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NOTE FROM THE CHAIR

To:	Code of Conduct Group (Business Taxation)
on:	4 and 5 October 2000
Subject :	Code of Conduct (Business Taxation) - Grandfathering - Rollback and standstill: draft guidance and background paper on finance branches, holding companies and headquarter companies

Delegations may find attached three items from the Chair for the meeting on 4-5 October.

The first short note on grandfathering is intended to complement the paper from the Commission services on issues for rollback.

The other two items are those agreed on at the last meeting for discussion under item 2 on the agenda (finance branches, holding companies, headquarter companies).

ANNEX A

GRANDFATHERING

INTRODUCTION

At its meeting on 4 April 2000 the Code Group asked the Commission Services to provide legal advice on certain issues relating to the interaction between the rollback of measures and the State aid rules. A paper entitled 'Issues related to the rollback process under the Code of Conduct (Business Taxation)' (SEC(2000) 1539) has now been circulated. It makes a valuable contribution to the Group's intended discussion of the issue of grandfathering on 4 October. This short note complements that paper and seeks the views of Member States on possible approaches to the timetable for rollback and on the grandfathering of existing situations.

The Minutes Statements to the ECOFIN Council Conclusions of 1 December 1997 record that:

> *The Council and the Representatives of the Governments of the Member States, meeting within the Council, as well as the Commission note that standstill and rollback are closely inter-related and stress the need for a balanced application to comparable situations, without this delaying the implementation of standstill and rollback. They also consider that a period of two years , as a general rule, should be sufficient for rollback. As from 1 January 1998 the actual rollback will have to take place within five years although a longer period may be justified in particular circumstances following an assessment by the Council.*

There will be further discussion under the second agenda item of the meeting of 4-5 October of the issues involved in ensuring a balanced application to comparable situations.

The issue for discussion under the first agenda item relates to the timetable for rollback and the interpretation of this Minutes Statement in that context.

As far as the timetable is concerned, the Minutes Statement makes four clear points:

1. Balanced application to comparable situations should not delay rollback.
2. As a general rule two years should be sufficient for rollback.
3. Actual rollback will have to take place within five years from 1 January 1998 (i.e. by 1 January 2003).
4. In particular circumstances an assessment by the Council may justify a longer rollback period.

Member States are aware from earlier discussions in the Group that some measures that have been given a positive evaluation in the November Report have given rise to existing contractual or administrative obligations for a fixed period of time although this is not the case with all such measures. The paper tabled by the Commission Services offers some comments on the issues of legitimate expectations and the rollback process.

Following discussion in the Group on the approach to the timetable for rollback and the issue of grandfathering the report of the High Level Group on Taxation (8998/00 FISC 73) to the ECOFIN Council was made in the following terms:

- *no new approvals should be accepted under these regimes, or*
- *if any projects are approved they should not benefit from these measures after 31 December 2002.*

This note sets out a number of options that could be considered in relation to rollback and grandfathering, bearing in mind the Minutes Statement to the 1 December 1997 conclusions of the ECOFIN Council.

In addressing these issues, Member States will also be aware that agreement has been reached in the following terms to establish a parallel timetable for the three elements in the tax package.

i. The report of the ECOFIN Council to the European Council at Feira (9034/00 FISC 75) includes the statement:

Work shall be pursued on this basis with a view to reaching agreement on the tax package as a whole, according to a parallel timetable for the key parts of the package (Taxation of savings, Code of Conduct (Business Taxation) and Interest and Royalties).

ii. The Presidency Conclusions from the European Council at Feira include the statement:

The European Council requests the ECOFIN Council to pursue with determination work on all parts of the tax package so as to achieve full agreement on the adoption of directives and the implementation of the tax package as a whole as soon as possible and no later than by the end of 2002.

The timetable for the Directive on Savings has now been established. The Annex to the report of the ECOFIN Council to the European Council at Feira (9034/00 FISC 75) states:

The ECOFIN Council and Commission have committed themselves to seeking agreement on the substantial content of a Directive on savings, including the rate of withholding tax, by the end of the year 2000.

Paragraph 2c) of the report also includes the statement:

Once sufficient reassurances with regard to the application of the same measures in dependent or associated territories and of equivalent measures in the name countries have been obtained, and on the basis of a report, the Council will decide on the adoption and implementation of the Directive no later than 31 December 2002, and do so by unanimity.

Member States will also be aware of the timetable for the separate OECD process on harmful tax competition. The guidelines for dealing with harmful preferential tax regimes in member countries approved by the OECD Council on 9 April 1998 call for the removal of harmful features of preferential tax regimes before the end of five years (by April 2003). The grandfathering clause for taxpayers benefiting from such regimes as at 31 December 2000 states that benefits from such schemes will be removed at the latest by 31 December 2005.

ISSUES FOR DISCUSSION

The Commission paper (SEC(2000) 1539): The Commission paper sets out the rollback process foreseen in the Council conclusions of the ECOFIN Council of 1 December 1997. The paper discusses the impact of the State aid rules on the rollback process and concludes that decisions taken by the Commission should not be an obstacle to rollback. It also addresses the issue of co-ordination with the timetable set by the OECD forum on harmful tax competition.

Member states are asked whether they wish to comment on the paper.

Cut off dates for new entrants and for the expiry of benefits for beneficiaries: As noted above, Member States have expressed a wish to reflect on the following issues relating to grandfathering in the context of rollback:

- the cut off date for new entrants into these regimes;
- possible transitional arrangements for new entrants and existing beneficiaries.

In this context it may be helpful for Member States to be reminded of the substantial content of paragraphs 18 and 19 of the Commission paper (SEC (2000)1539) which describe the agreed phase-out of three Irish measures under the State aid rules (10% rate for the manufacturing sector, the Shannon airport zone and the international financial services centre in Dublin) which are considered by the Commission no longer to be compatible under the State aid provisions of the Treaty.

The Commission decided that some companies can continue to benefit from the measures for a certain period of time: in the period to 31 December 2010 for manufacturing and in the period to 31 December 2005 for the other two schemes. As part of the transitional arrangements, the Commission has also decided that entirely new projects and new projects implemented by existing companies will cease to benefit after 31 December 2002.

Taking into account issues of the tax package as a whole, there are a number of options for Member States to consider for the elimination of measures found harmful under the Code:

i. **Cut off date for new entrants:** 31 December 2000;
Expiry of benefits for beneficiaries existing at 31 December 2000: 31 December 2002.

This option reflects the report of the ECOFIN Council to the European Council that agreement will be reached on the substantial content of a directive on the Taxation of Savings by the end of this year and that the Council will decide on the adoption and implementation of the directive not later than 31 December 2002.

ii. **Cut off date for new entrants:** 31 December 2002;
Expiry of benefits for new entrants receiving approvals between 1 January 2001 and 31 December 2002: 31 December 2002.
Expiry of benefits for beneficiaries existing at 31 December 2000: 31 December 2005 or, in the case of companies given time-limited approvals before 31`December 2000, the date up to which time-limited approval has been granted.

iii. **Cut off date for new entrants:** 31 December 2002;
Expiry of benefits for all beneficiaries existing at 31 December 2002: in the case of companies given time-limited approvals before 31 December 2002, the date up to which time-limited approval has been granted.

iv. **Cut off date for new entrants:** 31 December 2002;
Expiry of benefits for all beneficiaries existing at 31 December 2002: expiry on an agreed date, whether or not time-limited approval has been granted (eg 7 years from 31 December 2002 or 10 years from 31 December 2002).

Member States will wish to address the issue of whether all measures should be dealt with in the same way or whether measures which involve the granting of a specific time-limited approval should be treated differently.

If the Group decides to recommend dates as from 1 January 2003 this might require justification following an assessment by the Council as set out in the Minutes Statements to the ECOFIN Council Conclusions of 1 December 1997.

Member States are asked to comment on these options as presented.

Member States are asked whether there are other options which, in their view, ought also to be considered.

ANNEX B

ROLLBACK AND STANDSTILL - DRAFT GUIDANCE ON FINANCE BRANCHES, HOLDING COMPANIES AND HEADQUARTER COMPANIES

Introduction

1. To facilitate rollback of measures that the Group has found to be harmful, and to help Member States ensure that they do not introduce new or replacement regimes that contain harmful features, the Group at its meeting on 20 September felt that it might be helpful to have guidance in the 3 areas of finance branches, holding companies and headquarter companies.

Rollback and Standstill

2. Rollback may take the form either of:

- the abolition of a measure; or

- the removal of the harmful features of a measure.

3. In the case of the first approach (abolition), the action to be taken is clearly self-evident. In the case of the second approach (amendment), rollback will require the identification and removal of the harmful features.

4. Standstill means not introducing a new or replacement measure that contains harmful features.

5. Guidance on rollback and standstill would not replace the Code. The Code sets out the criteria agreed unanimously by ECOFIN for determining whether or not a measure is harmful. The purpose of guidance would be to set out features which, if present in a measure in the 3 areas, would mean that the measure was harmful under the criteria in the Code. Such features would need to be removed (either by complete abolition of a measure, or by removal of the harmful features) in order to achieve rollback. In order to achieve standstill, Member States would have to avoid including such features in new and replacement measures.

6. The Group in its November 1999 Report set out the features that it had taken into account in deciding that measures in the 3 areas are harmful. Those features, rooted in the Code, derived from the Group's discussion of the papers presented by the Chair at the Group's meeting in Fiuggi.

7. The attached note sets out in the form of draft guidance the features identified in the Group's 1999 Report as being harmful under the Code.

Are Member States happy with the format of the draft guidance?

Does the draft guidance adequately reflect the relevant features identified in the 1999 Report?

8. Member States will note that the attached guidance is limited to the basis of evaluation given for the specific measures in the November 1999 Report.

Are there any other features that should be included in the guidance bearing in mind that the criteria in paragraph B of the Code provide a framework for assessing whether tax measures might be considered harmful?

DRAFT GUIDANCE ON ROLLBACK AND STANDSTILL

1. The purpose of this guidance is to assist Member States in achieving a balanced approach to rollback and standstill of measures which the Code of Conduct Group has found to be harmful in the 3 areas of finance branches, holding companies and headquarter companies.

2. The guidance does not replace the Code. The Code sets out the criteria agreed unanimously by ECOFIN for determining whether or not a measure is harmful, and final evaluation of whether or not the rollback and standstill conditions in the Code are satisfied must therefore be made against the criteria in the Code itself.

3. The Council and the representatives of the governments of the Member States, meeting within the Council, agreed on the scope and coverage of the Code of Conduct and established the criteria on which the Group should base its assessment of tax measures in the following terms:

A. *Without prejudice to the respective spheres of competence of the Member States and the Community, this code of conduct, which covers business taxation, concerns those measures which affect, or may affect, in a significant way the location of business activity in the Community.*

Business activity in this respect also includes all activities carried out within a group of companies.

The tax measures covered by the code include both laws or regulations and administrative practices.

B. *Within the scope specified in Paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code.*

Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor.

When assessing whether such measures are harmful, account should be taken of, inter alia:

1. *whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or*
2. *whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base, or*
3. *whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or*
4. *whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD, or*
5. *whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way.*

4. The code adds:

C. Member States commit themselves not to introduce new tax measures which are harmful within the meaning of this code. Member States will therefore respect the principles underlying the code when determining future policy and will have due regard for the review process referred to in paragraphs E to I in assessing whether any new tax measure is harmful.

D. Member States commit themselves to re-examining their existing laws and established practices, having regard to the principles underlying the code and to the review process outlined in paragraphs E to I. Members States will amend such laws and practices as necessary with a view to eliminating any harmful measures as soon as possible taking into account the Council's discussions following the review process.

5. It was further agreed that the Code of Conduct Group (Business Taxation) would select and review tax measures for assessment in accordance with Paragraphs E to G of the Code.

6. Paragraph F requires that the *assessment will take account of all the factors identified in paragraph B* and paragraph G *emphasizes the need to evaluate carefully in that assessment the effects that the tax measures have on other Member States* inter alia *in the light of how the activities concerned are effectively taxed throughout the Community.*

7. Paragraph G also states that *Insofar as the tax measures are used to support the economic development of particular regions, an assessment will be made of whether the measures are in proportion to, and targeted at, the aims sought. In assessing this, particular attention will be paid to special features and constraints in the case of the outermost regions and small islands, without undermining the integrity and coherence of the Community legal order, including the internal market and common policies.*

8. The Group presented a Report in November 1999 setting out its assessment of measures which it had evaluated against the criteria in the Code.

9. Rollback of a measure that the Group has found to be harmful may take the form either of :

- abolition of the measure; or

- removal of the harmful features of the measure.

10. Standstill means not introducing a new or replacement measure that contains harmful features.

11. The features set out below have led to measures in the areas of finance branches, holding companies and headquarter companies being evaluated as harmful under the criteria in the Code. Under rollback, Member States will either have to abolish such measures that have been found harmful, or remove from the measures the harmful features listed below. Under standstill, Member States will have to refrain from introducing new or replacement measures that contain such harmful features.

12. The features listed below do not replace the criteria set out in the Code. They are features that the Code of Conduct Group has taken into account in evaluating whether measures are harmful under the criteria in the Code. The final evaluation of whether or not the rollback and standstill conditions are satisfied must be made against the criteria in the Code itself.

Finance Branches

- Allocation of less than the arm's length profit to the Head Office. This may arise for instance where the allocation is made in a formulaic way.

- Exemption of branch profits by the country of the Head Office in cases where the level of taxation in the country of the branch is significantly lower than in the country of the Head Office.

Holding Companies:

- Exemption of foreign source dividends in circumstances in which the profits giving rise to the dividends:

    - have been taxed at a significantly lower level in the source country than they would have been if they had arisen in the Member State; <u>and</u>
    - have not been subject to CFC legislation in the Member State.

- Exemption of capital gains on the disposal of subsidiaries in circumstances where losses on such disposals are tax deductible.

Headquarter Companies

- Determination of profits other than in accordance with the OECD's Transfer Pricing Guidelines.

- In particular, use of cost plus and resale minus methods of determining arm's length profits when some or all of the following apply:

    - the methods are used in circumstances where a comparable uncontrolled price might reasonably be obtained

- it is not clear that there is always an individual examination of the underlying facts of the particular case or that the mark-up or margin is reviewed regularly against normal commercial criteria

- there is a requirement for the company concerned to be part of an international group

- there is a reduction in the expense base taken into account for the purposes of determining taxable income.

ROLLBACK AND STANDSTILL – BACKGROUND PAPER ON FINANCE BRANCHES, HOLDING COMPANIES AND HEADQUARTER COMPANIES

INTRODUCTION

1. The report of the High Level Group on Taxation (8998/00 FISC 73) to the ECOFIN Council of 17 July noted that, in relation to standstill and rollback of the measures found harmful by the Code of Conduct Group, it would be necessary for the Group to ensure a balanced application to comparable situations which would enhance the effectiveness and fairness of the process. The report noted that the Group had identified 3 issues for further discussion in order to ensure such a balanced approach: finance branches, holding companies and headquarter companies.

2. At the meeting of the Code Group on 20 September it was agreed that a balanced approach to rollback and standstill in these 3 areas might be assisted by guidance drawn from the criteria in the Code. It was therefore agreed that to facilitate the further discussions envisaged in the High Level Group's report the Chair would provide a background paper and draft guidance on these 3 issues. Some Member States indicated that work in this area should not go beyond the Code.

3. Accordingly, this paper summarises the issues relating to the 3 areas, and the accompanying paper includes draft guidance.

Finance Branches

4. Finance branch measures concern the taxation of a company that has a finance branch in another country. Whether or not a finance branch measure is harmful under the Code depends, as with any other measure, on a consideration of all aspects of the measure. But there are 2 features of any finance branch measure that are particularly relevant in determining whether the measure provides for a significantly lower effective level of taxation and affects, or may affect significantly the location of business.

5. The first of these is the way in which income and expenses of the company are allocated between the Head Office and the branch. If this is not done on a case-by-case arm's length basis in accordance with the OECD Transfer Pricing Guidelines it can lead to profits being over-allocated to the branch and under-allocated to the Head Office. Criteria B4 of the Code specifically cites compliance with the OECD Guidelines as a factor in determining whether a measure is harmful.

6. The second feature of particular relevance to finance branches is the way in which the profits allocated to the finance branch are treated for tax purposes in the country of the Head Office.

7. Where the country of the Head Office gives relief for double taxation by the exemption method and the level of tax in the country of the finance branch is significantly below that in the country of the Head Office, the profits allocated to the foreign finance branch will be taxed at a significantly lower level than profits in a branch in the country of the Head Office.

8. Accordingly, in its November 1999 Report the Group gave a positive evaluation to finance branch measures *which provide for a significantly lower effective level of tax taking particular account of whether…they permit the profits to be allocated between a Head Office and a branch in a formulaic way contrary to the arm's length principle that can lead to a reduced effective rate of tax for the company as a whole*.

Holding companies

9. A number of papers on holding companies have been presented to and discussed by the Group. In particular, the Group noted in its November 1999 Report that in evaluating holding company measures it had taken note of both the general background paper and the cross-country review of holding companies carried out by the Commission Services, and also the thematic paper on holding companies prepared by the Chair.

10. The Report recorded that *the Group noted that many holding companies are set up wholly or mainly for tax planning reasons. In particular, holding companies may be used as a tax efficient holding point for profits or as a tax efficient conduit. Holding companies that are tax-driven have little or no economic substance, and may be no more than brass plate companies. They are therefore potentially highly mobile, and business taxation measures can have a significant effect on their location in the Community*.

11. The Group gave a positive evaluation to *measures that allow the exemption of foreign source dividends in circumstances in which the profits giving rise to the dividends have been taxed at a significantly lower level in the source country than they would have been if they had arisen in the Member State. Such measures allow income from tax havens and other harmful regimes to be received tax free in the Member State. In cases where participation exemptions are combined with an appropriate controlled foreign company legislation, the measures have not been given a positive evaluation*.

12. The Group also gave a positive evaluation to *asymmetrical measures where gains are exempt but losses are tax deductible*.

Headquarter Companies

13. In its November 1999 Report, the Group considered a number of headquarter company measures relating to the transfer pricing of intra-group services.

14. In considering these measures, the Group took note of the general background paper prepared by the Commission services. That paper noted that *Centralisation of various types of corporate functions to different group companies is a common practice with MNEs. The underlying objectives are usually based on sound commercial reasons and MNEs seek cost savings by assigning separate corporate functions to specialised subsidiaries. However, the location of such operations is often significantly influenced, in addition to commercial and logistic reasons, by the special regimes and incentives offered to intra-group service companies within the EU.*

15. The Commission Services paper noted that *The normal corporate tax rates are usually applied to companies benefiting from the intra-group service regimes. The preferential tax treatment is commonly provided by way of special rules for profit determination.*

16. In its November 1999 Report, the Group noted that, as reflected in Paragraph B of the Code, *the internationally accepted standard for transfer pricing is the arm's length principle, as set out in the OECD's Transfer Pricing Guidelines of 1995. To prevent a multi-national enterprise from shifting profits between countries by under or overvaluing transfer prices, the arm's length principle envisages that taxable profits on cross-border transactions between associated enterprises should be computed as if the transaction had been between parties acting at arm's length*.

17. *The generally preferred method in the OECD Guidelines for determining arm's length profits is the so-called comparable uncontrolled price method. This involves comparing the price charged for services transferred in a controlled transaction to the price charged for services transferred in a comparable uncontrolled transaction. But, as there may not always be comparable transactions, the Guidelines also recognise the use of the so-called cost plus and resale minus methods. These involve looking at whether the mark up or margin on a transaction is an arm's length one.*

18. *Most of the intra group service measures that were considered by the Group provided for the use of the cost plus and resale minus methods. In evaluating the potentially harmful intra-group service measures, the Group paid close regard to whether the measures conformed to the OECD Guidelines. In the case of cost plus and resale minus measures, the Group took particular account in its evaluation of whether some or all of the following features are present:*

- *they are used in circumstances where a comparable uncontrolled price might reasonably be obtained*
- *it is not clear that there is always an individual examination of the underlying facts of the particular case or that the mark-up or margin is reviewed regularly against normal commercial criteria*
- *there is a requirement for the company concerned to be part of an international group*
- *there is a reduction in the expense base taken into account for the purposes of determining taxable income*.