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Hearing "Tax Reform: Examining the Taxation of Business Entities"

Testimony: "Introduction into the Western European tax systems and the choice between taxable corporations and tax exempt pass-through entities"

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Good morning, Chairman Baucus, and members of the Committee.

I appreciate the opportunity to be here today to discuss the taxation of business entities and especially the question why -compared to the United States- relatively little use is made of pass-through entities for regular business ventures in most Western European countries

I see four possible reasons:

1. In some jurisdictions, the less defined legal position of pass-through entities with respect to legal ownership and protection against liabilities is a major obstacle for their use as business entity;
2. The international environment wherein most European businesses operate requires more certainty with respect to the tax and legal treatment of the entities by the countries involved;
3. The relatively low corporate tax rates in Europe as compared to individual income tax rates make the use of corporations more attractive; and
4. The availability of tax facilities for corporations as a result of EU direct tax measures makes corporations the most suitable entities for expansion in the EU internal market.

I will discuss these reasons now in more detail.

1. The less well defined legal position of pass-through entities in certain countries.

There exists a wide variety of entities treated as pass-through vehicles for tax purposes in most European countries. The most well known are the (limited) partnerships. In some countries legal characteristics of these entities may make them unsuitable for ordinary larger businesses. In The Netherlands, for instance, a partnership lacks legal personality and can as such not hold title to assets of the business. A corporate entity has a separate legal personality and offers the advantage of the ability to hold legal title. In The Netherlands, this type of entity is normally more attractive to investors and entrepreneurs than an entity without these characteristics. It should be noted that the legal position of entities normally considered as pass-through entities is quite different in each of the European jurisdictions and in some jurisdictions the described disadvantages may not or to a lesser extent exist.

2. The international environment for European businesses requires tax and legal certainty on a cross-border basis

The environment wherein European and US businesses are set up and expand is fundamentally different. The economy of the United States is the world's largest national economy with a GDP that was estimated to be over US $15 trillion in 2011. It is true that the economy of the European Union generates a GDP that is over US $17 trillion. However, that internal market for goods, capital and (to a lesser extent) services, is still carved up by the not-completely harmonized tax and legal systems of 27 different member states. Most small and medium sized US enterprises can for an extended period expand in the US market only, while many small and medium sized European enterprises, already at an early stage of their expansion, must invest in multiple jurisdictions throughout the European Union and face the consequences of the application of foreign tax and legal systems.

Since pass-through entities may face a different tax treatment in other jurisdictions, doing business internationally through these vehicles may bring uncertainty with respect to the tax treatment as compared to the use of a straight forward corporate vehicle.

The following is a brief summary of the tax uncertainties with respect to pass-through entities used for cross border investments or the raising of capital

Different Classification in Different Jurisdictions

The most complicated issues arise if an entity is classified for tax purposes as a corporation in one jurisdiction and as a partnership in another jurisdiction, leading to completely different tax results. Even if a jurisdiction classifies an entity the same way as another jurisdiction, the tax treatment may still differ. This well known issue occurs when one jurisdiction treats a partnership as a transparent entity, imposing no tax on the partnership itself, but on its partners, while the other jurisdiction treat that partnership as a taxable entity, taxing the partnership as a corporation.

There are many other examples that result in double taxation because of these differences in classification and tax treatment. For instance, some countries may accept that a partner may also be a creditor of the partnership and may therefore derive interest income from the partnership, while other countries consider that no interest may be paid to a partner, and any payment of what purports to be interest is treated as a distribution of the income of the partnership.

Classification Issues under Tax Treaties

When a business is operating in several countries (and therefore subject to different tax systems), another important issue with respect to the use of pass- through entities is the applicability of tax treaties.

The issue of applicability of the tax treaties to fiscally transparent entities is widely acknowledged. Tax treaties generally only apply to persons who are residents of one or both of the contracting states. In the OECD Model Convention, used as model for most bilateral tax treaties, a person is defined as 'an individual, a company and any other body of persons'. A company is defined as 'any body corporate or any entity that is treated as a body corporate for tax purposes'. In other words, if a non-corporate entity is treated as a body corporate, it will qualify as a person. In its Partnership Report published in 2000, the OECD finally confirmed that a partnership should be considered a person within the meaning of the OECD Model Convention. However, the position of other non-corporate entities such as trusts and other associations of persons is less clear.

Even assuming that all non-corporate entities should be qualified as persons within the meaning of a tax treaty, such entity should also be considered a resident of a contracting state in order to enjoy treaty protection. A resident is defined in the OECD Model Convention as 'any person who, under the law of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of similar nature…'. It is generally accepted that 'liable to tax' does not mean that tax is actually levied; entities that are fully exempt from tax could still be considered residents, as long as that state could assert jurisdiction to tax the entity on its world wide income. However, if a partnership is considered as tax transparent

in a contracting state, the partnership is not liable to tax in that state and so cannot be considered a resident for purposes of the Treaty.

Taxable presence in the country wherein an investor/partner is resident

Should an investor/partner of a pass-through entity be resident of another country than the country wherein the entity is situated then, under the specific circumstances of a case, the entity may be considered to have a taxable presence (“place of business”; “permanent establishment/agent”) in that other country.

3. Relatively low corporate income tax rates as compared with individual income tax rates.

In most European countries, personal income tax rates are significantly higher than corporate income tax rates. The use of a corporate entity allows for the deferral of the imposition of personal income tax until the business income of the corporation is distributed as a dividend or an interest in the corporation is sold (in the latter case a special capital gains rate may apply). The present value of the personal income tax will be low as long as the business is expanding and the corporation reinvests its profits.

Nevertheless it must be recognized that the income of the business is in principle subject to tax at both the corporate and the individual shareholder level. In the past a number of European countries mitigated this so called “economic double taxation” through the introduction of systems integrating the imposition of corporate and individual income taxes. For example, Germany introduced different corporate tax rates in 1953 for distributed (36%) and retained earnings (50%) The most well known of these integration systems are the “imputation systems” (introduced by France first in 1965, followed by the United Kingdom (1973) , Italy, Ireland and Denmark) allowing the shareholder to credit, in various degrees, corporate income tax paid by the corporation against his personal income tax liability with respect to dividends received. The problem with these systems in an EU context is that they tend to exclude foreign source income and foreign shareholders with respect to the granting of the imputation credit. The European Court of Justice (ECJ), in several decisions, found these aspects therefore discriminatory and a violation of the fundamental freedoms of establishment and capital movement enshrined in EU law as the backbone of the internal market. As a result most countries have largely abandoned these systems and fell back on the “classical system” wherein business income of a corporation is taxed at both the corporate and individual income tax level (albeit that in many countries special personal income tax rates apply for dividend income).

The resulting economic double taxation has, however, been mitigated as a result of a significant reduction of corporate income tax rates in almost all European countries. This reduction has been caused by a severe competition for investments between member states. Since the Single Market was completed by the end of 1992 (result of especially the 1988 Single European Act), substantial cross border investments took

place within the EU (and into the EU), and member states have competed for these investments by offering benefits, largely by reducing corporate tax rates. More focused tax benefits run the risks to be characterized as prohibited "state aid" or as being in conflict with the so called "Code of Conduct"). For instance the low Irish corporate tax rate of 12.5 percent is allowed but the tax facilities available for Irish "International Financial Services Centres" constituted State Aid (albeit declared compatible with the internal market by the Commission till 2006).

In other words, corporate income tax rates are currently relatively low, mainly as a result of this form of "tax competition" among the member states of the Union. Consequently, the double economic taxation attached to the classical system of taxation of corporate business income, as applied by most member states, has been significantly mitigated. Below is a chart that compares the highest tax rates for corporate income and personal income in six member states:

Jurisdiction	**Corporate income tax rate %(top bracket)** *investment through a corporation*		**Personal income tax rate % (top bracket)** *investment through a tax transparent partnership*	
Year	**1992**	**2012**	**1992**	**2012**
The Netherlands	35	25	60	45.76
United Kingdom	33	24	40	50
France	34	36.1	56.5	64.25
Germany	58.15	30.85	53	45
Ireland	40	12.5	52	48
Italy	52.2	27.5	51	43

Sources: "IBFD", "OECD 2010: Revenue statistics comparative tables, OECD tax database" and "1975-1999: World Tax Database, Office of Tax Policy Research"

4. EU law based tax benefits exclusively available for corporations.

As noted (see 2), a major difference between a US business and a similar European business is the fact that the latter operates in a market that to a large extent is single but nevertheless retains elements (tax, legal systems) of a combination of separate national markets.

However, especially in the tax area (but also in the corporate law area – the so called corporate law directives), a process of "harmonization" is taking place. This process is partly directly initiated by EU law and partly the result of tax competition among the member states.

The EU law initiated benefits concern tax facilities adopted in the legislation of member states on basis of EU Directives (a EU legislative instrument requiring member states to introduce national legislation with a content outlined in the Directive). The most important directives are the 1990 Parent-Subsidiary Directive and the 1990 Merger Directive. The first Directive reduces withholding taxes paid by a EU parent to a EU parent company to nil. The second Directive allows tax free mergers and reorganizations between EU based businesses. The facilities based on the Directives are only available to entities taxed as corporations (at the time of introduction – 1990 – only corporations; later, respectively in 2003 and 2005, extended to entities taxed as corporations). Consequently, for instance, a tax free reorganization of a cross border business carried on by corporations is easier to achieve than such business carried on by pass-through entities.

A degree of tax harmonization is also taking place as a result of tax competition. An example is the introduction of a territorial system of taxation by most member states. Originally The Netherlands and France were rare examples of countries exempting foreign source business income (dividends received from a foreign subsidiary) from corporate income tax (the so-called participation exemption in The Netherlands). Almost all member states have now replaced their “world wide” income tax concept by a territorial tax income concept. In other words replacing their credit systems with an exemption system (in some countries – Germany, Belgium, France, Italy, - 95% of dividends received are exempt). The UK was one of the last member states to introduce an exemption system for capital gains in 2002, extended to dividends in 2009. Ireland still holds out and applies a (severe) credit system.

There exist good arguments to claim that an exemption system for foreign source business income, emphasizing “capital import neutrality”, fits better in with the internal market concept. It could even be argued that the complexity a credit system (emphasizing “capital export neutrality”) usually brings is as such an obstacle to investments elsewhere in the internal market. It is, however, unlikely that the ECJ would find the application of a credit system to foreign source business income as such a violation of the freedom of establishment.

It is likely that tax competition for investments among the member states since the establishment of the internal market in 1992 has caused most member states to replace their credit systems with an exemption system. Countries applying a credit system are not considered a suitable base for a possible later expansion of a business to other member states of the Union.

It is noted though, that almost all member states, applying an exemption system in principle, do maintain a credit system with respect to controlled foreign corporations realizing “passive income” (e.g. interest income). The ECJ does allow in cases of “abuse”(no “substance”/”wholly artificial arrangements”) members states to apply a credit system and even to tax the foreign income of these subsidiaries on a current basis in the hands of the domestic corporate parent company.

The combination of EU law based tax facilities for corporate cross border investments, reorganizations and mergers combined with the gradual introduction of territorial (exemption) systems by member states with respect to foreign source business income, is for businesses in Europe an important reason to prefer the use of corporations over pass-through entities.

This concludes my testimony and I would be happy to answer any questions you might have.

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