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REPORT

From:	Chair of the Code of Conduct Group (Business Taxation)
to:	the ECOFIN Council
on:	6 December 2005
Subject:	Code of Conduct (Business Taxation) Report to the ECOFIN Council

INTRODUCTION

1. The Council and the Representatives of the Governments of Member States, meeting within the Council, adopted on 1 December 1997 a Resolution on a Code of Conduct for business taxation which provides for the establishment of a Group within the framework of the Council to assess tax measures that may fall within the Code. In its report to the Feira European Council on 19 and 20 June 2000, the ECOFIN Council agreed that work should be pursued 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).

2. On 9 March 1998, the Council confirmed the establishment of the Code of Conduct Group. The Group has reported regularly on the measures assessed and these reports have been forwarded to the Council for deliberation.

3. Two interim reports of the Code of Conduct Group were presented to the ECOFIN Council on 1 December 1998 and 25 May 1999 respectively (12530/98 FISC 164 and 8231/99 FISC 119). Subsequently, the Group reported to ECOFIN on 29 November 1999 setting out the results of the Group's work (SN 4901/99) on the assessment of 271 tax measures under the Code where 66 measures were considered harmful by the Group.

4. On 13 October 2003, the Council welcomed a report by the Working Party on Enlargement (Tax Experts) (13213/03 ELARG 94 FISC 138) establishing a list of 30 measures in the acceding States found harmful under the Code. The Council also agreed on the adequacy of the rollback measures envisaged or already undertaken for 27 of these measures.

5. On 26-27 November 2000, the Code Group presented a progress report on its work to the ECOFIN Council (13563/00 FISC 193). Further progress reports on the Code Group's work were presented to the ECOFIN Council on 5 June 2001 under the Swedish Presidency, on 4 December 2001 under the Belgian Presidency, on 4 June 2002 under the Spanish Presidency, on 3 December 2002 under the Danish Presidency, on 7 March 2003 under the Greek Presidency, on 25 November 2003 under the Italian Presidency, on 7 December 2004 under the Netherlands Presidency and 7 June 2005 under the Luxembourg Presidency (8789/01 FISC 83, 14467/01 FISC 249, 8848/02 FISC 129, 14812/02 FISC 299, 7018/1/03 FISC 31 REV 1, 14361/03 FISC 173, 15317/04 FISC 249 and 9427/05 FISC 55).

6. This latest report from the Code Group to the ECOFIN Council encompasses the work of the Code Group in 2005 under the United Kingdom Presidency.

7. As required by the ECOFIN conclusions of 9 March 1998, the Group's report to the 29 November 1999 ECOFIN Council reflected either the unanimous opinion of the members of the Group or the various opinions expressed in the course of discussion. References to 'the Group' in that report reflected the broad consensus where unanimity was not achieved and alternative views were shown in the notes as appropriate. Consistent with the Group's report to the 29 November 1999 ECOFIN, references to 'the Group' in this and other reports should be construed in the same way.

PROGRESS OF WORK

8. Since the ECOFIN Council meeting on 7 June 2005, the Code of Conduct Group has met on 15 September 2005, 18 October 2005 and 23 November 2005 under the United Kingdom Presidency.

9. Under paragraph 8 of the ECOFIN conclusions of 9 March 1998, if the Member State which holds the Chair also holds the Presidency of the Council, that Member State is excluded from holding the Vice-Chair for the six-month period of its Presidency and the preceding six months. As the UK holds the Presidency in the second half of 2005, there is only one Vice-Chair of the Code Group in 2005. Therefore, at the Code meeting on 15 September 2005, Mr Wolfgang Nolz, Director General for Taxes and Customs in the Federal Ministry of Finance (AT), was confirmed as the sole Vice-Chair for the period up to the end of the United Kingdom Presidency.

10. The Group confirmed its programme of work for the period to December 2005 under the United Kingdom Presidency. The Group's work focused on the following three areas:
    a) implementation of rollback
    b) standstill
    c) a discussion of the future of the Code of Conduct.

(a) Implementation of rollback

11. Rollback proposals provided by Malta in respect of the measures International Trading Companies (ML4) and Dividends from (other) Maltese Companies with Foreign Income (ML5) were held over from the June 2005 report to ECOFIN. The proposals were discussed at the meeting on 15 September 2005 and more information was requested from Malta. Malta has now withdrawn its original proposals. The Group expressed its continuing dissatisfaction with the delay in rolling back measures ML4 and ML5, including the fact that Malta will still allow new entrants beyond 2005. The Group urges Malta to submit new rollback proposals to the Commission services by 31st December 2005 and to the Group in time for the first meeting under the Austrian Presidency.[1]

12. The Group noted a report from the UK on the recent changes to the structure of the tax system in the British Virgin Islands. These changes have effected the rollback of measure F056 (International Business Companies) by amalgamating the local Companies Act with the International Business Companies Act into a single statute, which is now in force.

13. As reflected in the Group's reports to ECOFIN in December 2004 and June 2005 the Group had requested that the UK should submit a revised rollback proposal for measure B012 (UK: Gibraltar - Exempt (offshore) Companies and Captive Insurance), in particular relating to not having new entrants in 2005 noting that the measure should have been closed to new entrants in 2001.The UK explained that there was no viable alternative to the roll back proposal which followed the Commission appropriate measures decision under State aid rules, formally accepted by the UK and the Government of Gibraltar, and according to which the Government of Gibraltar is committed to the phased abolition of B012, with a reducing number of new entrants until June 2006 and existing beneficiaries able to continue to benefit from the regime until the end of 2010. The Group expressed its continuing dissatisfaction with the failure to fulfil the commitment to rollback measure B012.

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[1] Malta's roll-back proposals submitted prior to the February 2005 meeting were not discussed by the Group during the February 2005 and May 2005 meetings due to lack of time. The proposals were only discussed at the meeting held on 15th September 2005. Following this meeting the proposals were discussed with DG Competition leading Malta to agree to amend the said proposals to make them generally applicable. In the view of these developments, Malta withdrew the proposals before the Group and submitted an amended proposal to DG Competition. Malta is keen and committed to conclude this issue and will do its utmost to expedite matters. **(Malta)**

(b) Standstill

14. Member States are committed not to introduce new tax measures which are harmful within the meaning of the Code. No new measures which potentially fall within the scope of the Code of Conduct have been reported

15. Standstill descriptions provided by Hungary in respect of the measures: Interest from affiliated companies and Royalty Income were held over from the June 2005 report to ECOFIN. Both measures were considered against criteria 1 to 5 of paragraph B of the Code. The Group concluded that the Royalty Income measure was not harmful under the Code criteria.

16. With the benefit of additional information provided by Hungary the Group concluded that the Interest Measure was harmful, on the basis of a broad majority consisting of 16 Member States. Slovakia later joined that majority. Belgium, Hungary, Luxembourg, Lithuania, Poland and the Netherlands considered the measure not harmful. Malta and Estonia felt they needed more information before they could make a decision. [2][3][4][5][6]

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[2] The Netherlands, Luxembourg, Belgian, Hungarian and Lithuanian delegations note that in their opinion, given the number of Member States that could not conclude that the measure was harmful, there cannot be a reference to "the Group's" conclusion that the measure was harmful. Therefore the matter should be discussed in the ECOFIN.

[3] With particular reference to the Commission's room document of 24 May 2005, the Netherlands delegation, supported by the Lithuanian delegation, is convinced that there is no objective justification for this assessment, particularly given the fact that a comparable regime for royalties had been approved by the Group in 2003 (regime A012 doc 7018/1/03 FISC 31 Rev 1). In the opinion of the Netherlands delegation, supported by the Lithuanian delegation, this difference of assessment of two comparable regimes constitutes a non-justifiable inequality of treatment of Member States' tax regimes **(Netherlands)**.

[4] The Belgian delegation feels the Hungarian system concerning interest from affiliated companies is admissible because it is similar to the French system concerning royalty income on patents, which the Group validated in 2002. The points of comparison of the Belgian delegation are as follows:
<u>Income covered</u>
Interest and royalties have always been regarded as passive income which can easily be relocated elsewhere. That is why measures taken by many States against tax havens apply in the same way to interest and royalties. Interest and royalties are covered by a Community directive which aims to apply a single system (exemption) in the source State. These two forms of income therefore clearly belong to the same category and can be dealt with in the same way by the beneficiary's State of residence.
<u>Applicable rates</u>
In France, the rate of tax on the income in question is 15%. That is the rate applied to all long-term capital gains, according to the French delegation. However, that same delegation has itself drawn a parallel between changes in the corporate tax rate (33.3% instead of 35%) and in the royalties tax rate (15% instead of 19%). That comment is contained in meeting document No 7 of 18 October 2005 (footnote 2). The 15% rate is less than half the corporate tax rate currently applied in France (33.3%). In Hungary, the applicable rate of tax on interest is 8%, i.e. half the corporate tax rate. In both countries, the applicable rate is close or equal to half the corporate tax rate.

17. At the last meeting of the Group under the Luxembourg presidency, the Commission had requested clarification from Spain concerning a press report of a change in its holding company regime ('ETVE') which had been found not to be harmful in the Group's report to ECOFIN of 29 November 1999. Spain provided clarification which demonstrated that the report of the changes was incorrect, and the Group agreed that Spain had responded satisfactorily and in full in their standstill report.

Extension of benefits

18. Given the withdrawal of the rollback proposals for Maltese measures ML4 and ML5 (see paragraph 11) above, the Group agreed that outstanding requests for an extension of benefits for the two measures should be deferred to the first meeting under the Austrian presidency. The Group also noted that, according to the timetable for rollback, agreed in November 2000 that as a general principle, existing beneficiaries should not benefit from an extension of benefits if they entered into the regime after the regime was found harmful.[7]

Amounts involved

The amounts involved are considerably higher in France (EUR 7.2 billion) than in Hungary (EUR 101.8 million). While a decrease in these amounts has been observed in France up to 2004, the reduced rate applied from 2005 (15% instead of 19%) could well reverse that trend.

CONCLUSION

Comparison with the French system shows that, while not identical, the two systems are similar in many respects. Consequently, the two systems carry the same relocation risks and what has been allowed for France must be allowed for Hungary. (**Belgium)**

Belgium is supported by Hungary, Luxembourg and the Netherlands.

[5] The French delegation has supplied the Group with information showing the scheme in question not to be comparable to the French scheme pointed to by the Hungarian delegation, in two respects in particular: the French scheme does not apply to interest but only to patent royalties (it should be noted that the Group has approved a Hungarian scheme specifically relating to royalties); the French scheme is available to all firms and is thus not confined to affiliated firms. (**France)**

[6] Poland has made its decision in the light of existing precedent. Having analysed the Commission's room document of 24 May 2005, Poland is convinced that the tax regime for royalties approved by the Group in 2003 (tax regime A012 doc 7018/1/03 FISC 31 Rev 1) is comparable to the Hungarian regime for interest under evaluation. Therefore, in the view of Poland, the difference of assessment constitutes a non-justifiable inequality of treatment of Member States' tax regimes. Poland would also like to mention, that having in mind the number of Member States which assessed the Hungarian interest measure as harmful there should be no reference to "broad" majority, and therefore to the Group conclusion. **(Poland)**

[7] See paragraph 11, footnote 1

Future of the Code of Conduct

19. A discussion of the future of the Code of Conduct was held at the meeting of the Group on 23 November. During the Austrian presidency the Group will continue to consider this matter and will report on its progress on these considerations in its next report to the Council.