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REPORT

from:	Code of Conduct Group (Business taxation)
to:	ECOFIN Council
on:	8 June 2010
Subject:	Code of Conduct (Business Taxation) - Report to the ECOFIN Council

INTRODUCTION

1. On 1 December 1997, the Council and the Representatives of the Governments of the Member States, meeting within the Council, adopted a Resolution on a Code of Conduct for business taxation. This Resolution 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 tax 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 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 25 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 the Group considered 66 measures harmful.

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 found harmful under the Code in the Member States that acceded on 1 May 2004. The Council also agreed on the adequacy of the rollback measures envisaged or already undertaken for 27 of these measures.

5. On 11 July 2006, the Council took note of a report by the Working Party on Enlargement (10879/06 ELARG 66 FISC 96) establishing a list of 8 measures found harmful under the Code in the two Member States (Bulgaria and Romania), which acceded on 1 January 2007.

6. This report from the Code Group encompasses the work of the Code Group in 2010 under the Spanish Presidency.

7. In accordance with the Procedural Aspects of the Group (16410/08 FISC 174), the Group should maintain to aim at a (broad) consensus to reflect the positions of the Member States in the Group in its reports to ECOFIN, to avoid loosing the effectiveness of the Group, while respecting the principle of unanimity as laid down in the Council conclusions of 9 March 1998 concerning the establishment of the Code Group. In the case broad consensus cannot be reached, the Group's reports can express the various views mentioned.

PROGRESS OF WORK

8. The Code of Conduct Group met on 4 March and 20 May 2010 under the Spanish Presidency.

9. At the meeting of 4 March 2010 the Group also confirmed a programme of work under the Spanish Presidency, agreeing to take forward work in the following areas:

(a) new round of rollback notifications;

(b) new round of standstill notifications;

(c) continue its existing work on standstill;

(d) discussion on the substantial aspects of the Group's Work Package, in particular:
- anti-abuse;
- administrative practises;
- links to third countries.

Appointment of Vice-Chairs

10. Ms Julia Martinez (Deputy Director General for International Tax Affairs in the General Directorate of Taxation in the Ministry of Finance of Spain) and Mr Paul Hatry (Representative of the Minister in the Ministry of Finance of Belgium) were confirmed as the first and the second Vice-Chairs for the period up to the end of the Spanish Presidency.

Rollback

11. To facilitate the Code Group's work on the implementation of rollback, each Member State was asked to provide written information on developments since the last round of rollback returns in spring 2009 concerning the implementation of rollback of the measures in its name which appear in:

- Annex C of SN 4901/99; or
- in the case of the ten Member States which acceded on 1 May 2004, the Annex to the Enlargement Group (Tax Experts) report of October 2003 (13213/03 ELARG 94 FISC 138); or
- in the case of the two Member States which acceded on 1 January 2007, the Annex to the report from the Working Party on Enlargement of June 2006 (10879/06 ELARG 66 FISC 96).

12. At its meeting on 20 May 2010, the Group was provided with information on all developments since January 2009 on the implementation of rollback.

13. The Group was informed of the following developments:

Poland (Measures: PL1 - Special Economic Zones (original rules) and PL2 - Special Economic Zones (amended rules))

In case of Poland, two regimes were classified as harmful. Both the possibility of granting export aid in Mielec Special Economic Zone and the possibility of issuing permits at Minister discretion were eliminated. However, two enterprises have been covered by transitional periods granted by the Accession Treaty until 31st December 2011 and 31st December 2010, respectively.

Existing work on Standstill

14. Member States have made commitments not to introduce new tax measures that would be harmful within the meaning of the Code. The Group's work programme for the Spanish Presidency identified the following measures where further discussion under standstill was required:

- *The Netherlands - Interest Box*
- *UK: Jersey - Zero-Ten Corporate Tax Regime*
- *UK: Guernsey - Zero-Ten Corporate Tax Regime*
- *UK: Isle of Man - New Tax Legislation*

15. The report to the ECOFIN Council of 2 December 2009 (doc. 16233/09 FISC 163, par. 13) mentions regarding the Interest box measure that the Netherlands had not yet decided to amend the regime, and that therefore the description was premature. At the meeting of 4 March 2010 the Netherlands declared that the government had formally decided to abandon the introduction of an Interest box measure. Against this background the Group agreed that there was no need to assess the measure against the Code criteria and closed the file accordingly.

16. With regard to the UK, the Group discussed on 20 May 2010 the Jersey and Guernsey Zero-Ten Corporate Tax Regimes and the New Tax Legislation in the Isle of Man.

17. With respect to Guernsey, the Group was satisfied with the intention expressed by Guernsey to proceed with a planned review of the corporate tax regime on a presumption of a 10% general rate of corporate tax as well as the timeline of the proposed reform. The UK agreed to keep the Group informed on the progress of the reform.

18. With respect to Jersey and the Isle of Man, the Group requested the Commission Services to prepare agreed descriptions of these measures, in consultation with the UK.

New round of Standstill notifications

19. Member States have made commitments not to introduce new tax measures that would be harmful within the meaning of the Code. In view of this ongoing commitment, each Member State was invited - in accordance with the Group's established practise - to assist the Group in its work by notifying any new measures, which potentially fall within the scope of the Code of Conduct and which have been enacted in the twelve months to end-January 2010.

20. In this respect, at its meeting on 20 May, the Group was provided with information on all developments since January 2009. Four new measures were notified to the Group:

- Bulgaria: Remit of corporate tax for agricultural producers;
- Hungary: Determining the tax base for interest payments received from abroad;
- Slovenia: Tax relief Pomurje region;
- Slovenia: Amendments to the Economic Zones Act.

21. With respect to the Bulgarian remit of corporate tax for agricultural producers, the Group agreed that the question of this measure shall be addressed after current State Aid procedure will be completed.

22. With respect to the Hungarian tax measure on determining the tax base for interest payments received from abroad the Group requested the Commission Services to prepare an agreed description of this measure, in consultation with Hungary.

23. With respect to the Slovenian measures, the Group invited the Commission to enter into bilateral contacts with Slovenia to receive necessary additional information and to report back to the Group.

24. Regarding developments in the French and the Dutch overseas territories, France and the Netherlands agreed to provide information to the Commission with the view to further discussions in the Group, if necessary.

25. Regarding change in the legislation of Cyprus regarding taxation of interest and the participation exemption, Cyprus agreed to provide information to the Commission with the view to further discussions in the Group, if necessary.

Work Package

26. The Group finalised its discussions on transparency and exchange of information in the area of transfer pricing during the Swedish Presidency (doc. 16233/09 FISC 163). The Group continued its work on the other items of the Work Package, namely anti-abuse, administrative practices and links to third countries during the Spanish Presidency.

Anti abuse

27. Subsequent to the agreement of the Group on the further work in the area of anti-abuse (doc. 10200/1/09 FISC 69), the Council agreed[1] to the establishment of a sub-group of the Code of Conduct Group to examine, with a view to establishing guidelines, anti-abuse issues related to inbound and outbound profit transfers and mismatches between tax systems, in particular as regards the treatment of hybrid entities and profit participating loans, and invited the Working Party on Tax Questions (Direct Taxation) to examine other anti-abuse issues in the framework of the coordination exercise (doc. 11967/09 FISC 96).

28. A report with the conclusions of the examination by the sub-group (doc. 9779/10 FISC 43) was submitted to the Code of Conduct Group, which discussed the anti-abuse issues at its meeting of 20 May 2010.

29. Regarding **Inbound Profit Transfers**, the Group agreed that a problem arises regarding profits entering the EU from non EU countries, whether directly to the Member State of receipt or through several Member States up to the Member State of receipt, when such income has not been taxed or it has been subject to tax at source at a low tax rate. There is a risk of abuse in this case, since the subsidiary resident in a third country will be able to avoid inbound taxation by using the most convenient Double Taxation Agreement (DTA). That income will afterwards freely flow within the EU with no withholding tax (under the Parent-Subsidiary Directive), arriving untaxed at final destination. The Group agreed that further work is needed and decided to come back to this issue under the Belgian Presidency.

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[1] The Netherlands, Luxembourg and Belgium wanted to add the words "as a procedural decision taken by simple majority".

30. Regarding **Outbound Profit Transfers**, some Member States agreed that a problem arises regarding profit distributions from a Member State to a third country if that Member State wishes to apply a withholding tax. It could be that by channelling the dividends through another Member State which does not apply such a withholding tax, the profit distribution remains untaxed, as under the Parent-Subsidiary Directive it can be transferred untaxed to the specific Member State, from which it can flow untaxed to a third country. The Group agreed that it was not possible to find a satisfactory solution to this problem within the framework of the Code of Conduct.

31. Regarding **Profit Participating Loans**, the Group agreed that a problem arises when the Member State of the corporate taxpayer paying interest allows its deduction from the tax base, whereas the Member State of the corporate taxpayer which receives the income considers it as a tax exempted dividend income. In that case, such income would remain untaxed in both Member States. To avoid these mismatches, the Group agreed the following solution:

> ***A hybrid loan arrangement is a financial instrument that has characteristics of both debt and equity. In as far as payments under a hybrid loan arrangement are qualified as a tax deductible expense for the debtor in the arrangement, Member States shall not exempt such payments as profit distributions under a participation exemption.***

However, there was no agreement about the legal form. For the reasons of clarity, enforceability and transparency the Netherlands only accept this solution if it is implemented via EU legislation. Not all other Member States could support the approach of EU legislation. However, all Member States but the Netherlands could support implementation of this solution via soft law[2]. The Group agreed that further work is needed and decided to come back to this issue under the Belgian Presidency.

[2] The Netherlands, Luxembourg, Belgium and Estonia consider that the Code Group is not the appropriate body to discuss measures on tax coordination aimed at resolving mismatches resulting from disparities as this falls outside the mandate of the Code of Conduct Group.

Administrative practices

32. Continuing the work started under the Swedish Presidency (doc. 16233/09 FISC 163), the Group discussed the issue of administrative practises at its meetings on 4 March 2010 and 20 May 2010 concentrating in particular on three issues:

- Defining and identifying harmful rulings, with a view to being able to better distinguish general administrative practices of granting advance clearance from harmful rulings,
- Improvements in the field of transparency, and
- Improving exchange of information for cross border rulings - broader exchange of relevant information on rulings that may affect tax bases of other Member States.

33. Rulings concern the advance interpretation or application of tax provisions by the tax administration to a specific fact pattern of a specific taxpayer. With respect to the identification of harmful rulings:

- all Member States except the Netherlands and Luxembourg agreed on the following guidance:

    - ***In order to start a review process with respect to administrative practices, MSs are invited to share with the Group their knowledge or suspicion about harmful administrative practices of other MSs. In doing so MSs could consider the following factors:***
        - ***An administrative practice is publicly or privately promoted;***
        - ***An administrative practice appears to be in conflict with the purpose and aim of the provision in question or with balanced international taxation (zero taxation);***

- the Group agreed:

    - ***The criteria for assessing the harmfulness of an administrative practice are the five criteria for harmfulness as laid down in Paragraph B of the Code of Conduct.***

The Group agreed that further work is needed and decided to come back to this issue under the Belgian Presidency.

34. With respect to improvements in the field of transparency, the Group agreed the following guidance:

    - ***To the extent that a MS accommodates the advance interpretation or application of a legal provision to a specific situation or transaction of an individual taxpayer, the underlying procedures should be embedded in a transparent legal and administrative framework, that is public legislation or administrative guidelines.***

    - ***Where the advance interpretation or application of a legal provision to a specific situation or transaction of an individual taxpayer is suitable for horizontal application in similar situations, this interpretation or application should be published or be reflected in updated guidance, or be made otherwise publicly available.***

35. With respect to improving exchange of information for cross border rulings, all Member States except the Netherlands and Luxembourg supported the following guidance[3] [4]:

- ***If a Member State provides advance interpretation or application of a legal provision for a cross border situation or transaction of an individual taxpayer (hereafter: cross border ruling), which is likely to be relevant for the tax authorities of another Member State, the tax authorities of the first Member State will spontaneously exchange the relevant information regarding this cross border ruling in accordance with Community law provisions with the latter Member State in order to assure coherent overall taxation.***

- ***By means of a non-exhaustive list, this would specifically concern the following types of cross border rulings:***

    - ***MS 1 gives clearance on the absence of a PE in MS 1 to a company resident in MS 2. Such a ruling could be relevant for the tax authorities of MS 2 (same applies in reverse situation).***

    - ***MS 1 gives clearance on specific items related to the tax base of a PE in MS 1 to a company resident in MS 2. Such a ruling could be relevant for the tax authorities of MS 2 (same applies in reverse situation).***

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[3] Italy considers that these guidance notes, being part of a soft law process, do not properly identify which specific information should be exchanged. Taking also into account that administrative practises may significantly vary among Member States, these guidance notes may lead to an uncertain and unbalanced implementation of the political commitment, unless a substantial reciprocity in the exchange of information is assured.

[4] The Netherlands notes that further legal investigation in the Netherlands is needed regarding this guidance as well as the application of the principle of reciprocity.

- ***MS 1 gives clearance on the tax status of a hybrid entity resident in MS 1 which is controlled by residents of MS 2. Such a ruling could be relevant for the tax authorities of MS 2 (same applies in reverse situation).***

- ***MS 1 gives clearance to a company resident in MS 1 regarding the tax value for depreciation for an asset that is acquired from a group company in MS 2. Such a ruling could be relevant for the tax authorities of MS 2 (same applies in reverse situation).***

The Group agreed that further work is needed and decided to come back to this issue under the Belgian Presidency.

Links to third Countries

36. Continuing the work undertaken under the Swedish Presidency (doc. 16233/09 FISC 163), the Group discussed the issue of links to third countries at its meetings on 4 March 2010 and 20 May 2010.

37. On the basis of a 4-step approach the Group identified which third countries or third country regimes should be considered with priority. Several Member States provided input for to that extent. The Group agreed that the biggest priority should be given to neighbouring 3rd countries with potentially harmful tax regimes, notably Liechtenstein and Switzerland. The Group recommends that the Commission would be invited by the Council to start a dialogue with these countries in order to investigate to what extent they would be willing to subscribe to the principles and criteria of the Code, and to report back to the Group on the progress before the end of each Presidency[5].

38. In relation to negotiations on including a good governance provision in line with that approved by Ecofin in May 2008, the Group asked the Commission to make its own assessments of the respective third countries and report back to the Group. To that effect, the Group was provided with information on third countries with which the negotiations have more advanced, namely South Korea and Ukraine. While noting that this is an ongoing exercise which will be regularly monitored in the future, in line with the follow-up of the Agreements, the Group agreed that the quick review of the tax systems did not give rise to concerns and therefore there was no need for these regimes to be reviewed under the Code criteria.

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[5] Italy and Denmark consider that, in order to maintain the credibility of the whole exercise, at least an informal assessment of the third countries' regimes, identified as a first step by the Group as the regimes which should be considered with priority, and which are known to be attractive for fiscal reasons, should be concluded before starting discussions and negotiations with third countries concerned.