corporation setting (for corporation groups a better harmonization of the consolidated profit and loss account would also be necessary).

However, all in all, the present level of accounting harmonization is not enough, in our opinion, for Europe wide tax purposes. The accounting profit or loss suffers from a lack of homogeneity among Community countries and, therefore an effort should be made to investigate the use of other indicators of contributive capacity, related to current accounting practices of corporations in Europe, as the basis of a fifth Community resource. This will be done in the following pages and a final recapitulation will compare all possible tax bases.

## 4. Other common indicators of the contributive capacity of corporations

### *4.1 Net wealth of corporations*

One possibility is to turn to the balance sheet instead of considering the profit and loss account. This possibility, however, has to be disregarded for the following reasons:

- from the accounting point of view it is clear that both the valuation of assets and of liabilities differ among Community countries, raising a similar set of problems to those already contemplated in the analysis of the accounting profit or loss. Many of the divergences studied with reference to the accounting profit or loss will be transferred to the balance sheet. At the same time, the 4th Directive establishes two balance sheet models (articles 9 and 10) and different options for the member States.

- another difficulty is the fact that a positive net wealth situation may exist in a corporation and be compatible with losses in the profit and loss account. This means that a corporation may have a positive tax base, if net wealth is used, and no income to pay the tax.

- the taxation of net assets, which form the productive capacity of corporations and increase the possibilities of employment, presents difficult political and economic problems in the international and competitive setting in which European corporations operate.

- the taxation of the net wealth of corporations discourages the formation of reserves and, therefore self-financing, and favours undercapitalization of investments.

- net wealth taxation would tax new enterprises more heavily than old ones, given historical costs of assets.

### *4.2. Taxation of the flow of funds of corporations*

The idea of an Expenditure Tax is translated, in the business field, into the taxation of the flow of funds of undertakings rather than their profits. Business income is not taxed if it is reinvested and the system provides a tax bonus for corporate investment, similar to that which the taxation of expenditure offers to the individual investor.

There are various possibilities for applying taxation to the flow of funds of corporations, including VAT, at source, with an annual accounting base. Under the present heading we follow mainly the structure of the flow of funds basis for taxation presented in the Meade Report (chart 1 represents Table 12.1 of the Meade Report, showing the corporate flow of funds referred to the case of the UK).

There are three different concepts of a flow of funds base. One is the real ("R") tax base, i.e.: all sales of real goods and services (including the proceeds of sales of real fixed assets) less:

- purchases of real goods and services and of real fixed assets.

- wages, salaries, social security charges and related items.

In terms of chart 1, base R is R-~~R~~

The information needed for the "R" flow of funds tax base can be obtained from the accounting records using either of the following two methods:

**a) Adjusting the operating profit or loss**

Under this procedure, the operating profit (or loss) is adjusted as follows:

i) Elimination of the amounts corresponding to the variation in stocks of raw materials, finished products and work in progress, since these variations do not represent a consumption item but are investments of the corporation.

ii) Elimination of the balance of the accounts corresponding to the work performed by the corporation on its own assets. This elimination would be applicable only to those member States where the accounting rules provide the capitalization of the cost incurred in this specific purpose through the use of a separate income account. The adjustment is needed to eliminate transactions that do not really mean a flow of funds because they are recorded within the corresponding accounts of purchases, wages and services, and that represent investment.

# CHART 1
# CORPORATE FLOW OF FUNDS

| | *Inflows* | | *Outflows* |
|---|---|---|---|
| *Real items* | | | |
| $R_1$ | Sale of produce | $\bar{R}_1$ | Purchase of materials |
| $R_2$ | Sale of services | $\bar{R}_2$ | Wages, salaries and purchases of other services |
| $R_3$ | Sale of fixed assets | $\bar{R}_3$ | Purchase of fixed assets |
| $R$ | | $\bar{R}$ | |
| | *Financial items other than shares of corporate bodies resident in the UK* | | |
| $F_1$ | Increase in creditors | $\bar{F}_1$ | Decrease in creditors |
| $F_2$ | Decrease in debtors | $\bar{F}_2$ | Increase in debtors |
| $F_3$ | Increase in overdraft | $\bar{F}_3$ | Decrease in overdraft |
| $F_4$ | Decrease in cash balance | $\bar{F}_4$ | Increase in cash balance |
| $F_5$ | Increase in other borrowing | $\bar{F}_5$ | Decrase in other borrowing |
| $F_6$ | Decrease in other lending | $\bar{F}_6$ | Increase in other lending |
| $F_7$ | Interest received | $\bar{F}_7$ | Interested paid |
| $F_8$ | Decrease in holding of shares in other corporate bodies not resident in the UK | $F_8$ | Increase in holding of shares in other corporate bodies not resident in the UK |
| $F$ | | $\bar{F}$ | |
| | *Share items of corporate bodies resident in the UK* | | |
| $S_1$ | Increase in own shares issued | $\bar{S}_1$ | Reduction in own shares issued |
| $S_2$ | Decrease in holding of shares in other corporate bodies resident in the UK | $S_2$ | Increase in holding of shares in other corporate bodies resident in the UK |
| $S_3$ | Dividends received from other corporate bodies resident in the UK | $\bar{S}_3$ | Dividends paid |
| $S$ | | $\bar{S}$ | |
| *Tax items* | | | |
| $T$ | Tax repaid | $\bar{T}$ | Tax paid |

*R+F+S+T* Total inflows= $\bar{R} + \bar{F} + \bar{S} + \bar{T}$ Total outflows

Base R=R-R ● Base R+F = R+F-R-F ● Base S=_-S

Source: Meade Report, table 12.1, p. 231.

iii) Elimination of any debit or credit balances relating to amortization, depreciation or provision accounts, since they do not mean a real flow of funds. (Bad debt provisions, however, may not be eliminated since they compensate sales which collection is doubtful.)

iv) Elimination of the corporate income tax charge and any other related account.

v) Addition of the proceeds of all sales of fixed assets, excluding VAT when applicable, since they are real inflows. Sales of financial assets should not be added.

vi) Subtraction of all fixed assets purchases (excluding the capitalization of financial expenses, if included as purchase cost, and capital subventions, if exist, net of corporate tax) taking place during the tax year, including intangible assets such as start-up, R&D or any other deferred expenses, since they are real outflows (purchases of goodwill, financial or not, should not be included). Financial asset purchases should not be deducted.

### b) Break-down of inflows and outflows

This alternative procedure is a direct derivation from the first section of the Corporate flow of funds (Chart 1).

For a better understanding of this procedure we indicate the accounts to be taken into consideration in determining the amount corresponding to inflow and outflow items shown in the above mentioned first section of Chart 1.

i) Inflows:

Items $R_1 + R_2$ will correspond to the addition of the accounts recording the net revenue (i.e. income for sale of goods and/or rendering of services, net of volume discounts -"rappels"-, goods returned and, possibly, bad debts provisions). Other operating income such as commissions, leases, royalties, sale of scrap, etc. are to be considered as accounts to be reflected within $R_1$ or $R_2$.

Item $R_3$ will correspond to the addition of all the proceeds of sales of fixed assets. It is our understanding that this information can be easily deduced from the accounting records and it is generally disclosed either in the notes on the accounts or in the annual report although such disclosure is not mandatory in all member States.

ii) Minus, Outflows:

Item $Ɍ_1$, will correspond to the addition of all accounts relating to purchases of raw materials and consumables, including the cost of production work performed by third parties.

Item $Ɍ_2$, will correspond to the addition of all the accounts relating to staff costs (wages, salaries and related social security costs) and to other operating charges excluding amortization, depreciation and operating provision charges.

Item $Ɍ_3$, will correspond to the addition of all the purchases of fixed assets (tangible and intangible but excluding financial assets and goodwill). For this purpose, items that are capitalized as work performed by the undertaking on its own assets should not be considered as a purchase of assets because the real outflow of funds is reflected within the accounts relating to purchase of materials, staff costs and other operating charges which are to be included as $Ɍ_1$ or $Ɍ_2$ items.

After this description of methods a) and b) of obtaining the "R" base from the accounting records, it is necessary to point out that their result is not conceptually correct. A flow of funds base requires strictly that inflows and outflows should be accounted for on a cash basis, not on an accrual one. This, however, is impossible since accounting records follow the accrual principle.

The necessary adjustments to pass the "R" base from an accrual to a cash basis would mean, in practice, the use of an "R + F" base (see below and in Chart 1). Therefore, we accept the result of methods a) and b) as an "R" base, albeit conceptually flawed.

The main advantage of using the "R" flow of funds tax base is that the specific accounting information to be used refers to items or accounts with a more harmonized regulation. This is due to the fact that most of the items included within the "R" flow of funds are items which represent either real costs (outflows) or real revenue (inflows) being excluded those internal charges (or income) related to valuation, depreciation, provisions (possibly excluding bad debts), etc. which are affected by the previously studied problems of insufficient accounting harmonization within the EU. At the same time the stimulation of investment implicit in the flow of funds concept is a political and economic plus.

On the other hand, a problem with the "R" flow of funds base is that it can not be applied to financial institutions which rather than selling "real" goods and services, do business through financial transactions. This forces the use of a separate "corporate" tax or "accounting profit or losss" tax for financial institutions, or to tax financial transactions separately.

The latter problem may be overcome if the tax base is the excess of inflows over outflows of funds in respect of both "real" and "financial" transactions, whether these transactions are on current or capital account (the "R + F" base - see chart 1-R+F-~~R-F~~). But in this particular case the financial profit or losss, which is the added information to be derived from the accounting records, would have to be adjusted by:

- the subtraction of income from equity interest, to avoid double taxation.

- all the adjustments derived from the changes in creditors, debtors, cash and banks, borrowing/lending and equity interest.

In fact, the "R + F" basis requieres:

- to add all reductions of financial reserves, amounts borrowed and interest received.

- to substract all additions to financial reserves, amounts loaned and interest paid.

to the financial profit and loss account.

All the adjustments needed to the accounting profit or loss, both for the "R" and the "R+F" basis, make the case for the use of the latter concept as the basis of a fifth Community resource weak. The lack of previous administrative and business experience with these concepts is also a big drawback.

Nevertheless, the working of the flow of funds of corporations produces a third concept (the "S" base, following the terminology of the Meade report). Since, for a corporation, the total inflow of funds must equal to the total outflow of funds, any net receipt of funds from "real" and "financial" transactions must go either to the shareholders or to the tax collector. This means that the "R+F" flow of funds tax base is equal to the net amount of cash flowing out of the corporate sector of the economy on account of share capital (see chart 1, base S being _-S). In other words the "S" base includes:

- own dividends payments less dividends received from other corporations resident in the EU (to avoid double taxation)

less:

- the issue of new own shares minus the reduction in own shares issued

plus:

- the increase in holdings of shares in other corporations minus the decrease in holdings of shares in other corporations.

The latter "plus" adjustment is a device to avoid tax strategies and double taxation. In the words of the Meade Report (p. 234):

> "*The addition of this term* (our "plus" adjustment) *is simply a means of avoiding double taxation or double tax relief. In its absence there would exist obvious avoidance devices of the following kind. At the close of each tax year corporation A issues shares to corporation B, which issues shares to corporation A on a scale which would be sufficient to wipe out their tax liabilities if each corporation received a tax remission on its own newly issued shares without incurring a tax liability on its new holding of the shares of the other corporation*".

An advantage of the "S" base is that it can also be applied to financial institutions as well as to any other corporation. Another advantage is its simplicity and the fact that it can be administered on an uniform fiscal-year basis which would be convenient in order to prevent avoidance schemes like the one just mentioned. The "S" base admits adopting a common fiscal year without the need for corporations to change their accounting periods. On the other hand, contrary to the corporation income tax that has a tax-inclusive rate, the "S" base would be taxed at a tax-exclusive rate (which means that, to obtain the same amount of revenue, the tax rate has to be nominally higher in the tax-exclusive case). The "S" base is neutral with regard to future forms of investment if, in the event that the tax base is a negative amount, it is carried backward or forward at an appropriate rate of interest (this is also applicable to the "R" and "R + F" basis). Negative tax basis will appear in this case when equity issues exceed dividend payments (when a company is first quoted or when it issues new share capital for new investments). The "S" base may possibly be an appropriate base for a fifth Community resource, its main drawback being the explicit taxation of dividend payments although adjusted by other components of the base.

### *4.3 An alternative to base "R": the balance of real operations*

Since the Meade Report a good number of papers and books have been written on the subject of the taxation of expenditure and the flow of funds of corporations. Part of the work has aimed at simplifying the application of this kind of taxation. A good simplification could be the result of the following.

Given the accounting problems that we have already considered when dealing with the accounting profit or loss and the difficulties of the adjustments necessary to obtain the "R" base, an alternative would be to make use of the information arising from VAT.

The tax we are thinking of would be a tax on corporations, on a yearly basis, established on real transactions in the way the latter are defined for VAT purposes Europe wide. The estimation of the base would be made in accordance with VAT rules as the difference between:

- sales that imply output VAT and sales that give the right to deduct input VAT (intracommunity transactions, exports and non-exempt services).

less: all purchases (including fixed assets) that imply a deduction of input VAT, and

- less wages, salaries, social security charges and related items such as Pension Plan payments deductible for national corporate income tax purposes, and all deductible taxes for national corporate income tax purposes.

One should quickly point out that the tax objective of this balance of real operations (BRO) base is completely different to the objective of VAT. In the latter case it is mainly consumption and in the former it is profits. This justifies the application of VAT by transaction and of BRO on a yearly basis within a business operation. The relevant point in this respect is that VAT legislation and administration could be used to estimate the new tax base, which would be closely coordinated with VAT.

In general terms, the BRO base would be sales which give the right to deduct input VAT less purchases with deductible input VAT less personnel costs (the deduction of which would follow the deductibility rules of national corporate income taxes). Many of the country divergences studied in section 3 with regard to the profit and loss account disappear.

In the BRO base it would not be permitted to deduct purchases on which the VAT is not deductible under VAT legislation. On the other hand, self-consumption of goods and services would be taxed even though no cash flows are implied. The BRO base implies a source criterion while the corporation income tax implies, in theory, a residence criterion for international transactions.

The main difficulty of the BRO base is that VAT-exempt corporations could not be taxed. This is the same problem as with the "R" base with regard to financial corporations. Therefore, for financial entities and VAT-exempt corporations in general, either an accounting base or an "S" base should be used. So the drawback of the BRO base is that the help derived from VAT administration could not be used either for the taxation of financial institutions or for that of all corporations conducting VAT exempted business. In this respect, and in comparison to the "R" base, the number of corporations not covered by the BRO base would be larger.

## 5. Final recapitulation and conclusion

The first indicator studied was the current national income tax bases. The lack of harmonization in this case, and the corresponding lack of equity, derive mainly from the "tax competition" process which has taken place in Community countries over recent years. This process has, on the one hand, "spontaneously" alligned national corporate income taxes; but, on the other, it has also generated divergences in areas such as:

- depreciation/amortization for tax purposes, plus the use of accelerated depreciation/amortization
- tax incentives
- capital gains and losses, or
- tax loss set-off

which added to the underlying divergences existing in the formation of the profit and loss account, make the case of present national corporate income tax bases as indicators of EU corporation's contributive capacity very weak. Corporation tax directives would be needed to change this situation and to promote a convergence of European corporate income taxes, which may be a desirable objective in itself.

The accounting profit or loss is not free from difficulties for our purposes. But, in comparision with corporate income tax bases, the profit and loss account as an indicator of corporation contributive capacity in the EU presents less divergences. In this sense, the accounting profit or loss is a better indicator.

The accounting profit or loss of corporations is simple for tax payers to understand and to comply with and for national tax administrations to manage and control. It means very small modifications in the existing corporate taxes and adding one extra page to corporate tax returns would be sufficient for tax administration purposes. Nevetheless, the level of accounting harmonization found in the formation of the profit and loss account is also insatisfactory for the purposes we have. A strong accounting harmonization effort would be necessary in order to use equitably the profit and loss account as the basis of a fifth Community resource.

An analysis of other indicators of corporation's contributive capacity shows that the net wealth of corporations should be disregarded for mainly economic reasons.

A different view should be taken, however, with regard to the taxation of the flow of funds of corporations. Since, applying this concept, income is not taxed if it is reinvested, taxing the flow of funds of corporations gains good economic and political marks.

At the same time, using the real ("R") flow of funds base eliminates a good number of the divergences arising from the use of the accounting profit or loss as an indicator of corporation's contributive capacity. Since the "R" base excludes internal charges (or income) related to valuation, depreciation, provisions (possibly excluding bad debts), etc., it can be concluded that, in this sense, it is a better indicator for our purposes than the accounting profit or loss. In addition, the information needed for the "R" flow of funds base can be easily obtained from the accounting records using any of the two ways explained above, and, therefore, has the same administrative advantages than the accounting profit or loss as a basis of a fifth Community resource.

The problems of international coordination that arise with the unilateral adoption of a flow of funds concept as a tax base are clearly reduced in our context if a Community Tax is a deductible item for national corporate taxes. Tax coordination of international investments is already considered, with a better or worse approach, nationally. The same may be argued with regard to the problems of integrating corporate and personal taxes. To tax the flow of funds of corporations is internally neutral, being, therefore, designed to fit in a "classical system" relationship of corporate and personal taxes. National corporate and personal income taxes will be integrated, or not (the Dutch case), and the deductibility of a Community Tax for national corporate taxes lessens the problem.

Considering now the variant of the "R" base that uses VAT administrative information, the BRO base, its main difficulty is the number of corporations that fall outside the scope of the base due to VAT exemptions. In any case, the BRO base might be used as an alternative to the "R" base for non-VAT exempt corporations. A similar difficulty faces the "R" base in the sense that it can not be applied to financial institutions. If an "R" base is chosen, financial institutions should either be taxed in accordance with the accounting profit or loss, following the "S" flow of funds base or taxing financial transactions independently.

The "S" flow of funds base is in fact an "R+F" base and can be applied to all corporations, not having a limited scope. It is also a simple base with the main economic and political drawback of taxing adjusted dividends paid.

In our view, either an "S" flow of funds base is selected as an indicator of corporation's contributive capacity in the EU or the choice should be an "R" flow of funds base (complemented with an independent tax for financial institutions), if a corporate base is wanted as a basis of a fifth Community resource. The "S" base is possibly not so simple to understand as the R base and, although, in fact it is also conducive to corporate investment, it presents the difficulty of explicitly taxing dividends with the corresponding adjustments mentioned above.

No tax base is perfect or equitable in a national setting, so in an international context it will be even less so. The "R" base may be the best measure -Europe wide- of the contributive capacity of corporations and, therefore, the most appropriate to serve as a tax base of a possible fifth Community resource, even though its difficulties are considerable. Ranking probably at the same level, also with a good number of difficulties, the alternative is the "S" base. Since the "S" base is equal to an "R + F" base, but has less administrative complications, we rank the former over the latter. The use of the profit and loss account or of present corporate tax bases for Community tax purposes requires a process of accounting and tax harmonization. In a summary below we highligt the main pros and cons of the different tax bases considered.

The results of our study indicate that, at present, there is no perfect, or even good, corporate tax base for a fifth Community resource. This, however, does not mean that we are at an "endgame". Problems and difficulties are always present in the tax field, as in other economic and social areas. Political considerations and financial needs should also enter the stage.

We believe that the flow of funds concept -especially the "R" and "S" basis- deserve further study. Given the matter discussed, decisions and recommendations are obviously complex to take and make. From our part we would recommend a closer consideration of the "R" and "S" tax bases, since sufficient accounting and tax harmonization may be impossible for the time being.

# SUMMARY

## MAIN ADVANTAGES AND DIFFICULTIES

## OF DIFFERENT INDICATORS OF THE CONTRIBUTIVE CAPACITY OF CORPORATIONS IN THE E.U.

## TO SERVE AS THE BASIS OF A FIFTH COMMUNITY RESOURCE.

| BASE | ADVANTAGES | DIFFICULTIES | RECOMMENDATIONS |
|---|---|---|---|
| A. "R" | A.1 Incentive to investment and tax neutrality<br>A.2 Simple to administer<br>A.3 More equitable than D or E | A.1 Incentive to excesively retain earnings<br>A.2 Not on a cash basis, since use is made of accounting records<br>A.3 International context<br>A.4 Not applicable to financial institutions | FURTHER<br>STUDY |
| B. "S" | B.1 A.1, A.2 and A.3<br>B.2 Applicable to all corporations<br>B.3 Administration on an uniform fiscal year basis | B.1 A.1 and A.3<br>B.2 Use of a nominally higher tax exclusive rate<br>B.3 Explicit taxation of dividend payments although adjusted by other components of the E.U. | |
| C. "R+F" | C.1 A.1, A.3 and B.2 | C.1 A.1 and A.3<br>C.2 More complex to implemento than A or B | |
| D. P&L ACCOUNT | D.1 A.2 and B.2 | D.1 Insufficient harmonization<br>D.2 Known tax problems | HARMONIZATION<br>PROCESS |
| E. CORPORATE TAX | E.1 A.2 and B.2 | E.1 D.1<br>E.2 D.2 | |

## Notes

1..See article 10 of Council Decision of 31 October, 1994 on the system of the European Communities' own resources (94/728/EC, Euratom) and article 2 (2) of the Decision of the Council of 24 June 1988 (88/376/EEC, Euratom).

2.. - classical system -no reduction of double taxation- (The Netherlands)
- exemption of the dividend received by the shareholder who is a natural person (Greece)
- application of reduced tax rates in the taxation of the shareholder who is a natural person (Austria, Belgium, Denmark, Luxembourg, Sweden and, optionally, Portugal).
- total or partial imputation formulae (Spain, Finland, France, Ireland, Italy, United Kingdom)
- application of a system with two tax rates (Germany, which is globally similar to an imputation system), or
- the use of tax credits (Portugal).