Reforming International Capital Income Taxation

Report

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at the German Federal Ministry of Finance

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I. Introduction

During recent decades, the world economy has enjoyed a significantly higher degree of integration. The advantages offered by this globalisation process are indisputable. They are inherent in a more efficient distribution and utilisation of resources and in the associated gains in prosperity, but also in the substantial increase in the number of goods people can consume and buy: the purchase of foreign products and financial assets, holidays in far-off lands, and even the opportunity to work abroad are now freedoms that are widely taken for granted.

Admittedly, there is another side to globalisation, in that it creates new problems or exacerbates existing ones. This applies in particular in the area of fiscal policy. Almost all historical tax systems were developed for economies with a comparably low level of integration with foreign economies and can barely cope with the challenges posed by the new era. Occurrences that used to be considered as exceptional cases without fiscal relevance and which were of interest only to a small circle of experts – such as foreign production sites, multinationals, international virtual markets or cross-border commuters – are unmistakably gaining in importance, and it is no surprise that the media have been trying for some time to explain what is actually happening in the field of international taxation.

The public interest in international fiscal problems indicates the growing pressure surrounding this issue. This is likely to increase in the future. One of the reasons for this is the introduction of a single European currency effective from 1st January 1999. The disappearance of the exchange-rate risk between the participating nations will encourage companies and individuals to engage in more cross-border activities than ever before. A further challenge is posed by the frenzied developments in electronic media, which not only mean a reduction in the cost of cross-border communications, but also give rise to new means of doing business. To date, traditional tax legislation has provided hardly any solutions for profits earned on the virtual (Internet) marketplace. Finally, as a result of the general opening-up of borders, the mobility of companies and individuals will continue to increase in the near future.

The Scientific Council has taken these observations as an opportunity for a fundamental discussion of international capital income taxation. The present report thus deals with only part of a complex overall problem, namely the method of taxing capital, the factor considered the most internationally mobile and the most difficult to tax. By "capital income" we mean income not derived from dependent employment (earned income). This includes interest and dividends, but also covers licence fees, rents, and pure profit. Pure profit is that part of capital income which remains after deduction of the costs of one's own labour and own capital[1].

In restricting the theme of this report we are not denying that the international taxation of earned income is generating more and more problems. Phrases such as "Schumacker decision" or "nominal unlimited tax liability" serve to underline this fact, as do net salary agreements in professional sport or the comments made by numerous companies that taxes imposed on the salaries of their executives and skilled workers was of importance for their choice of location. The complexity of the problem as a

1 The assignment of costs for one's own labour is not clearly defined in the literature; these costs can fall under earned income or capital income.

whole leads us to concentrate our attention on individual aspects; this is also the reason why indirect taxes will not be considered.

The report is based on the two frequently encountered suppositions that:

- German companies also invest abroad and create jobs there for tax reasons, whereas foreign companies often refrain from investing in Germany for tax reasons;
- some capital income escapes taxation, either by legal means or by tax evasion.

The first supposition is often based on Federal bank statistics in respect of cross-border direct investments, which have been showing a deficit for some years. It is indeed apparent that German direct investment abroad is significantly higher than foreign direct investment in Germany; the latter was even negative in 1996 and 1997. In general terms, outflows of capital from a country are not necessarily damaging: they could, for example, reflect a change in locational conditions not related to taxation and could as such be efficient. A compelling case against capital outflows would result only from a comparison of actual direct investment with the notional direct investment that would occur in a world free from distortions. Nonetheless, a connection between taxes and direct investment can certainly be said to exist, since profit-oriented companies and investors unquestionably include tax aspects in their general considerations. In view of the comparably high taxes incurred by German companies the alleged connection is thus very plausible.

Whereas the first supposition is a central theme of the public debate on tax in Germany, the second – centred on the erosion of the tax base – is also a major subject of discussion abroad. All industrial nations foresee increasing difficulty in tackling legal and illegal tax avoidance in the area of capital income. This is due, on the one hand, to the options available to private investors for shifting parts of their tax base abroad either openly (transfer of profits) or secretly (capital flight) and, on the other, to the attacks by foreign states on the domestic tax base.

Both suppositions, if correct, certainly allow different economic conclusions to be drawn: fiscal distortions that render Germany unattractive for direct investment are inefficient in terms of the world economy and can reduce domestic employment levels as well as domestic tax revenue. In contrast, the erosion of the tax base should be considered primarily from fiscal and equity aspects. It is not linked directly to employment and investment.

The present report considers various changes to current taxation procedures assuming a given tax revenue (so-called "differential impact analysis"). In order to rule out any misunderstandings, the Scientific Council wishes to stress this important point right from the outset: a broadening of the tax base leaves the overall tax burden unchanged if it is accompanied by a corresponding cut in tax rates. Only a differential impact analysis of this kind permits a proper comparison of alternative measures.

In conclusion, we wish to stress, however, that a net reduction in the tax burden is just as essential as changes within the tax system. A reduction of tax rates would at the same time substantially alleviate many of the problems described below. Conversely, said problems would continue to get worse if the government were to increase the tax burden imposed on capital income.

In essence, the central question dealt with by the present report is how to get German capital income taxation into shape for the 21st century, taking into account both national and international interests[2].

II. Capital income taxes in Germany and abroad

A. On the measurement of the tax burden

The supposition that the German tax system drives capital abroad – presumably with negative consequences for tax revenues and employment levels – is based on the assumption that capital income earned in Germany incurs comparably high taxes.

Comparisons of international tax burdens are not easy and have almost become a science in their own right, the reason being that tax systems differ not only in respect of tax rates, but also with regard to the definition of the tax base. Sectoral, regional and other selective tax benefits, as encountered in every country, make the comparison more difficult and raise doubts as to the meaningfulness of any differences in nominal tax rates.

It is therefore often proposed that comparisons of tax burdens should be based on so-called effective tax rates, which are calculated according to the various tax bases, rather than on nominal tax rates. However, such calculations can provide little more than examples because in every country there are various selective tax benefits according to industry, activity or company size. These selective benefits permit only limited conclusions with regard to the effects of the tax on the economy as a whole.

Yet this is not the only reason why the Scientific Council is of the opinion that nominal tax rates can be used for the purposes of comparing international tax burdens and that decisions taken by companies in respect of location and investment depend to a major extent upon these nominal rates. The following circumstances would appear to back this viewpoint:

- When choosing a location a company cannot forecast precisely to what extent it will subsequently be able to satisfy conditions that make it eligible for a tax benefit, because the choice of location is a fundamental decision, whereas the utilisation of tax benefits is usually tied to special operative measures. Owing to the uncertainty with regard to their future business operations companies often ignore selective benefits when comparing potential locations.
- Low nominal tax rates are of benefit to all companies in the country concerned, which is why attempts to raise them meet with great political opposition. In contrast, selective reliefs are advantageous to some companies only; their continued existence is therefore under some political threat. Tax benefits which are identified for abolition by politicians almost every year – when the question of tax reform is debated – are unlikely to be a prime consideration for companies making future-oriented location decisions.
- Nominal tax rates are particularly significant with respect to shifting profits abroad because in this case only the marginal rate is of any relevance: irrespective of domestic tax-loopholes, the incentive to shift remaining profits abroad results from a simple comparison of the statutory tax rates.

[2] The report was completed on December 12th, 1998. The changes to the law with effect from 1999 that were under discussion at that time have not been taken into detailed consideration.

- Finally, there is also a psychological aspect that should not be overlooked: nominal tax rates that are excessive in international terms have an obtrusive effect that is not to be underestimated, especially on senior managers, who are not necessarily noted for their expertise in tax matters. The availability of detailed information on tax matters may qualify the importance of the nominal rate; owing to the initial impression, however, it is questionable whether such information will ever be requested.

These reasons speak for the correctness of a policy combining a broadening of the tax base with a reduction of the nominal tax rate. They also speak for taking nominal tax rates as the basis for the following comparison of tax burdens.

B. Tax-related disincentives to domestic investment

The tax burden imposed on investment in Germany has been lightened in recent years, in particular as a result of the abolition of the wealth tax (*Vermögensteuer*) and the local trade capital tax (*Gewerbekapitalsteuer*). However, the cumulative burden imposed by the individual income tax (*Einkommensteuer*) or the corporate income tax (*Körperschaftsteuer*), the solidarity surcharge (*Solidaritätszuschlag*) and the local trade tax (*Gewerbeertragsteuer*, which is essentially a profit tax) remains high. The overall burden amounts to 58% on the retained profits of corporations if we assume a local trade tax rating factor of 500%[3]. The following comparison covers only genuine capital income taxes. Other taxes that may have an indirect effect on capital income, such as domestic property taxes or fuel taxes, and foreign property taxes or "rates", are not taken into consideration, nor are social-insurance contributions. Although it cannot be denied that the aforementioned public fees and taxes can have an effect on capital income, it is not possible to quantify the shifting processes.

As Tab. 1 shows, German tax rates rank at the upper end of the international scale, and in some cases even occupy top position, if one includes the solidarity surcharge and local trade tax, which have no equivalent in other countries, in the comparison of tax burdens. For individuals, the burden is up to 60% for commercial capital income and 56% for non-commercial capital income. From the point of view of foreign investors, distributed profits of corporations are subject to 45% corporate income tax, solidarity surcharge and the local trade tax, while the figure for retained profits, the taxation of which forms a particularly conspicuous exception internationally, is 58%. Where possible, a foreign parent company will distribute profits of its German subsidiary in order to reinvest them abroad if necessary. This is because the income-tax burden on retained profits – in other words the burden imposed by local trade tax plus corporate income tax plus solidarity surcharge or by comparable foreign taxes – does not reach the levels in Germany in any of the countries under consideration.

[3] The values in force in 1998 were employed for the basic local trade tax rate (5%), the corporate income tax rate (45%) and the solidarity surcharge (5.5%). When calculating the total burden it should be noted that local trade tax is deducted both from its own tax base and the income tax base.

Country	Individuals (top rate in %)	Corporations (%)
Canada	36-50	45
Denmark	40-58	34
Finland	28	28
France	25-62	42
Germany	60/56	58/45
Japan	65	41
Norway	28	28
Sweden	30	28
Switzerland	42	17-34
UK	40	31
USA	46	41

Tab. 1: Capital income taxation 1998[4].

The German tax burden is still comparatively high even if profits are rigorously distributed, irrespective of whether the foreign country applies the tax-exemption method or the tax-credit method to repatriated profits. Where the exemption method is employed, profits upon which tax has been paid in Germany are not subject to further taxation on being distributed to the foreign parent company. As a consequence, German income taxes are a definitive burden in this case and have to flow into the tax plans of the foreign parent company. By way of example, let us consider a French multinational that wishes to establish a subsidiary either in France or in Germany. The effective tax rates are 42% for a location in France and 58% or 45% for a location in Germany. Consequently, firms will consider Germany as a possible business location only if there are major non-fiscal reasons in its favour. Where Germany enjoys only a slight natural advantage, the investment decision will become distorted in favour of France.

The case is similar when the foreign country applies the tax-credit method instead of the exemption method, as is customary in the Anglo-Saxon countries. Here, the profits made and taxed in Germany remain liable to tax abroad; however, the corporate income tax paid in Germany (and in many cases the local trade tax, too) can be deducted from the foreign tax liability. Nonetheless, under the tax legislation in the foreign country concerned the credit is regularly limited to the amount that would arise following a corresponding investment in the parent company's residence country (ordinary credit). Any higher tax becomes, in turn, a definitive burden; a so-called excess foreign tax credit results. For this reason a British group, for example, that is contemplating establishing a subsidiary either in Great Britain or in Germany, makes the following calculation: if it invests in Great Britain it will be liable to pay British corporate income tax in the amount of 31%. If it sets up the subsidiary in Germany instead, an excess foreign tax credit of 14% ensues even when all profits are distributed permanently, thus optimising the company's tax position; the total burden corresponds to the German burden of 45% due to the corporate income tax, the solidarity surcharge and the local trade tax. Here, too, the decision is distorted to the detriment of Germany by the tax rates.

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[4] Source: Federal Ministry of Finance. Figures rounded up/down. Denmark, France and Canada: differentiated rates for dividends and interest. Switzerland and USA: figures differ by region, figures quoted here are for Zurich canton and New York state.

Admittedly, the distortions described occur only if the German subsidiary actually records a profit. A tried-and-tested method employed by the foreign parent company to prevent such a situation occurring consists of it equipping its German subsidiary with very little own capital and providing it with outside capital in the form of loans. Because the interest on the loans can be deducted when assessing the German tax base, this signifies a shift of profits abroad combined with a reduction in German tax revenues. Legislation to counteract this was introduced by the addition of § 8a to the Corporate Income Tax Act. According to this provision in respect of so-called thin capitalisation, loan interest is under certain preconditions classified as a hidden distribution of profits and thus subject to German corporate income tax. However, the preconditions are very generous; evidently, the aim of the legislation was to keep the tax burden imposed on subsidiaries in Germany within reasonable limits. Here, too, high nominal tax rates are combined with substantial tax reliefs.

In the debate over location it is often emphasised that investment decisions are not made solely on the basis of tax considerations. In the non-fiscal area, so the argument goes, i.e. infrastructure, education and social peace, Germany does indeed have something to offer, even if its wages are high. This is undoubtedly true. Despite this fact, or perhaps precisely because of it, it would be nice if investment flows actually reflected these locational advantages instead of being distorted by taxation. At any rate, the above considerations allow one to draw the conclusion that Germany does indeed suffer a disadvantage in terms of taxation, especially if companies are self-financing. This would seem to give cause for concern if one considers that direct investments do not merely represent flows of capital, but can have a direct effect on employment. They also signify a transfer of knowledge and skills that is indispensable in modern knowledge-based societies.

C. Tax-related incentives to international investment

The question of whether the tax system deters foreign companies from making direct investments in Germany raises the subsequent question of whether German investors also invest abroad for tax reasons. Exports of capital in pursuit of other advantages are not necessarily bad because they effect an efficient allocation of capital and therefore usually benefit both countries concerned. However, the situation is different for capital exports motivated by tax considerations, as in this case the decision in respect of a particular location is distorted to the detriment of Germany, resulting in a significant and inefficient flow of capital abroad.

Whereas the tax burden on domestic investment is primarily dependent upon the legal form of the company, in the case of foreign investment several factors are involved. Besides the tax rate levied in the foreign country, the following are the most important:

- Firstly, one must distinguish between investments in countries with which Germany has concluded a double-taxation agreement (DTA countries) and those where no such treaty is in place (non-DTA countries). As regards income taxes, Germany currently has DTAs with more than 70 countries, including all its major trading partners.
- For investments in a DTA country, the tax burden on foreign investments often depends upon the income schedule, as this determines whether Germany provides relief from double taxation by way of a credit or by exemption. Generally, the credit method is applied to revenues from portfolio investments (interest and dividends from portfolio investments), whereas income derived from direct

investments (profits from permanent establishments abroad and dividends from affiliated companies) is usually exempted.

- Finally, it is important whether the investment abroad was made by an individual or by corporations at home or abroad.

Owing to the numerous factors of relevance for determining the tax burden we have selected a few typical examples below that illustrate the way in which German investments abroad are treated for tax purposes.

1. Individual with foreign real property

Firstly, we shall consider an individual residing in Germany with income derived from a foreign real property holding. The foreign tax rate applied under the terms of the non-resident tax-liability regulations in force in the country concerned is assumed to be 25%; this is quite a typical value. In Germany the individual pays the top tax rate (including solidarity surcharge) of 56%. If the property is in a non-DTA country, the foreign tax is credited against the German tax liability in accordance with § 34c of the Individual Income Tax Act. As a result, the tax burden on the foreign investment in the case under consideration equals the burden on a corresponding investment in Germany; in both cases the individual, where his assumed gross income equals 100, is left with 44 after tax. The tax is thus neutral with regard to the investment decision.

Things change if the real property is in a DTA country (Fig. 1). In this case the revenues are exempt from German income tax. They are, however, subject to the exemption with progression method, which means that the average tax rate for the non-exempted income is assessed as if the exempted income were also taxable. The tax burden moves up or down, depending on whether foreign income is positive or negative. The fact that foreign income is subject to exemption with progression – rather than to full exemption – is of subordinate importance for individuals with very high incomes. Under the law the exemption with progression method does not apply to corporations and, incidentally, the constant corporate income tax rates would in any case render it meaningless. To simplify matters, the exemption with progression method is disregarded in the text below; we will consider only the full exemption method.

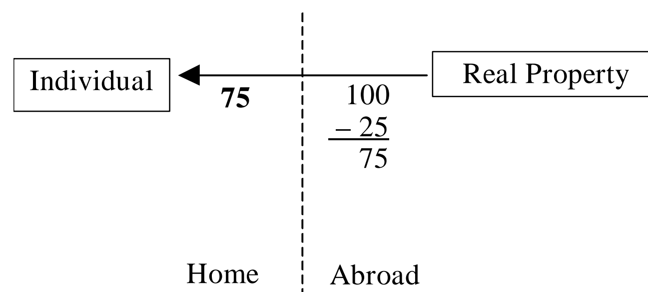

Fig. 1: Foreign real property in a DTA country.

As shown at Fig. 1, where the assumed gross income is equal to 100 the individual is left with 75 after tax. In comparison with the investment in Germany, which under a net tax burden of 56% only yields 44, the investment abroad is a much better option. The investment decision is therefore distorted by the tax system.

Incidentally, the advantage described here is retained under certain preconditions, if, instead of purchasing foreign property, the individual invests in a foreign real-estate fund. Following the expiration of the special depreciation allowances in the former communist German states this type of investment is enjoying increasing popularity as a tax shelter.

2. Partnership with permanent establishment abroad

This case is very similar to the previous one. Let us assume a partnership whose members are German residents and are subject to the top tax rate. Taking into account local trade tax and the reduced tax rate for business income, this amounts to 60% (see Tab. 1 in Section II.B). If the partnership establishes a permanent establishment in a non-DTA country, e.g. a sales outlet or a production facility, any advantages in respect of income tax are lost under the credit method, i.e. the tax burden is bumped up to the German tax level. Profits liable to the local trade tax are reduced, however, by the foreign profit element (§ 9 No. 3 of the Local Trade Tax Act), so that in this respect a tax advantage remains.

If, however, the permanent establishment is located in a DTA country, its profits are exempt from German tax. A tax advantage arises in the amount by which the foreign tax burden on income falls below 60%, which is almost always the case. The same applies to the liberal professions if the professional has a fixed place of business abroad, e.g. a solicitor's office.

A foreign tax burden of 30% means, for example, that where the gross profit made in the foreign country is equal to 100 the members of the partnership are left with 70 after tax (Fig. 2), whereas only 40 would be left from a corresponding profit in Germany (not shown in the Figure), after deduction of local trade tax, income tax and the solidarity surcharge. The tax burden imposed on the domestic investment is thus twice as high. This can have various consequences. In the most favourable case the members of the partnership will aim to achieve a situation in which the permanent establishment abroad accounts for as much of the profit as possible, e.g. by allocation of income and expenditure. This case leads "only" to reduced tax revenues in Germany, yet it cannot be ruled out that the different tax burdens imposed on domestic and foreign profits lead to shifts in production, and thus jobs, abroad. The incentive to do so is likely to increase, the more strictly the allocation of overall profits is investigated by the German revenue authorities and other arrangements are blocked off.

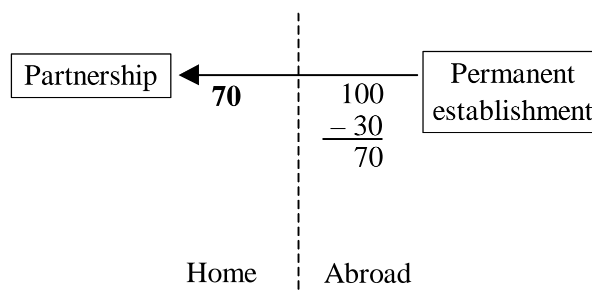

Fig. 2: Partnership with a permanent establishment in a DTA country.

3. Corporation with permanent establishment abroad

If, in the first instance, one considers this case from the point of view of the corporation, rather than its shareholders, it strongly resembles the case of the partnership: in accordance with § 26 Para. 1 of the Corporate Income Tax Act the tax paid abroad is credited against the German corporate income tax if

the permanent establishment is located in a non-DTA country. So where foreign tax rates are low, the tax charge is bumped up to the German tax level. Where a DTA exists, the profits accounted for by the permanent establishment in the foreign country are exempt from German tax, which means that any general or specific foreign tax advantages are retained in full. Therefore, as far as corporations are concerned, the same tax distortions arise as in the case of partnerships.

This picture would appear to be different if one considers the foreign investment from the point of view of the shareholders instead of that of the corporation. If the shareholders are resident individuals, the domestic corporate income tax on distributed profits constitutes only a transitory item because the corporate income tax is credited fully against their individual income tax. Technically, if profits from so-called „EK 45“ are distributed, shareholders receive the dividend plus a corporate income tax credit which can be credited against the individual income tax[5]. However, the Corporate Income Tax Act does not make provision for a credit in respect of foreign profits which have been exempted from taxation under German law. Profits such as these are allocated to the so-called "EK 01" and are not subject to the corporate income tax when distributed to the shareholders[6].

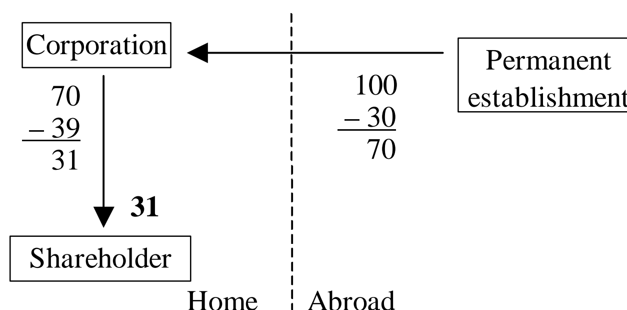

Fig. 3: Corporation with a permanent establishment in a DTA country.

Fig. 3 is a schematic representation of the economic relations. Of the profit made by the permanent establishment in the foreign country (100) the sum of 70 flows to the resident corporation after deduction of foreign tax (30) and is allocated there to the EK 01. On distribution the shareholder pays income tax and the solidarity surcharge in the amount of 56% on the taxable dividend (70), which corresponds to a tax charge of 39. Therefore, 31 remains from the original profit.

The significantly higher total tax burden borne by the resident shareholder compared to the resident partnership with a permanent establishment abroad (Fig. 2) has met with massive protest on the part of German business in recent years and has led to demands for the introduction of tax credits for German residents in respect of corporate income tax paid abroad. However, the increased burden described above is incurred only if the corporation actually makes distributions from the EK 01 because, for example, there is insufficient EK 45. The following thoughts illustrate why distributions from the EK 01 are not advisable for tax purposes.

Let us assume that the corporation invests the foreign profit (70) in fixed-interest securities. At an interest rate of 5% this yields a taxable profit of 3.5 in each subsequent year. Owing to the corporate

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[5] The abbreviation "EK 45" refers to retained profits that have been subject to 45% corporate income tax. The above-mentioned provisions apply to public limited companies (AG) as well as to private limited companies (GmbH) and other corporations.

[6] "EK 01" refers to retained profits on which no tax has been paid in Germany because of exemption.

income tax credit each German shareholder, irrespective of his individual marginal tax rate, assesses the flow of subsequent profit distributions as if it were a security that attracts 3.5 in interest per year. Yet at the assumed interest rate the present value of such an interest flow is by definition equal to 70. Thus from the point of view of the shareholder the foreign profit is worth 31 on distribution, but 70 if re-invested. Therefore, the distribution of exempted profits does not represent an optimum strategy from the point of view of the investors[7].

To summarise, as far as exempted foreign profits of a corporation are concerned, the shareholder, too, can benefit from the tax advantages open to members of a partnership with a permanent establishment abroad. However, this holds true only if the corporation reinvests the profits made abroad instead of distributing them. The economic literature refers to a "Siemens effect", since these fiscal realities also serve to explain why some German corporations retain large-scale financial assets instead of making profit distributions to the shareholders.

Admittedly, the situation outlined above applies only to corporations that are not compelled to distribute earned surplus from foreign profits exempt from German tax. In the assessment a further differentiation has to be made between publicly traded corporations, which can pay dividends out of taxed domestic profits (EK 45), and other corporations, especially family-owned corporations, which are compelled to make profit distributions from EK 01, especially in inheritance cases. For the latter, the permanent establishment abroad brings mixed tax blessings as they incur a high tax burden – as illustrated at Fig. 3 – while benefiting from a so-called tax deferral.

4. Corporation with foreign subsidiary

Finally, let us consider the case of a foreign subsidiary. Where the shareholding is at least 10%, the dividends paid by the subsidiary are exempt at the level of the resident parent company if the subsidiary resides in a DTA country (international affiliation privilege); the same applies to profits from the sale of shares (extended international affiliation privilege).

In these exemption cases the fiscal treatment of the foreign subsidiary is similar to the case involving the permanent establishment abroad described above, to the extent that the subsidiary continuously distributes its profits to the German parent company. In particular, a direct and definitive tax advantage arises at the level of the resident parent company in the amount of the difference in tax burdens. This unequal fiscal treatment of domestic profits takes on an almost bizarre aspect if the foreign country grants selective tax reliefs for income that is exempt from taxation under German law. Certain investments in the Dublin docks in Ireland, for example, are taxed at a rate of 10% there and are tax-free in Germany. Here, it is clear that domestic investments cannot compete, even if they attract a significantly higher gross yield and should therefore be given priority from the point of view of national and international efficiency.

On occasions a situation in which there is zero taxation may also arise. Consider, for example, the regulated investment companies (RIC) in the USA: national American tax law allows these companies to deduct distributed dividends from their taxable income and thus selectively removes the twin burden of corporate income tax and individual income tax that typically arises in the American tax system. The

[7] Alternatively, the corporation could use the retained profit for investments with a yield of just 2.3%. From the point of view of the shareholders the present value of the income flow thus generated amounts to 70 ?2,3% ÷ 5%, i.e. approximately 32, which is more than the value on distribution (31). Clearly, this represents a distortion, since the investment return is inefficiently small.

German exemption of dividends under the international affiliation privilege thus amounted to complete freedom from taxation for the repatriated profits. Once this shortcoming was recognised, the exemption of RIC dividends was removed from the German-American DTA in 1989.

With regard to profit distributions made by subsidiaries residing in non-DTA countries, under § 26 Para. 2 of the Corporate Income Tax Act the foreign tax is credited against German corporate income tax where the shareholding is at least 10% (indirect credit). In this respect there is again similarity to the fiscal treatment of the permanent establishment abroad. However, even in this case, the profits from sales of stock are unilaterally exempted under § 8b Para. 2 of the Corporate Income Tax Act.

The most important difference between the permanent establishment abroad on the one hand and the foreign subsidiary on the other is the fact that German tax law generally respects the legal personality of the foreign corporation in line with international practice. As a result, profits made by the subsidiary are shielded from German taxation so long as no profit distributions are made to the parent company.

Where no DTA is in place the parent company thus has an incentive to leave in the foreign country the profits made by the subsidiary instead of distributing them (Fig. 4). With an assumed tax burden on retained profits of 47% in Germany, in the form of corporate income tax and the solidarity surcharge, and 30% in the foreign country, the corporation has funds worth 70 available to it if it re-invests the profit abroad, whereas only 53 remain if the profit, on distribution to the German parent company, is re-invested at home. This analysis requires qualification, however, if the profit re-invested abroad is later to be transferred to Germany (see III.B.2). A real economic distortion does not come about, since the subsidiary can place the retained profit at the disposal of the parent company, in the form of a loan for example, where the situation demands.

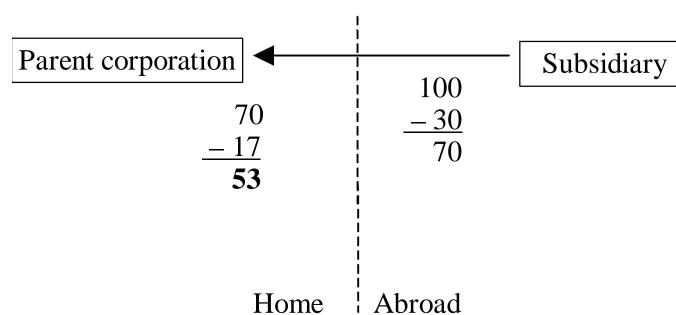

Fig. 4: Corporation and foreign subsidiary in a non-DTA country.

5. Summary

The mostly lower income taxes imposed on foreign investments in comparison with similar investments in Germany, taken together with the use of the exemption method, gives rise to incentives for companies to shift their tax base and active production abroad. It is therefore very likely that German capital exports partly reflect fiscal distortions. Moreover, sectoral distortions and discrimination according to company size probably arise because the option of reducing the tax burden through cross-border arrangements or activities is not open to all resident companies on an equal basis. Large parts of the service industry as well as small- and medium-sized companies almost certainly never benefit from the tax reliefs described above. The resulting additional tax burden suffered by these companies is likely to have a negative effect on start-ups in the long term.

D. Gaps in the assessment of income

The previous section showed that, compared to domestic investments, cross-border investments often incur a lower tax. This legal reduction of the tax charge is brought about by the use of tax exemptions, by retaining profits abroad, by manipulating transfer prices as described in Subsection IV.B.4, or by other legal arrangements.

A strict distinction should be drawn between the above and all forms of tax evasion, whose common feature is the fact that information of relevance for tax purposes is concealed from the revenue authorities. An opinion heard more and more often these days is that tax evasion has now reached substantial levels, especially in the international sector. It is clear that if domestic capital income is investigated and foreign capital income is not, then the income recipient has a considerable incentive to reduce his tax liability by means of cross-border investments. The practical consequences of this hypothesis, however, are unclear for several reasons.

Firstly, a major proportion of foreign investments is made by companies with a legal obligation to keep books of account. Tax evasion by companies – in contrast to private individuals – is difficult because the books are subject to fiscal and non-fiscal inspection and, above all, because there are numerous witnesses to the fact. A manager or company director is hardly able to order an act of tax evasion openly, if only because he would leave himself open to blackmail if he did so. It is therefore widely held, both at home and abroad, that tax evasion is committed primarily by individuals rather than by companies.

Secondly, German individuals seeking to evade the payment of tax on their capital income have an opportunity to do so both at home and abroad. In spite of a certain softening up as a result of judgements made by the Federal Fiscal Court, § 30a of the German Fiscal Code (*Abgabenordnung*) continues to grant a high degree of protection against exposure. According to this provision, loosely known as the "banking-secrecy law", the finance authorities are obliged to exhibit special consideration for the relationship of trust between banking institutions and their customers. The routine sending of tracer notes during tax audits is not allowed, in contrast to dealings with self-employed persons. Therefore, private individuals seeking to avoid paying tax by illegal means enjoy a certain degree of protection in respect of their domestic investments.

If an individual intends to avoid capital income tax by investing abroad, then not all investment forms are equally appropriate. The purchase of shares or stakes in companies, in particular, does not usually achieve the desired objective. The foreign country levies corporate income tax and possibly a withholding tax on dividends, which cannot be credited if the income is not disclosed; the total burden is often not much lower than the German income-tax burden. In many cases the Foreign Information Centre at the Federal Finance Office is informed of investments in or formations of companies abroad. In contrast, the opening of a bank account abroad can be considered relatively "safe" (unless a country is chosen which sends information to the German revenue authorities, such as the USA). In this case capital does not flow directly to companies in the form of own capital, but is made available by banks as outside capital.

In sum, tax evasion does not primarily distort the decision between investments at home or abroad, but rather the decision between own capital on the one hand and outside capital on the other. This is because income derived from own capital is taxed at source much more strictly than income from outside capital (especially interest on bank deposits) both in Germany and abroad. Additional real economic distortions as a result of international tax evasion cannot be ruled out, however.

E. Unfair tax competition

Increasing attention has been directed to unfair tax competition over recent years. A wide variety of attempts have since been made at national and international level to define and check this phenomenon. The first practical progress was achieved by the OECD and within the European Union, whose member states recently reached agreement on a code of conduct. The non-binding code of conduct names certain fiscal measures considered by the member states to be harmful or potentially harmful and lays down moratorium, retraction and consultation obligations in respect of such measures.

By fair tax competition the Scientific Council understands measures by which a generally attractive fiscal environment is created in the country concerned. It goes without saying that these also include general tax cuts, a side effect of which could be a distortion in the international capital allocation. Unfair tax competition is a term that is virtually impossible to define generally. However, unfair competition can be said to exist whenever the prime aim of measures introduced at national level is to create a distortion in the international allocation of capital or to raise tax revenues to the detriment of a foreign country, rather than creating a general improvement in the domestic tax climate. Some of the main indications of such an intent are listed below:

- Foreign individuals or companies without active business are subject to a much lower tax rate than is usually levied in the country concerned. In this case the consequence is more a shift of tax base into the particular country rather than any real economic distortion.
- Foreign corporations are subject to a much lower tax rate on their retained profits than is usually levied in the country concerned. Owing to tax deferral, this attracts tax base in the form of foreign capital, and also perhaps real economic activity.
- The country permits arrangements that deviate intentionally from international standards and are difficult to disentangle for the foreign revenue authorities or which openly create opportunities for tax evasion.

A common feature of unfair measures such as these is so-called offshore clauses: provisions granting non-residents preferential treatment over citizens of the country concerned. The intention is to attract foreign tax base without offering relief to its own residents at the same time. An example of this is the aforementioned Dublin docks scheme in the Republic of Ireland. Capital income accruing to non-resident investors is taxed at 10% in this area, whereas the normal corporate income tax rate is 38%. Other reliefs are not formally linked to the tax rate, but apply with regard to the tax base instead. Thus, although the so-called Co-ordinating Centres in Belgium are subject to the normal tax rate, their "profits" are taken to be equivalent to 8% of directors' salaries.

One of the problems with the above definition of unfair practices is as follows: the effect of many tax policy measures on allocation and foreign tax revenues is dependent on the tax law of the foreign country concerned, and especially on whether it provides relief from double taxation by means of credits or by exemption. In general terms a country that applies the exemption method will consider some measures unfair which from the point of view of a country that grants tax credits are irrelevant or even advantageous.

Example: Source country S cuts the tax rate levied on profits made by local permanent establishments owned by foreign companies from 50% to 30%. Companies resident in country E, which applies the exemption method, are thus caused to shift profits to S, either in accounting terms or in fact, if E taxes profits at more than 30%. This results in a drop in tax revenues in E and possibly the loss of jobs. For

companies resident in country C, which applies the credit method and imposes a tax rate of more than 30%, the companies' total tax burden remains unchanged because it is always bumped up to the tax level in C under the credit method. The revenue authorities in C may even consider the tax cut in the source country to be an advantage, since the amount of tax to be credited falls and its own tax revenue rises.

Countries that apply the exemption method are thus more vulnerable to attacks from abroad and will want to define the catalogue of unfair measures more broadly than countries that grant tax credits, whose system is robust by comparison. The latter countries fear two types of attack in particular, namely, tax deferral and foreign assistance with obscure arrangements and tax evasion.

All in all, unfair tax competition represents a serious threat to beneficial world economic co-operation. The inefficiencies in conjunction with tax loopholes, which stretch as far as zero taxation, are probably much more serious than those related to differences in the general levels of taxation, which remain within relatively tight limits.

F. Conclusion

The wedge between taxes in Germany and in other countries hinders the inflow of foreign capital and drives large amounts of capital abroad. This applies particularly to income that is tax exempt, i. e. income derived from real property, permanent establishments abroad as well as dividends from affiliated companies. Because tax exemption is applied primarily in the business sphere, the international tax wedge induces not only a shift of capital and tax bases, but also drives out economic activity and employment. Further distortions result from tax evasion and, in particular, from unfair tax competition.

Distortions in the international allocation of capital are harmful at both the national and the international level. The crux of the problem is the fact that from the point of view of the investor the tax burden on an investment is dependent on the investment location. As a result, two potential solutions to the problem are obvious: the international allocation of capital will remain undistorted if the tax burden on an investment is not dependent on the place where the investment is made despite differing tax rates or if there is no difference between the tax rates. These principal solutions will be discussed in the following two chapters[8].

[8] One member does not agree with the basic opinion of the Scientific Council that the German tax law is incoherent: the form of international taxation applied by Germany under which income derived from permanent establishments, holdings in affiliated companies, and dependent and independent employment is taxed in the source country, whereas interest, licences and dividends (apart from dividends paid by affiliated companies) are taxed in the residence country, constitutes a form of international capital income taxation that has developed during a lengthy historical process and whose coherent character cannot be denied. It is based on a balanced waiving of tax rights by the countries involved. While the residence country does not tax earnings arising in the source country from direct investments and employment for reasons of competitive neutrality, the source country is in return prepared to give up its right to tax interest and licences and to reduce withholding tax on dividends or even to waive it. After all, almost half of the countries with which Germany has concluded a DTA follow this course. These include almost all the countries of continental Europe; the German form of international capital income taxation is not unique in this respect. In principle, it should not be abandoned.

III. Reinforcing the residence principle

As the previous chapter showed, distortions in the international allocation of capital arise if the tax burden on an investment is dependent on the investment location from the point of view of the investor. Consequently, a consistent solution to the problem lies in the creation of a situation in which the tax burden imposed on the investment is independent of the investment location from the point of view of the investor. This solution, which, incidentally, has been put forward repeatedly by several federal states in recent years, has its essence in the reinforcement of the residence principle.

A. Characterisation of the residence principle

1. Treatment of individuals

Where the residence principle is applied, individuals are assessed for tax in the residence country on the basis of their entire world-wide income (world-wide principle) and then charged according to the tax rate levied by this residence country[9].

This definition centres on the treatment of the individual, not on the allocation of tax revenue between the countries involved. The expression "residence principle" does not imply that only the residence country receives the tax revenues. Of more importance for an understanding of the term is that an individual living in, say, Germany and in receipt of foreign income pays the same tax as an individual who has only domestic income, all other conditions being equal. When the residence principle is applied, the allocation of tax revenue between the countries involved is optional within broad limits. Under a typical double-taxation agreement, the source country, in other words the country in which the income is earned, is allowed to tax income derived from permanent establishments in full, whereas interest and dividends can be taxed to a limited extent, and licence fees not at all. Consequently, in the first two cases the residence country receives – at most – a part of the tax revenue.

Owing to the assessment of world-wide income, the residence principle corresponds to the idea of a tax which is levied according to one's personal ability to pay. The individual's ability to pay, as it were, is expressed as one figure, the global income, regardless of where this income is earned; a deutschmark earned abroad increases one's ability to pay to the same extent as a deutschmark earned in Germany.

In addition, the residence principle ensures that the regional allocation of capital remains undistorted. This objective is termed capital export neutrality or (regional) production efficiency[10]. Since individuals know that foreign income is subject to the same tax as domestic income, they will invest abroad only if it is advantageous to do so in global economic terms, in other words whenever the gross foreign return is higher than the domestic one. Under the residence principle, the market process works towards an alignment of gross returns world-wide, and in a theoretical state of equilibrium capital yields the same return everywhere. Uniform gross returns world-wide are a necessary precondition for maximising the

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[9] The double taxation agreements specify the exact meaning of the term „residence country". This is necessary because an individual can have several domiciles or even be without one. For tax purposes, the place of residence is determined, in that order, by one's permanent home, the centre of vital interests, one's habitual abode, one's nationality or an individual agreement between the countries involved.

[10] Capital export neutrality does not mean that inefficiencies other than regional ones, e.g. sectoral inefficiencies, cannot exist within countries.

world's national product; for if gross returns differ the world's national product can always be increased by a shift of capital to a more profitable location.

A major advantage of the residence principle is that the capital export neutrality or production efficiency it generates does not require a harmonisation of national tax systems. Let us assume that the income tax rate is 50% in country A and 25% in country B. At a globally uniform gross interest rate of 8%, individuals in A receive 4% net interest on their capital, and individuals in B receive 6% net interest. Obviously, neither group has grounds for preferring particular investment locations for tax reasons.

Under the residence principle residents of a high-taxation country may, at most, have an incentive to move to a low-taxation country. However, a change of residence is the *ultima ratio*, with little significance in practice. Residents with high incomes are rarely prepared to move away merely for tax reasons, severing personal and cultural links in the process, while residents with low and average incomes have hardly anything to gain by moving in any case. Moreover, special fiscal regulations make such moves abroad especially difficult[11].

2. Treatment of corporations

Under the residence principle, a corporation pays tax on its world-wide income in accordance with the law of the country in which its seat or its place of management are located. If one considers the benefits of domestic and foreign investments from the point of view of the corporation, then there is still capital export neutrality, as foreign profits incur the same tax burden as domestic profits. The corporation thus has no grounds for preferring certain investment locations simply for tax reasons.

Admittedly, the application of the residence principle to corporations impedes its enforcement in respect of individuals. To demonstrate this, let us consider a corporation residing in country A whose sole owner is an individual residing in country B. On strict enforcement of the residence principle for individuals, profits made by the corporation would be attributed to the owner in the year they accrue irrespective of whether they are retained or distributed. However, international legal practice respects the independence of the corporation which means that its retained profits incur tax only in country A. As a result, the owner residing in country B has a temporary advantage or disadvantage, depending on the relationship between the tax rates. The profit is not attributed to him before distribution. In addition, profits arising from the sale of shares in the corporations are always taxed in country B.

This tax deferral could be completely eliminated by a fundamental amendment of the corporate tax law, namely by transition to a corporate income tax under which all corporate profits are attributed directly to the shareholders. However, this route would appear impractical for a number of reasons.

B. Unilateral measures

In practice, the residence principle is realised by the so-called credit method: the granting of a credit for foreign taxes by the residence country. Put differently, the crediting of foreign taxes against domestic taxes implies that residents are treated as if all their income accrued to them in the home country. However, foreign taxes are normally credited only up to the amount of the notional domestic tax borne.

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[11] Besides the extension of German taxes to certain non-residents (§§ 2 to 5 of the Law to Prevent International Fiscal Evasion) these include, above all, the emigration tax (§ 6 of the Law to Prevent International Fiscal Evasion) and the rules on realisation (disposal) of assets. Put simply, the move abroad triggers a final tax assessment during which hidden reserves are uncovered.

This is known as the ordinary credit method. If the foreign country levies a higher tax rate than the home country, an excess foreign tax credit arises. As a result, under the ordinary credit method, the residence principle is implemented only approximately rather than in its purest form.

1. Removal of exemption

Tax exemptions of foreign income contradict the residence principle and the world-wide principle. If one wishes to reinforce the residence principle, the most important individual measure is therefore a general transition from the exemption method to the credit method. In economic terms this means that individuals and corporations resident in Germany would no longer enjoy any fiscal advantages from their foreign activities; any lower foreign tax is cancelled out by the credit method. In particular, those reliefs purposely employed by foreign countries in order to attract investment away from other countries would become ineffective. This would also apply if the reliefs were to take effect at the tax base, because under the credit method foreign income is assessed in accordance with domestic tax law.

The exemption of foreign income from taxation can be revoked unilaterally whenever it is rooted in national law (rather than in agreements with other countries). This is the case in respect of the exemption of gains on the disposal of shares as defined by § 8b Para. 2 of the Corporate Income Tax Act, and also in respect of the Foreign Activities Ruling (*Auslandstätigkeitenerlaß*). To what extent the quantitatively more significant exemptions rooting in DTAs should be revoked unilaterally by means of a tax treaty law shall be discussed in Subsection III.B.2.

In keeping with the idea of taxing total world-wide income, any losses made abroad, which are not taken into account on application of the exemption method, qualify in full for a reduction in the domestic tax to be paid[12]. This is significant in microeconomic terms, but irrelevant in terms of the total tax base; if the exemption method is renounced tax revenue is certain to grow, because income is normally positive. Overall, a transition to the credit method would therefore not only get rid of any fiscal distortions, it would also result in higher tax revenues. If these extra revenues were used to cut tax rates, which is both feasible and advisable, then additional distortions would disappear, in particular the excess foreign tax credits which arise in conjunction with cross-border investments in Germany (cf. Section II.B).

Without a concurrent cut in tax rates, a transition from the exemption method to the credit method would exacerbate the tax situation to the detriment of Germany's attractiveness as a business location, which is in no way to be recommended[13]. By comparison, an revenue-neutral combination of these measures would have the following consequences: foreign investments that are exempt from taxation

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[12] In this respect § 2a Paras. 1 and 2 of the Individual Income Tax Act are in need of legislative review. These regulations control the allowance of relief for foreign losses more tightly than would appear necessary to prevent abuses.

[13] One Council member emphasises the point that the transition would have the following consequences if the average tax rate remained unchanged: German companies investing abroad would be at a disadvantage when competing with investors from countries that continue to employ the exemption method. In spite of continuing civil-law difficulties (a change of company residence leads to liquidation) and the taxation on liquidation provided for by § 12 of the Corporate Income Tax Act, German companies would still seek to move their residence to "exempting countries". It is questionable whether the taxation of hidden reserves in accordance with § 12 of the Corporate Income Tax Act in a single market can continue in the long term in the light of Art. 52 of the Treaty of the European Community (freedom of establishment), especially in respect of assets remaining with the domestic permanent establishment that originates on relocation. It is likely that foreign shareholdings of German companies would then only ever be "attached" to subsidiaries residing in an exempting country. Germany would no longer be considered as a location for the type of joint undertaking with foreign involvement that is gaining in importance in the wake of globalisation (Daimler-Chrysler), as the tax burden imposed on foreign profits would first have to be bumped up the high levels in force in Germany before any pro-rata distribution to the foreign shareholders. This would also impair the efforts of German multinationals to introduce their shares onto foreign stock markets. Financially sensible tax benefits allowed by the source countries would lose their effect. The comparatively easy-to-operate exemption method would be replaced by the extremely complicated – especially in its indirect form – credit method.

would be less attractive for individuals and companies and domestic investments would increase in attractiveness. Moreover, foreign countries would have an incentive to levy withholding taxes and would be more likely to refrain from granting tax reliefs – which are often selectively turned against Germany at present and are ineffective in conjunction with credits.

This raises the question, however, as to whether there would be a risk of more relocations abroad and, if so, to what extent. In Subsection III.A.1 it was argued that changes of residence by individuals had hardly any effect on taxation. In the case of corporations the assessment is more difficult because the benefits of relocating abroad are dependent on a host of individual factors. Firstly, it should be noted that a mere change of residence does not discharge a corporation from its liabilities as a resident; the move must be combined with a change in the place of management. However, this results in a disadvantageous final tax assessment during which any hidden reserves are uncovered. The same applies when a corporation transfers individual assets to its foreign subsidiary.

Of more significance could be the case in which shares in a German corporation are transferred to a foreign corporation. From the point of view of the shareholders this amounts to a share exchange because they relinquish shares in the German corporation and obtain shares in the foreign corporation. The exchange of shares is regularly effected on a tax-free basis, be it because an imposition of tax on any uncovered hidden reserves is not scheduled anyway or because German tax law grants a delay in the payment of tax on the basis of the European Merger Directive. Nonetheless, it remains questionable whether this arrangement offers any advantages to German shareholders. After all, they then have only an indirect stake in the German corporation and therefore lose their claim to the corporate income tax credit.

The risk of a creeping change of corporation residence would therefore appear greater than sudden relocations, which occur only rarely in practice. A creeping change of residence refers to a situation in which investments are increasingly undertaken abroad by subsidiaries based there to the detriment of investments in the home country, with the resident corporation ending up as little more than a empty legal shell. This form of migration was described in Chapter II and was attributed to the interaction of benefits from exemption and from tax deferrals on the one hand and differences in tax burden on the other. Consequently, a transition to the credit method would not speed up the process of a creeping change of residence. On the contrary, it would even slow it down if the tax burden were cut, or at least did not rise, at the same time.

2. Expansion of controlled foreign corporation-legislation?

For a permanent foreign establishment – whose entire profit is included in the domestic tax base – the credit method always generates capital export neutrality, because the way in which profits are allocated between permanent domestic and foreign establishments is irrelevant for the total tax burden.

The situation is different in the case of a foreign subsidiary that generates the aforementioned tax deferral if profits are retained rather than distributed. In order to create capital export neutrality, German tax law would need to tax the profits retained by foreign corporations in which resident individuals or corporations hold an interest. The immediate attribution of foreign corporations' retained profits to the resident shareholders is known as controlled foreign corporation legislation (CFC-legislation).

To date, German CFC-legislation combats the sheltering of profits in foreign corporations only under very stringent conditions: The foreign corporation must be more than 50% German-owned, it must be subject to foreign income taxation of less than 30% and it must have income from "passive activities", i.e. income not earned from active business such as trade or manufacturing. Where these conditions, listed in §§ 7 and 8 of the Law to Prevent International Fiscal Evasion (*Außensteuergesetz*) are fulfilled, a statutory categorised abuse is said to have occurred with the consequence that the retained profits of the foreign corporation are added to the resident shareholder's annual income.

The general regulations of the German Fiscal Code (§ 42) governing abuse are also applicable: if the German revenue authorities rule that an abuse has taken place, for example in the case of companies that exist on paper only, the foreign corporation is not taken into consideration during taxation ("piercing the corporate veil"). Expenditure incurred in connection with their formation is not tax-deductible, and taxes paid abroad cannot be credited.

Since the tax referral remains intact if the corporation is actively engaged in business and since this distorts the decision between domestic and foreign investments, the question emerges of whether the controlled foreign corporation-legislation should be extended. The following aspects are in need of consideration. Although comprehensive CFC-legislation would be possible under international law, it would involve additional administrative effort because German revenue authorities would have to assess the amounts of foreign retained profits. The comprehensive attribution of foreign retained profits to residents would also fly in the face of international practice, as the independence of the corporation is universally respected.

However, the most important aspect is the fact that the tax deferral offers far fewer advantages than would appear at first sight. This is due to a detail of tax law. By way of example, let us again consider the case of a German corporation that may either leave the profits of its foreign subsidiary abroad or may distribute them to itself for re-investment purposes. If the income tax burden in the foreign country is comparatively low, it would appear advantageous not to distribute the subsidiary's profits. Despite the fact that under the credit method taxes would have to be paid retrospectively on distribution in some subsequent year, an advantage remains because the present value of future taxes is lower than the present value of taxes that have to be paid immediately. This advantage is counterbalanced by the disadvantage that Germany grants (indirect) credits only for the foreign corporate income tax paid in the year of distribution. In this respect retained profits incur double taxation with regard to foreign taxes

paid during the years before distribution. Put differently, the principle of granting credits for foreign taxes on an annual basis only generates an incentive to repatriate profits of foreign subsidiaries immediately.

	Foreign tax rate		
Domestic tax rate	30%	20%	10%
47%	54	24	9
40%	82	31	11

Tab. 2: Tax deferral payback period in years[14].

Owing to these contradictory effects –advantage from the tax deferral versus double burden due to the loss of the tax credit – the strategic use of tax deferrals makes sense only in conjunction with high tax rate differences and lengthy planning periods. This applies at least where gains on the disposal of shares are taxed consistently. Tab. 2 shows the minimum time periods during which retained profits must remain with the foreign subsidiary in order to produce a tax advantage for the parent company.

The figures in Tab. 2 are based on an assumed constant interest rate of 6%. Because foreign profit components are not subject to German local trade tax, the profitability comparison reflects the current domestic tax burden in the form of corporate income tax and the solidarity surcharge, which taken together total approximately 47%. If the foreign country imposes a 30% tax rate, the tax deferral yields an advantage only if the profit is retained by the subsidiary for at least 54 years; under a more attractive German tax burden of 40% this period would stretch to 82 years. Moreover, it would prove profitable only if the foreign tax rate did not increase during the entire period. Accordingly, only those residents prepared to accept correspondingly long payback periods will be able to benefit from tax deferral. However, the reinvestment strategy outlined here is always advantageous for residents (individuals or corporations) not planning to repatriate the capital they have invested abroad.

Reasonable payback periods arise only if the foreign tax rate is unusually low; where there is zero taxation in the foreign country the payback period drops to one year. In practice, extremely low foreign tax rates are encountered mainly in tax havens or where selective benefits are granted, since no country funds its public expenditure with general tax rates of 10% or lower. A foreign country that actually practised this form of unfair tax competition would hardly be in a position to make a serious complaint if tax were imposed on the profits reinvested there.

The following model puts forward a solution that caters both for capital export neutrality and simplicity of taxation: retained profits of foreign corporations in which a German resident holds an interest of at least 10% are added to his domestic income if they are subject to an income tax burden of less than 25%; the type of business transacted by the company is unimportant. Changes to the existing law are to be found in the reduction of the income tax threshold and the scrapping of the catalogue of business activities (§ 8 of the Law to Prevent International Fiscal Evasion), which constitutes an invitation to creative individuals to misrepresent the actual facts of a particular situation in order to suit the statutory requirements. Lowering the investment limit to 10% would lead to a harmonisation of the provision

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[14] The table was generated by a comparison of the final capital values resulting from the retention of profits in Germany and abroad. Where K_o is the initial capital stock, i = an interest rate of 0.06, $?_i$ and $?_a$ are the tax rates in Germany and abroad respectively and q = the net accumulation factor for a reinvestment abroad $1 + i ?(1 - ?_a)$, this gives final capital values in year n for a reinvestment in Germany of $K_n = [1 + i ?(1 - ?_i)]^n ?K_o$ and $K_n = (1 - ?_i) ?q^{n-1} ?(1 + i) ?K_o + ?_i?K_o$ for a reinvestment abroad.

containing the conditions for an indirect tax credit (§ 26 Para. 2 of the Corporate Income Tax Act). If no credit is granted in respect of foreign corporate income tax – for dividends derived from portfolio investments or dividends paid to individuals – the use of foreign corporations as a tax shelter entails even longer payback periods[15].

In contrast to the current Law to Prevent International Fiscal Evasion, the solution under description targets neither abuse by residents nor abuse by foreign countries. Rather, its purpose is to eradicate the consequences of detrimental (in terms of efficiency) differences in tax burdens. Accordingly, the addition of foreign profits to a resident's domestic income would come into effect only where the foreign tax burden is extraordinarily low, but on doing so would also, and this is the whole point, apply in the case of companies actively engaged in business, which not only means a loss in tax revenues but also a real economic distortion. One could object that taxing such income may not be acceptable under current international law, provided that the corporations are engaged in active business. In addition, it has already been pointed out that the above arguments are based on the assumption that gains on the disposal of shares are taxed consistently.

Capital gains taxation has hitherto constituted an exposed flank in German tax law because resident individuals have been able to avoid tax on such gains when selling foreign shares that do not represent a major holding (§ 17 of the Individual Income Tax Act) on expiration of the speculation deadline (§ 23 of the Individual Income Tax Act). This amounts to a hidden unilateral exemption of certain foreign income components and is thus a loophole that has to be closed in any case. Likewise, the extended international affiliation privilege for corporations (§ 8b of the Corporate Income Tax Act) would also have to be abolished.

C. Bilateral and multilateral measures

1. International agreement on the taxation of interest income

Foreign interest and dividend income accruing to German residents is always taxed according to the credit method; the same applies to individuals based abroad in receipt of interest or dividend income derived from Germany. The international tax system thus provides for *de jure* capital export neutrality in this area. However, *de facto* fiscal distortions arise when the relevant residence country levies a higher tax rate than the source country and when foreign interest or dividend income is not assessed effectively. In this case individuals have an incentive to evade the payment of tax by declining to disclose their foreign income.

This problem affects all countries of residence, not just Germany. Whereas the "migration of toads to Luxembourg" has become proverbial in Germany, the Luxembourg revenue authorities, in turn, are forced to accept that many of the residents based there have accounts with German banks. The rationale behind this behaviour is the fact that Germany does not levy its withholding tax on interest income (*Zinsabschlagsteuer*) when the interest income accrues to non-residents, nor does it send information to the residence country.

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[15] Here, the mathematical expression q^{n-1}?$(1 + i)$ must be replaced by the expression q^n in the first summand of the second equation in Footnote 14, as the foreign tax incurred in the previous year is also ineligible for a tax credit.

In general it can be said that the industrial nations impose a relatively high level of tax on the interest income accruing to residents while levying low withholding taxes or none at all on interest accruing to non-residents. In conjunction with the lack of information on foreign income this leads to an undermining of the residence principle. For tax reasons various forms of "crossover investment" manifest themselves. In simplified terms this means that citizens of country A invest in country B and vice-versa. The primary impact of this type of investment is a reduction of tax revenues rather than a distortion of the capital allocation.

Insofar as the countries involved acknowledge their common interest in the fight against international tax evasion, it is feasible that agreement could be reached on corresponding countermeasures. Possible measures include the following:

- Harmonisation of withholding taxes: countries reach agreement on minimum tax rates for interest payments made to non-residents.
- Greater exchange of information: countries exchange tax-audit tracer notes in respect of interest paid to non-resident citizens of the other country.

The harmonisation of withholding taxes is a difficult task for a number of reasons. In order to remove all and any incentives for tax evasion, the agreed minimum tax rate would have to correspond to the top tax rate in the country that taxes capital income the most. However, in conjunction with interest payments to other countries this would lead to excess foreign tax credits that impinge upon capital export neutrality. In addition, such a high withholding tax rate would run counter to current tax treaties, under which the source country has only a very limited right to tax interest and dividends; under normal circumstances the source country may levy a maximum tax rate on interest and dividends of between 5 and 15%. In particular, however, all countries would have an incentive to deviate from the terms of the agreement because the taxation is not ideal from the point of view of the source country (for details see IV.C.2), and any deviations would remain concealed from the residence countries.

Cross-border tax-audit tracer notes, as are regularly sent out by the USA, for example, are an alternative instrument in the fight against international tax evasion. The source country informs the residence country of the capital income received by persons residing in the latter. The information is sent in standardised electronic form on the basis of reciprocity. In contrast to the withholding tax case, the residence country is able to check to what extent the other country is abiding by the agreement. Tax audits conducted by the residence country at the companies or individuals based there reveal whether information has been received in respect of foreign income derived from the country concerned. One advantage of a greater exchange of information compared to harmonised withholding taxes is thus the fact that the relevant agreement is easier to verify. However, a disadvantage is that the incentive to deviate from the terms of the agreement is likely to be greater in comparison.

In principle, a greater exchange of information can be agreed on a bilateral or a multilateral basis. The multilateral solution is to be preferred because an agreement between just two countries offers individuals the opportunity to turn to a third country. The member states of the European Union are predestined for the introduction of a greater exchange of information for the following reasons:

- The single European market, because of the removal of the restrictions on capital movements, has generated a particularly intensive degree of economic integration, which means that tax evasion is likely to exist on a large scale in the EU region.

- The introduction of the single European currency increases the likelihood of tax evasion still further due to the disappearance of the exchange-rate risk.
- Finally, a greater exchange of information within the European Union could be introduced by EU legislation instead of a multilateral agreement under international law.

Greater exchange of information within EU territory would comprise two elements, namely communications in respect of cross-border capital income within the EU territory and communications in respect of payments made to and received from any non-participating country. The second element is necessary to ensure that the system is not bypassed by tax evasion in non-EU countries. Greater exchange of information does not stand in contradiction to the principle of unrestricted capital movements in the European Union; Art. 58 Para. 1 (b) (formerly Art. 73d Para. 1 (b)) of the EC Treaty (TEC) expressly permits member states "to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security". In addition, a greater exchange of information between the EU member states and other interested countries, say the USA, could be agreed by treaty. Yet it is clear that a prudently operated system of exchange of information will never put a stop to every type of tax evasion; this applies equally to national tax evasion.

Germany, which unlike France, for example, has largely declined to control interest income, would also have to implement a number of changes at national level if it wished to ensure uniformity of taxation. With this aim in mind an orientation to its neighbour may not be a bad thing at all: In France all account-holding banks are obliged to send tax-audit tracer notes automatically to the revenue authorities. Moreover, the revenue authorities maintain a database that allows them to conduct a search for all the accounts held by a particular resident or, vice-versa, to ascertain the identity of the holder of a particular account. Physical transfers of money abroad and the opening of new bank accounts abroad have to be declared under threat of a fine. Where this obligation is not met all capital flowing back into the country is considered to be income, unless the resident can prove that he has already paid tax on some income components.

Politically, the proposal to assess capital income more stringently than before will be a controversial one. This is why the Scientific Council would like to emphasise that it is not its wish to introduce restrictions on the movement of capital, but rather a system of information exchange whose only purpose is to ensure that every citizen actually pays the tax he incurs under the law.

2. Revision of double-taxation agreements

The key element of any plan to reinforce the residence principle is a general transition from the tax-exemption method to the tax-credit method (see III.B.1). Where exemptions are based on unilateral law this does not present a problem. It would appear more difficult to remove the exemption method wherever it is rooting in bilateral treaties (double-taxation agreements). Although it would be possible to renegotiate all DTAs, this would be extremely difficult to put into practice:

- Amending a DTA would be a prolonged process of negotiation and approval requiring subsequent ratification by the parliaments of the countries involved as they are treaties signed under

international law. Realistically, it would take about 10 years to renegotiate all DTAs, of which there are approximately 70.

- Some contracting states would reject Germany's proposal to switch from the exemption to the credit method because the disadvantages to Germany described in the introduction – the depletion of the tax base and economic activity – have as their antithesis corresponding advantages for other countries.
- Above all, however, a problem of timing would arise if the transition to the credit method were to be combined with tax relief measures for companies, especially tax rate cuts. It would be virtually impossible to introduce all these measures at the same time.

For these reasons the enactment of a tax treaty law has been proposed by a number of experts and politicians, by means of which Germany would unilaterally replace the exemption method by the credit method. The tax treaty law would be effective domestically; however, at the international level it would amount to a breach of treaty – a so-called treaty override. Some members of the Council are of the opinion that this proposal generates more fiscal disadvantages than advantages. Under the Vienna Convention on the Law of Treaties the contracting states would in this case have the option of terminating the DTA or suspending its application. Retaliatory measures are also admissible. First and foremost, these would probably consist of a withdrawal of withholding tax exemptions. For an exporter of capital and technology like Germany this would have serious consequences, since credits would have to be granted at home in respect of the higher withholding taxes levied abroad.

Nonetheless, a majority of the Council believe that several factors speak in favour of the enactment of a tax treaty law:

- The assignment of taxation rights to the source country and the residence country, respectively, is the core element of each DTA. These provisions would not change. In particular, there would be no reduction in the tax revenues due to the source countries.
- The question of how the residence country – in conjunction with a given right of taxation in the source country – removes the double taxation, by exemption or by credit, is considered to be its own internal affair. The OECD Model Convention allows either option.
- The contracting states frequently choose different methods, i.e. one grants a credit, while the other exempts. Those contracting states that themselves allow a credit, and they form the majority, will hardly regard a transition to the credit method by Germany as an affront.
- Finally, it would be difficult to persuade those countries that in the past have exploited Germany's use of the exemption method by consciously creating loopholes to agree to an amendment of the agreement. In this case the only available option would be to terminate the agreement and then conclude a new one. This would lead to an economically damaging period without a DTA until such time as the new one came into effect.

The tax treaty law could be supplemented by renegotiating the DTAs on a step-by-step basis. Such negotiations would also include those DTAs in which Germany has provided for a tax sparing credit. A tax sparing credit in this sense is a credit granted in respect of taxes that have not been paid at all or have not been paid in the relevant amount in the source country. This boils down to an inappropriate subsidy, originally intended as a development aid. Compared to direct payments to developing countries, the first disadvantage of tax sparing reliefs is that they are fixed in the DTA. Thus the credits cannot be

revoked unilaterally even where there is advanced economic development. This is why tax sparing credits are still granted in dealings with countries such as South Korea or Malaysia. Above all, however, it makes no economic sense to provide development aid in the form of systematic distortions in the allocation of capital. The associated loss in efficiency means that the taker receives less than the giver foregoes.

Finally, a general transition to the credit method would allow the terms of the DTAs to be tidied up and simplified. In particular, switch-over clauses (Germany reserves the right to switch from the exemption method to the credit method when the source country imposes an insufficient level of taxation), subject-to-tax clauses (Germany allows exemptions only when the source country imposes a sufficient level of taxation) and activity clauses (exemptions are allowed only when a corporation is engaged in active business) would become obsolete.

3. Cross-border imputation relief

Thus far, the term "tax credit" in this outline of the residence principle has always referred to cross-border matters and to taxes of the same type; we have considered the credit of foreign individual and corporate income tax, respectively, against domestic individual and corporate income tax. In addition, there exists a further, somewhat complicated tax-credit problem that has attracted increasing attention over recent years, namely cross-border credits of corporate income tax against individual income tax. There are two different problem areas:

- Under the existing law non-resident individuals who own shares in German corporations, in contrast to residents, are not granted a credit in respect of the corporate income tax. As a consequence, the corporate income tax (including solidarity surcharge) imposed on dividends becomes definitive for foreign investors. Because foreign individual shareholders cannot in any case obtain a credit at home for the local trade tax paid by the German corporation, the total tax burden on distributed profits amounts to 45% from their point of view (see Tab. 1 in Section II.B). In the home country the remaining dividend is taxed in full after allowing for a credit in respect of German capital gains tax. A problem of double taxation exists.
- Conversely, resident individuals with shares in foreign corporations do not receive a refund in respect of foreign corporate income tax. This also amounts to double taxation, since profits distributed abroad are subject to corporate income tax and then incur individual income tax in Germany[16]. With a view to this case the European Commission instigated breach of treaty proceedings against the Federal Republic of Germany in 1995, accusing it of fiscal discrimination against the purchase of foreign shares by German residents.

Where two countries each maintain an imputation system, the situations described above exhibit a tendency to split the market and in this respect hinder the free movement of capital. This becomes clear if one considers the example of a German and an Italian resident who both have shares in publicly traded corporations in their respective home countries. Both view the corporate income tax on distributed profits as a transitory item. Yet they are hardly likely to exchange shares, even if it were profitable to do so, because the corporate income tax credits would be forfeited in both cases.

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[16] France is an exception. Under the German-French DTA the German fiscal authorities refund the corporate income tax paid in France to individuals domiciled in Germany and receive a corresponding refund from the French fiscal authorities.

There are two possible ways of preventing such a market split. Firstly, the residence country could also allow foreign corporate income tax to be credited against domestic individual income tax. Alternatively, the source country could refund the burden on distributed profits in the case of shareholders who prove they are non-residents. The first solution is more in line with double taxation-agreements, which put the onus to prevent double taxation on the residence country; this solution is also less liable to abuse because the resident has to declare the foreign dividends in order to benefit from the credit. By contrast, if the dividends remain tax-free in the source country, a problem of assessment results.

Yet the real difficulty is rooted in the substantial differences between the national corporate income tax systems. In Germany, Finland, France, Italy and Norway, domestic corporate income tax is credited against the domestic individual income tax in full. This full credit system prevents the double taxation of profits made by corporations and ensures neutrality in respect of legal form. Great Britain, Ireland, Japan, Canada, Portugal, Spain, amongst others, prevent double taxation only in part by crediting certain percentages of the corporate income tax against the individual income tax (partial credit system). Other countries do not allow any corporate income tax credits (classical system); in addition to the USA the main ones are Belgium, Denmark, The Netherlands, Greece, Sweden and Switzerland. Many of the latter countries tax dividends accruing to the shareholder at reduced rates (shareholder relief), which stretch to tax-free dividends in Greece.

In relations with countries operating the classical corporate income tax system the above-mentioned market split does not appear, at least not in a clear form. Take, for example, the USA, which levies corporate income tax on distributed profits and subjects the remaining net dividend accruing to the shareholder to income tax at the full rate. As far as a US resident choosing between US and German shares is concerned, the current system of double taxation is neutral in international terms, at least where corporate income tax rates are the same, because the individual suffers the same double taxation in both cases. A refund of the corporate income tax to non-residents by Germany could be construed as an aggressive policy by the USA because dividend payments to US citizens from German corporations would receive a more favourable tax treatment than dividend payments from US corporations. Conversely, a curious "clientele" effect would come about, were Germany to credit the US corporate income tax against the German individual income tax: from the point of view of German taxable individuals, US corporations would be a better bet in comparison with US partnerships than they would be for US individuals.

In sum, the problems addressed in this section should not be resolved unilaterally. Crediting foreign corporate income tax against German individual income tax as well as refunding of German corporate income tax to non-residents may generate advantages as far as the allocation of capital is concerned; yet a unilateral combination of these measures would amount to a general shift of the tax yield abroad, which is not in the German interest.

In contrast, bilateral or multilateral agreements with those countries that also allow a full credit in respect of corporate income tax would appear possible. A corresponding revision of existing double-taxation agreements with these countries would entail crediting foreign corporate income tax against domestic individual income tax generally. The allocation of tax revenues to the two countries involved could be regulated by the agreed taxation right of the source country; alternatively, a scheme of refunds between the countries could be agreed. Obviously, the prospects for negotiations in this respect are good only if Germany has not already given up its taxation rights unilaterally.

At the European level even a multilateral agreement by which each member state credits the corporate income tax paid in another member state against its domestic individual income tax would appear possible. A corporate income tax system incorporating full credits across national borders corresponds to the fundamental principle of the single market that investment decisions should not be distorted by fiscal regulations. Moreover, a system of this type allows extensive fiscal autonomy for the member states; it therefore satisfies the principle of subsidiarity.

A possible European corporate income tax system would have the following features. Firstly, the corporate income tax paid in any EU country would be credited against the domestic individual income tax according to the ordinary credit method. Secondly, there would be harmonisation of the assessment of profits and the taxation of distributed profits (e.g. 20%). Thirdly, a uniform tax rate would be agreed in respect of retained profits. This rate would correspond at least to the highest income tax rate within the EU (e.g. 50%).

These harmonisation measures may appear far-reaching at first glance, but they are compatible with the principle of autonomy of the member states in the organisation of their individual income tax structures. Their sole purpose is to remove the possibility of tax deferrals within the EU region, with the result that controlled foreign corporation-legislation would be required only for corporations in non-EU countries. Owing to the incentive for companies to distribute profits, the system would not be neutral. However, this distortion is of minor importance compared to the existing market split. Taken together, the fiscal incentive for corporations to distribute profits and the harmonisation of corporate taxation represent the price to be paid for an otherwise neutral European corporate income tax that grants member states wide-ranging freedoms with regard to individual income taxation.

IV. Reinforcing the source principle

Distortions in the international capital allocation and losses in tax revenue arise, as shown in Chapter II, as a result of regionally differing taxes and opportunities for avoiding taxes on foreign income. A consistent application of the source principle can help to rectify these problems.

A. Characterisation of the source principle

On application of the source principle individuals and corporations are liable to pay tax only at the place of income accrual; their tax liability is restricted to income earned in the relevant state (territorial principle). Cross-border investments in themselves no longer incur a tax liability in the residence country.

A fascinating advantage of the source principle is the simplification of affairs for revenue authorities, individuals, and companies. For the revenue authority this means less work in the clarification of foreign tax matters, in particular the identification of foreign income and the taxes paid abroad. For taxpayers the arduous, extensive "duty to co-operate" (§ 90 Para. 2 of the German Fiscal Code) largely disappears. Consistent taxation of all income components at source cuts off opportunities for tax evasion and renders the exchange of information across national borders by revenue authorities largely unnecessary. Nonetheless, some degree of co-operation between the revenue authorities will be necessary: when payments are received from abroad, for example, the home revenue office must be able

to distinguish between capital income (already taxed at source) and payments for goods supplied (as yet untaxed).

A further advantage often attributed to the source principle is that it establishes a connection between the services a source country renders on behalf of resident companies and the taxes it receives from these companies. According to this benefit principle the taxes paid in the source country represent a price to be paid for the infrastructure provided by the state. Admittedly, this argument does not hold up for two reasons: firstly, the majority of the value added is subject to taxation exclusively in the source country, even when the residence principle is enforced. This applies in particular with regard to wages and local rents. The difference between the two principles mainly concerns the fiscal treatment of company profits. Yet if the profit accrues in the source country on the basis of capital or know-how that was created in the residence country utilising the infrastructure there, the residence country could equally construct a valid claim under the benefit principle. Moreover, the fact that it is mostly the residence country and not the source country that offers the owner of capital social protection justifies at least a partial taxation right on behalf of the residence country, similar to an "insurance premium".

Secondly, and more importantly, benefit taxation is advisable only when services are allocable to individuals or groups, but not in the case of public goods, which are made available to all companies and individuals together. However, if services are allocable to individual entities, then charges or market prices and not taxes are the most appropriate financing instrument. This notion can be illustrated by the example of the public good "social peace", which is also unquestionably of benefit to companies resident the country concerned. Of sole relevance for fiscal policy is the question of whether more funds need to be invested in order to preserve this peace if more companies settle in the country, and not whether the companies benefit from the existence of social peace. If the influx of new companies generates no extra costs, then it is right to tax only local factors and not the companies. In sum, benefit considerations cannot be used in support of the source principle.

The source principle can be put into practice by exempting all foreign income from taxation in the residence country (exemption method). Some observers also see an economic advantage here in that German companies with foreign operations and foreign companies are treated as equals for tax purposes. Indeed, the source principle ensures that all investments made in a given country are treated the same in tax terms, regardless of the country of origin of the investment funds. This is called capital import neutrality. In contrast, the residence principle ensures that all investment funds carried out by residents of a given country are taxed equally, irrespective of the countries in which the funds are invested (capital export neutrality). These conditions for neutrality can be satisfied concurrently only if tax systems are identical the world over.

One explanation put forward for the significance of capital import neutrality is that its infringement leads to a distortion of competition. Where the residence principle is applied – so the argument goes – companies from high-taxation countries investing in low-taxation countries suffer a disadvantage due to the bumping up of the taxes on profits to the levels imposed in the residence country. In reality, however, there is no real distortion of competition because companies residing in high-tax countries incur lower opportunity costs.

Example: The residence country of a company imposes a tax rate of 50%, the source country imposes 25%. With a gross interest rate of 8% and an investment opportunity in the source country yielding exactly 8%, it seems as if the company is hardly in a position to compete with rivals resident in the source country. This is because the company faces a net return of 4% whereas its rivals make 6%.

However, when gauged against an alternative investment in securities, the company has lower opportunity costs than its competitors; these are also 4%, whereas its competitors have to earn 6%.

It is true that highly-taxed companies are left with fewer funds with which to finance future investments and that, if self-financing, they grow more slowly than competitors incurring low tax rates. However, this reflects merely the general disadvantages of high tax burdens – the companies under consideration suffer the same problems as savers in the high-tax country, whose assets grow correspondingly more slowly. Although the affected individuals will consider this a disadvantage, there is no relevant distortion of competition; the investment decisions remain fiscally undistorted.

Accordingly, where capital income taxes differ, only the residence principle, and not the source principle, will guarantee an efficient capital allocation (production efficiency): the residence principle induces an alignment of gross interest rates world-wide, and in a theoretical state of equilibrium each investment attracts the same yield everywhere. Each infringement of production efficiency means that the world's national product is not maximised but can be increased by a shift of capital to the location offering the higher return.

A subtle advantage of the source principle shows itself in the sphere of savers, in that it works towards an alignment of net interest rates. If the savers resident in various countries can expect the same net interest rate, the decision on whether to spend or to save remains distorted in every country. This is why one also speaks of consumption efficiency rather than of capital import neutrality. However, proportional income taxes are a precondition for the equalisation of net interest rates, because otherwise each saver will face an own net interest rate in accordance with the personal marginal tax rate, and the equalisation of net interest rates will already fail at the national level.

With a progressive tax neither the residence principle nor the source principle is able to generate consumption efficiency. Moreover, the source principle is compatible with production efficiency only in one special case, i.e. when mobile factors are subject to the same tax burden everywhere. Consequently, tax harmonisation acquires a high status when the source principle is applied. This is not the case for the residence principle, which ensures production efficiency irrespective of differences in tax rates. Without tax harmonisation the world's capital stock is allocated inefficiently under the source principle. In this respect unilateral measures designed to reinforce the source principle have to be combined with multilateral tax harmonisation measures, if the international allocation of capital is to remain free from tax distortions.

B. Unilateral measures

1. Consistent exemption

Unilaterally, the source principle can be reinforced by consistent exemption of all foreign income. To date, only selected income components are exempt, primarily income from permanent foreign establishments or facilities, foreign real property, dividends from affiliated companies and certain types of earned income named in the Foreign Activities Ruling. By comparison, a source principle implemented on a consistent rather than on a selective basis necessitates the exemption of all foreign income components – including interest and dividends accruing to individuals. If the exemption is granted only in selected cases or is subject to progressive taxation, the main advantage of the source principle mentioned above, i.e. the fact that transactions in the foreign country no longer play a role in

the assessment of the domestic tax charge, disappears – details of foreign income will still have to be assessed in order to determine whether or not the income is eligible for exemption or in order to set the average tax rate.

Consistent exemption also means that income from abroad is not taken into consideration during assessment of the domestic tax liability irrespective of its origin and that expenditure related to this income is not deducted from the domestic tax base. This brings us to the problems regarding foreign losses and interest charges on holdings in affiliated foreign companies, which are in need of detailed discussion on account of their fiscal importance. Both problems are not inherent in the source principle, quite the opposite; they are to be considered a breach of this principle.

2. Treatment of foreign losses

According to an easily remembered legal formulation foreign income is "non-existent" for tax purposes under the source principle. Positive foreign income is not considered to be an enhancement of the ability to pay domestic tax, irrespective of whether it has been taxed abroad. The Federal Fiscal Court has thus shown consistency in ruling that negative foreign income cannot be construed as a reduction in the ability to pay domestic tax, and that it is therefore the task of the foreign country alone to make allowance for such losses.

The legislature expressed its opposition to these judgements in the shape of the Foreign Investment Act (*Auslandsinvestitionsgesetz*), now phased out, the relevant provisions of which were adopted in § 2a Para. 3 of the Individual Income Tax Act. Under this stipulation, losses from tax-exempt foreign activities are deductible, if a deduction would have been allowed had the income not been exempt. Positive income components accruing in subsequent years must be included in the tax base up to the point where they correspond to the losses deducted previously; these positive income components are taxable, of course. In defence of this provision it is argued that enterprises suffering losses in DTA countries should not be treated less favourably than enterprises in non-DTA countries.

This justification does not bear close examination, since in dealings with non-DTA countries the credit method (§ 34c of the Individual Income Tax Act, § 26 of the Corporate Income Tax Act), which is usually less favourable from the point of view of the resident, is applied. Under the tax credit method, the deduction of foreign losses is appropriate because world-wide income forms the yardstick for the ability to pay; under the exemption method (which is applied in the DTA case), the deduction is inconsistent. In addition, the stipulations of § 2a of the Individual Income Tax Act mean that losses may be taken into account twice if they are deductible from taxable income abroad[17]. Paragraph 3 Sentence 4 of this provision even states that subsequent profits will not be taken into account if the foreign country does not allow losses to be deducted from income across a given period. So Germany not only deploys

[17] This situation arises, for example, when the taxable person derives income from non-commercial sources in a foreign country and the country's tax law allows any commercial losses to be set off against this income.

its own tax revenues to iron out defects in the foreign country's tax law, but also implicitly gives the foreign country an incentive to refuse to allow deductions of any losses incurred[18].

Furthermore, it is questionable whether the attribution and taxation of subsequent profits would remain free from evasion. After all, the requirement to assess any foreign losses and check back over several years under a special procedure whether tax has been paid on subsequent profits negates the actual advantage of the source principle, that is, to simplify taxation. In sum, the allowance of relief on foreign losses represents an inconsistent break with the source principle for which there is no professional justification.

3. Business expenses where foreign income is exempt

For the source principle to be implemented in a coherent way it is essential that business expenses, in particular interest expenses related to foreign income, are not deducted from the domestic tax base. Opponents of this legislative principle, which was incorporated in the Income Tax Act in 1958, claim that the allowance for interest charges is lost in full if interest charges are not deductible abroad either. However, it depends on the actual facts of the case concerned whether or not an allowance is granted abroad in respect of interest charges. The allowance can be obtained, for example, by assigning the debt to the foreign subsidiary or by interposing a foreign holding corporation. In the rare event that the law of the foreign country does not allow any such arrangements, the country concerned has only itself to blame for the resulting unfavourable investment climate; the German revenue authorities cannot be held responsible.

Under § 3c of the Individual Income Tax Act items of expenditure that exhibit a direct economic relationship with tax-free income do not constitute tax-deductible expenses. This rule would appear to satisfy the requirement outlined above. The requirement for a "direct" economic relationship and the relevant rulings of the Federal Fiscal Court mean that the purpose of the provision is far from satisfied, especially in the quantitatively significant case of interest charges related to the purchase of holdings in foreign affiliated companies.

According to decisions made by the Federal Fiscal Court interest charges on debts incurred on purchase of holdings in foreign affiliated companies are not deductible, but this applies only up to the amount of dividends paid. In practice this has led to the so-called "ballooning concept": instead of paying dividends on a continuous basis, the foreign subsidiary pays them together once a few years have elapsed. In the period before the dividend payment is made the interest charges thus remain fully deductible; the

[18] One Council member does not agree with the Council’s view that the granting of relief for losses incurred by permanent foreign establishments runs counter to the principles of the exemption method: in cases where such losses outweigh the positive domestic earnings, the taxation levied on repeal of § 2a Paras. 3 and 4 of the Individual Income Tax Act would be incompatible with the system, at least with regard to the corporate income tax, since there would be no available income at all and the exemption with progression method is not applicable to corporate income. The fact that the ban on the deduction of losses made by permanent foreign establishments in exemption cases is not an obligatory system component is demonstrated by the arrangements in other countries such as Switzerland and The Netherlands, for example, where such deductions are permitted. The draft EU directive on the setting off of losses dated February 28, 1991 also includes the option of setting off losses made by permanent foreign establishments in exemption cases. In October 1998 the International Fiscal Association also announced its support for such an arrangement. If one considers the repeal of § 2a Paras. 3 and 4 of the Individual Income Tax Act from the point of view of promoting Germany as a business location, then the conclusions drawn will give cause for concern. The risk-laden industrial engineering industry, in particular, which falls back on this regulation in its foreign business dealings, will establish corresponding companies in the countries that allow losses made by permanent foreign establishments to be set off where the exemption method is used. Business activity would in this respect be forced out of Germany. It would therefore make more sense to introduce measures to make sure that the profits subsequently made by the permanent foreign establishment are actually subject to taxation, rather than repealing the stipulations of § 2a Paras. 3 and 4 of the Individual Income Tax Act.

restriction on such deductions does not take effect until the year of distribution. Yet even this restriction can be successfully evaded if the foreign investment is sold tax-free before the profits are distributed (§ 8b Para. 2 of the Corporate Income Tax Act) and the debt is discharged using the proceeds of the sale. What is more, if the recipients of the interest charges are domiciled abroad, the entire tax revenue accrues there.

The necessity for a direct economic link between tax-free income components and interest charges is a fundamental problem. One could say that such a link exists, if the resident corporation funds the purchase of the foreign holding by means of a loan taken out especially for this purpose. Yet the link is very tenuous because a company balance-sheet gives no indication of which assets were funded by what liabilities.

Under the traditional income tax, then, the source principle reveals its limitations as soon as revenues and the associated expenditures do not accrue within a country, but across national borders. In this case, income, the difference between receipts and expenditure, can no longer be tied down to a specific location. One possible solution entails jettisoning the overly restrictive prerequisite regarding a direct economic relationship between tax-free income components and the deduction of interest charges[19]. Alternatively, a standardised comparison of assets and liabilities (asset test), as provided for in some foreign tax laws, could be made: a holding company, for example, can deduct from its tax charge half of the interest charges incurred if half of its assets consist of investments in affiliated companies in a foreign DTA country[20].

4. Transfer prices

The problem of transfer prices has already been touched upon several times. It is being dealt with at this point because the problem of inter-company transfer prices takes on extreme proportions whenever foreign income components are exempt from taxation and when differences in national tax rates exist. Under these conditions a multinational can reduce its total tax burden by shifting profits to low-taxation countries by setting inter-company transfer prices. Whereas the shifting of profits by means of transfer

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[19] One member considers this Scientific Council viewpoint to be worthy of criticism for several reasons. Firstly, the restriction on tax deductions is not limited to interest charges. The costs of investment administration, research or general administration will no longer be tax-deductible on a pro-rata basis in future. However, because the investment abroad represents a domestic asset an allowance cannot be granted abroad either, which means that the costs would not be deductible anywhere. This is unsatisfactory, and not only because the dividends paid by the affiliated company abroad incur a profit tax that is borne by the resident parent company. Where the foreign subsidiary returns a loss there is also no opportunity for compensation for business expenses that cannot be deducted from the parent company's tax liability. Thus, on accrual of business expenses in Germany, the exemption from taxation of foreign dividends received from affiliated companies is in overall terms less favourable than the indirect setting off of foreign corporate income tax. Finally, one of the aims of the 1993 Business Location Act, i.e. to make Germany an attractive location for holding companies, would be impaired. Multinational concerns, in particular, would establish holding companies in countries where there are no such regulations.

[20] One member recommends a regulation corresponding to § 8a of the Individual Income Tax Act that lays down a limit on the third-party funding of the foreign investment. This would permit a reasonable tax deduction of interest charges related in cause to foreign investments in affiliated companies, counteract the ballooning concept and, at the same time, take into account the fact that foreign investments, even where these are in affiliated companies, are in the interest of the German economy, since it is generally felt that they also help to secure German jobs.

prices makes little sense under the tax-credit method from the point of view of the taxpayer[21], under the exemption method it leads to an immediate tax advantage in the amount of the difference in tax rates. This applies to resident parent companies as well as to shareholders if the exempted profits are subsequently reinvested at home ("Siemens effect", see Subsection II.C.3).

Transfer prices are customarily set by reference to market prices under the arms-length principle[22] (market price concept). They are difficult to compute whenever directly comparable market prices are not obtainable. This is why transfer pricing problems are encountered in conjunction with patents and licences, loans from shareholders and products for which no market prices are available. Although the parent company cannot set prices at random in such cases – something it will often refrain from doing for commercial reasons as well – there is some nebulousness, which can be utilised for the purposes of reducing the tax charge. Because the achievable tax advantage depends on the tax rate difference, transfer prices are particularly important in conjunction with foreign subsidiaries resident in tax havens or in countries with extremely low tax rates.

Transfer prices are important not only from a commercial point of view, but also because they influence the way in which the tax yield is distributed between the revenue authorities concerned. Even if the resident has no incentive to engage in "manipulative" pricing, the supply country draws more benefit when transfer prices are as high as possible, whereas the recipient country benefits more when they are as low as possible, irrespective of whether the tax systems of the countries concerned follow the residence principle or the source principle. Owing to the difficulty in calculating transfer prices and the variety of methods used (comparable uncontrolled price method, resale price method, cost-plus method, profit-split method, transactional net marginal method) there is an acute danger that companies operating across national borders will slip between two fiscal millstones. The mutual agreement procedures provided for in the DTAs and the EU Arbitration Convention are able to reduce the risk of residual double taxation only in part.

A possible solution to the transfer price problem therefore lies in an international agreement similar to the German rules regulating the apportionment of the corporate income tax among the German states (*Länder*). Inter-company profits are allocated according to an objectively determinable key (such as fixed assets or wage bills), which means that transfer prices serve only commercial purposes and are irrelevant in taxation terms. From the point of view of companies the agreement provides a legal safeguard and prevents double taxation, insofar as the revenue authorities agree on factors of allocation and the amount of the total annual profit. However, current international opinion opposes a global formula with regard to the allocation of profits.

To conclude, it should be noted that an international tax policy oriented toward efficiency would ease the transfer price problem; transfer prices are useful as a flexible corporate instrument only under the tax-exemption method in combination with differences in tax rates.

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[21] Owing to tax deferral strategies, transfer prices can form a part of tax planning only in conjunction with extreme tax rate differences, inadequate CFC-provisions or gaps in capital gains taxation; c.f. Subsection III. B. 2.

[22] The arm's length principle means that income components are set at the amount that would have arisen in business transactions between independent enterprises.

C. Bilateral and multilateral measures

1. Source principle and tax harmonisation

If all kinds of foreign income are tax-exempt, capital import neutrality is always guaranteed. However, capital export neutrality and production efficiency are guaranteed only when mobile factors are subject to comparable tax burdens at home and abroad. If domestic tax rates are higher than those abroad, a tax wedge arises and production activities and tax base migrate to foreign countries. Consequently, exemption makes sense as a unilateral measure only when tax rates are comparatively low. On the other hand, it would hardly be possible to cut German tax rates in the course of a unilateral transition to the exemption method, since the transition itself would lead to a drop in tax revenues and therefore, where the budget is the same, require tax rates to rise rather than fall. Thus, a strategy to reinforce the principle of source becomes attractive only when agreed upon by many countries.

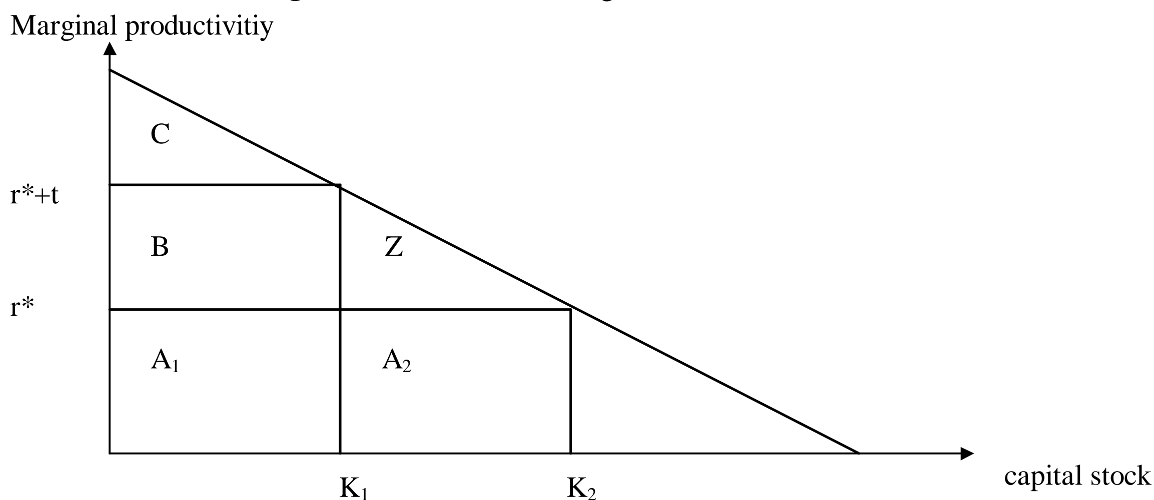
The basic idea underlying this chapter is for all countries, where possible, to impose taxation on capital income at source, namely at the point where it accrues, in the companies. If this were the case, companies would only be able to pay out net returns to their creditors, and the tax component would be remitted directly to the revenue authority. Put differently, individuals would only receive investment income on which tax has already been paid, which would render tax evasion almost impossible.

Example: All countries levy a withholding tax of 25% on the capital income earned by companies at home. No other capital income taxes exist. A German investor receives 75 of every 100 of capital income earned at home or abroad. The decision taken by the investor with regard to investment location, therefore, is subject to no distortion and he has no means of evading capital income taxation.

2. International agreement of minimum tax rates

Modern fiscal theoretical research has drawn attention to a fundamental problem associated with this proposal: it is not in the interest of an individual country to levy withholding taxes on mobile factors where taxes on immobile factors are available. It should be emphasised here that even the providers of immobile factors – above all, recipients of earned income – will be opposed to positive withholding taxes on capital income once they recognise their consequences. Fig. 5 illustrates the intuition behind this argument.

Fig. 5: Effect of a withholding tax.



The diagram shows the marginal productivity in a country as a function of the real domestic capital stock. It is based on the assumption that the extra output derived from a small increase in the capital stock (marginal productivity) decreases as the capital stock grows. The figure r* symbolises the rate of return on investments in the country required by foreign investors; expressed in simple terms, r* is the world market interest rate. If the country under consideration imposes no withholding tax, then investments are profitable up to the capital stock K_o. The domestic product corresponds to the trapezoid below the curve between the points zero and K_o. It is made up of the capital income $r^* \cdot K_o$, which corresponds geometrically to the rectangular area A_1+A_2, and the wage bill given by $B+C+E$.

If the country under consideration decides to levy a withholding tax in the amount of t per capital unit, the required rate of return for investors rises to r^*+t to ensure they still receive r* after deduction of the withholding tax. The value of domestic capital stock falls to K_1 in order to satisfy this requirement; the domestic product now corresponds to the trapezoidal area A_1+B+C. If one subtracts the capital income A_1, one is left with tax revenue B and wage bill C. Even if the country pays out the entire tax revenue to the workers, the wage bill is only $B+C$, i.e. less than when no withholding tax $(B+C+E)$. The triangular area E thus represents the excess burden of taxation, i.e. that part of the national product which has been destroyed by the inefficient withholding tax. Workers who understand this prefer the abolition of the withholding tax to lower wage taxes, because withholding taxes on capital are taxes on jobs[23].

We would like to emphasise that this argument applies only to capital income taxes imposed at source. The argument does not apply to capital income taxes imposed on residents because residents – unlike domestic capital – cannot easily avoid taxation by moving abroad. In addition, because of the credit method inherent in the residence principle each source country has a major incentive to levy withholding taxes insofar as it avoids the formation of excess foreign tax credits: withholding taxes imposed at home and credited abroad do not reduce the domestic capital stock; their sole effect is to reduce the foreign tax yield.

Thus a system in which capital income is taxed at source everywhere and is exempt from taxation in the residence countries benefits *all* countries in that it rules out opportunities for tax evasion without a need for an exchange of information. However, each *single* country will not tax capital income at source if the income is exempt in the residence country, unless perhaps to serve as an example for other countries. For this reason, the situation we have outlined will not develop spontaneously but will require an international agreement.

The most important element of any such agreement is minimum tax rates in respect of capital income. Tax rates that are higher than the envisaged level could of course be allowed; however, it is to be expected that the minimum tax rates would correspond approximately to the ones actually imposed, for even if a country offers an above-average infrastructure, it will, for the reasons outlined above, find it ideal to raise the funds required for said infrastructure by taxing immobile factors only and staying as close as possible to the lowest permissible figure when setting the capital income tax rate. Without binding minimum tax rates, the source principle leads to competition in the taxation of mobile factors involving ever diminishing tax rates.

[23] In the view of one Council member the distribution theory in the above model is not suitable for explaining distribution correlations in the economy as a whole and drawing conclusions for distribution policy. The fact that there is no uniform world market interest rate, that the value of capital stock changes constantly and that the marginal revenue curve shifts position on a daily basis is not taken into account.

A decisive aspect of the international agreement is the parties contracting to it. It will not be enough to restrict the system to the EU member states or a similar group because this would lead to substantial distortions between the participating region and the rest of the world. Ideally, the system would embrace all countries, or, more realistically, at least a very large – in terms of value added – part of the world. The charge that smaller countries, in particular former tax havens, would hardly be likely to co-operate does not hold water if one considers the function of a tax haven properly: the value added there is normally negligible, and if only net profits flow into the tax haven because all gross profits have already been taxed at source, the haven will run dry. So it is essential that many of the countries accounting for a high proportion of world value added are persuaded to participate.

If a substantial number of countries decided to continue to impose taxes according to the residence principle, the system would not be able to function: the latter countries would not levy withholding taxes – due to the exemption method practised abroad – with the result that investors from the participating region could collect profits made in non-participating countries tax-free. In market equilibrium, net interest rates in the participating countries would be same as gross interest rates in non-participating countries. The capital stock invested in the participating area would thus be inefficiently low and the system would probably gradually break apart.

3. International agreements

A country that exempts foreign income from taxation leaves itself in a vulnerable position because aggressive foreign policies can lead to a shift of tax base and production abroad. To counter the risk of the participating countries attacking each other in such a way, the international agreement on minimum tax rates would have to be bolstered with the aid of some additional arrangements.

In particular, these include regulations on the harmonisation of the tax base and taxation procedures. Otherwise, it would be possible to undermine the agreement by generous definition of the tax base or by lax taxation procedures. This risk should not be underestimated, because lower domestic taxation is always in the national interest where the source principle is universally applied. With regard to the tax base it could be agreed that each country assesses it on the basis of international accounting standards and declines to grant selective benefits. As regards taxation procedures, one would have to ensure that capital income is actually taxed. In addition, it is essential that the unfair practices referred to in Section II.E are effectively repressed.

The system thus calls for a far-reaching harmonisation of national taxes with regard to mobile factors and requires a proportional tax rate[24]. Autonomy in tax matters can be retained, however, in respect of immobile factors. Here, each country could decide whether to stick with the comprehensive income tax principle – in this case capital income and earned income are taxed at the same rate – or whether it wishes to introduce a separate, perhaps progressive, rate for earned income and thus renounce the comprehensive income tax.

The statutory implementation of the proposal is not an easy task because the participating group, as we have seen, needs to be made up of a large number of countries, and the only possible instruments outside of the European Union are international treaties. Also, one could perhaps consider setting up a

[24] Progressive rates of withholding taxes generate severe distortions and can be avoided by dividing up the investment in as many locations as possible ("country splitting").

"World Tax Organisation" along the lines of the "World Trade Organisation", which would ensure compliance with the rules and regulations agreed under international law.

V. Alternative forms of taxing capital income

In the previous chapters the reinforcement of both the residence principle and the source principle was considered as possible solutions for the problems of international capital income taxation. It became clear that both avenues would require a certain degree of international co-operation. A tax system based on the residence principle calls for the assessment of foreign income components and thus necessitates an exchange of information on at least an EU-wide basis. Under the source principle no system of information exchange is necessary, but a far-reaching harmonisation of tax rates, tax bases and taxation procedures would be required.

Both proposals, then, generate problems of their own. For this reason alternative forms of capital income tax systems have been considered in recent years and, in some cases, have been put into practice, whose common feature is a break with the principle of the comprehensive income tax. The tax base is no longer annual income, which is taxed regardless of income type or origin; instead, the proposals feature rates that distinguish between different income schedules.

With the interest-adjusted income tax, the dual income tax, the final withholding tax and the comprehensive business income tax, the Scientific Council will outline below four taxation models that represent possible alternatives to the traditional income tax. The selection was based on the importance attached to the proposals in the literature and on the practical experience already gained. The following discussion focuses on the question of what role the models can play in resolving the international problems of taxation, while any other possible merits or disadvantages are ignored for the time being.

A. Interest-adjusted income tax

1. Characterisation of interest-adjusted income tax

Based on the phrase "consumption-oriented tax", parts of the academic, business and political communities have in the past few years called for the replacement of the traditional income tax (which follows the accrual principle) by a consumption tax. The reasons given are varied and range from arguments in terms of equity and efficiency to a rather resigned point of view to the effect that in a globalised world it is not possible to levy a tax on interest anyway. In the sphere of direct taxes a consumption-oriented tax can be achieved by two methods:

- Savings-adjusted (or cash-flow) income tax: individuals calculate their tax base by deducting the money they have saved from their income. Anyone who has earned, say, e.g. 60,000 in the year under consideration, of which 10,000 has been saved, pays tax on 50,000. Conversely, subsequent withdrawals are added to the income. In contrast to the current system, taxation falls due on the utilisation of income and not on its accrual.
- Interest-adjusted income tax: individuals calculate their tax base by deducting interest accrued from annual income. If taxable income under the current definition totals, say, 55,000 and this includes 5,000 interest income, the tax base is 50,000.

In complete capital markets, the economic effects of the two methods are equivalent, at least if one leaves out of account important details such as problems of transition or inheritances. However, administrative considerations speak clearly for the interest-adjusted tax because a savings-adjusted tax brings with it two major collection problems. Firstly, savings-adjustment places very high demands on the thorough assessment of all withdrawals, which is likely to prove difficult, especially in conjunction with foreign bank accounts. It has therefore been proposed that only deposits on certain qualified accounts should be deductible from the tax base. However, this would equate to a split in the market and would also be risky in the light of European law. Secondly, the savings-adjustment method will create problems if not introduced world-wide. For example, if one country levies the traditional income tax and another levies the savings-adjusted version, individuals are presented with a major incentive to change their residence country. From their point of view it would make sense to earn one's income in the latter country and spend it in the former. The country that levies taxation on savings-adjusted income would therefore have to introduce regulations on retrospective taxation on emigration, and this would certainly be difficult to implement.

Interest-adjustment alleviates these difficulties and also creates fewer problems with regard to the transition process. Therefore, the Scientific Council has subjected only this alternative to a more detailed review. The main features of the interest-adjusted income tax can be described as follows:

- Companies compute their profit in the current manner, that is by a balance-sheet comparison, but deduct implicit interest in respect of own capital. Individuals with income accruing from leases are in this respect treated in the same way as companies.
- Interest on outside capital as well as dividends and other profit components that flow from the company to individuals remain tax-free for the recipient up to the point where it equals a standard statutory interest rate. Amounts exceeding this total are subject to the customary income tax rate.

Neglecting the local trade tax, the system produces neutrality with regard to legal form and corporate finance. It also allows the marginal return of investment to equal the market interest rate. Under traditional income tax neutrality cannot be achieved insofar as the depreciation allowed for tax purposes deviates from the depreciation on capitalised value, i.e. the actual, difficult to calculate, loss in value. Moreover, rules and regulations governing the determination of profits mean that investments of equivalent value are often reflected very differently in the tax balance sheet. For example, self-produced tangible assets have to be charged to the balance sheet, whereas this is not allowed for corresponding intangible assets. For these reasons the existing income tax infringes the weak efficiency condition of distorting all investment decisions equally. The interest-adjusted income tax satisfies this condition, and depreciation, provisions and other stipulations with relevance over more than one year no longer play a role, at least where the taxpayer and the government use the same interest rate. In addition, there is no longer any distortion of the spend-or-save decision facing savers.

The question of whether a transition from the existing tax to the interest-adjusted income tax would yield efficiency advantages on the domestic front, never mind in any other respect, is the subject of controversy in the literature and cannot be gone into any further in the present report. Proponents of interest-adjustment refer to the advantages mentioned in the previous paragraph. Sceptics argue, amongst other things, that the interest-adjusted income tax falls back on a narrower tax base with the result that for a given tax yield all other income components have to be taxed more heavily. These include not only earned income, but also those capital income components that are not interest, especially pure profits. If one considers the interest income accruing to *rentiers* to be a rather static

element within the economy, then interest-adjustment ultimately eases the burden on this static sector to the detriment of the dynamic entrepreneur, who seeks to use his inventiveness to obtain a pure profit and not just the standard interest rate.

The end result is also mixed in respect of tax simplification. Doubtless, the controversial problem which consists in the computation of annual profits would be alleviated on transition to an interest-adjusted income tax, insofar as taxpayer and government use the same interest rate. On the other hand, companies would only be able to deduct incurred interest charges up to a (statutory) standard interest rate, and no longer at random, if the recipient is not engaged in business. Without stipulation of a standard interest rate, a whole host of possible arrangements would exist for redefining other income components, especially earned income, as interest income. Admittedly, the limitation of the allowance for interest charges up to a standard value places risk-taking, innovative companies, who in actual fact have to pay their creditors a higher interest rate than the standard rate, at a disadvantage.

The following argument focuses mainly on the question of the effects a transition to an interest-adjusted income tax would have in the open economy. There is no general answer to this question because interest-adjustment can be combined with the residence principle or the source principle and can be introduced unilaterally or by international treaty.

2. Unilateral transition to the interest-adjusted income tax

Let us first consider the case in which Germany unilaterally switches to an interest-adjusted income tax, whereas the rest of the world retains the current income tax. On application of the residence principle interest income accruing to taxable German residents would be tax-free up to the point where it equals the standard interest rate, irrespective of whether the capital income originated in Germany or abroad. The assessment problem associated with cross-border investments would thus be substantially alleviated. However, it would not disappear because the interest-adjusted income tax does not involve a general exemption of capital income, but merely grants relief on the interest component. Foreign capital income that is not interest – especially payments in respect of patents and licences as well as pure profits – and foreign interest, where it exceeds the standard rate, would still have to assessed for tax purposes.

Resident corporations could repatriate profits tax-free up to a point where the profit rate equals the standard interest rate and would have to pay tax only on the extra amount. The average burden on retained profits would thus fall significantly under normal circumstances. Based on the assumption that the rest of the world would continue to levy the traditional income tax, Germany could even develop into a kind of tax haven in the view of foreign countries and companies. These countries would probably view a unilateral transition to interest-adjustment as an aggressive policy. There would be a risk of them taxing retained profits of subsidiaries resident in Germany by means of stipulations corresponding to those under CFC-legislation or even extending such stipulations to cover active business, too. This would result in a simple shift of tax revenue abroad, there being no gain in the attractiveness of Germany for business.

Example: The German-based subsidiary S, having share capital in the amount of 100 million, records an annual profit of 7 million which on application of a standard interest rate of 7% is tax-free in Germany. The residence country of the parent company deems this an excessively low rate of taxation and allocates the retained profits to the parent company. From the point of view of the parent company

the total tax burden is the same as if Germany had levied a profit tax not exceeding the maximum tax credit.

In general terms it is apparent that interest-adjustment would have little effect on the allocation of capital in dealings with countries that allow tax credits, but tax revenues would shift abroad. Equally, in dealings with exempting states interest-adjustment would enhance Germany's attractiveness as a business location only to a limited extent: for if the foreign tax law included a subject-to-tax clause (see Subsection III.C.2), the exemption would be lifted since Germany would not be imposing an adequate tax on capital income from the point of view of the foreign country. With regard to individuals residing in DTA countries and receiving interest from Germany, there would again be hardly any changes since Germany already voluntarily gives up its right to levy withholding taxes in the majority of cases. And if one considers the example of cross-border investments from the point of view of German residents, then excess foreign tax credits would occasionally arise on account of the fact that Germany would no longer be able to credit the tax paid abroad against the tax falling due on interest, as there would be no such domestic tax liability. Admittedly, the excess foreign tax credits would also make it more difficult to benefit from tax deferral, which would lead to a strengthening of domestic investments.

As regards pure profits, allocation and assessment problems would probably be exacerbated by a transition to interest-adjustment because all income components that are not interest would be subject to a higher tax rate in conjunction with a given tax yield. Consequently, there would be a threat of shifts of profits in the field of patent exploitation. Moreover, especially innovative companies with returns considerably higher than the stipulated standard interest rate would take the comparatively high associated tax rates into account when choosing their business location.

3. Internationally agreed interest-adjusted income tax

As an alternative to the unilateral introduction of the interest-adjusted income tax, which would probably be viewed as an aggressive policy outside of Germany and trigger countermeasures, interest-adjustment could be implemented jointly on the basis of the source principle under the terms of the international agreement discussed at IV.C. Under this agreement income components would generally be taxed in the source country; in the residence country they would be exempt from taxation. In addition, all the source countries would exempt interest income from taxation up to a point where it equals an internationally stipulated standard interest rate. The stipulation of the standard interest rate would not be an easy task, especially if the inflation rates of the participating nations were to differ by large amounts.

The system combines the features of the source principle with those of the interest-adjusted income tax. As far as capital income components that are not interest are concerned, steps towards harmonisation would have to be taken for the reasons mentioned at IV.C. However, the need for harmonisation is not so strong because the remaining capital income items are made up in part of local rents, and the elastic component of capital income, interest income, is removed from the tax base. Where tax rates are the same all over the world, the system guarantees production efficiency and also removes any intertemporal distortions.

The introduction of the system throughout the member states of the European Union is not a feasible solution because it involves too few participants; rigorous taxation at source within the EU would lead to a shift of capital income into non-participating countries and run counter to the interests of the member states. However, interest-adjustment could perhaps be combined with lower tax rates on other

capital income components, as discussed below. If the tax rate were low enough, the system would not offer any major incentives to shift capital abroad.

B. Dual income tax

The dual income tax is understood here to mean a schedular tax with separate scales for earned income and capital income. Earned income components are taxed at a progressive rate, whereas capital income is taxed proportionally at a rate substantially lower than the top rate of earned income tax. To provide neutrality of legal form the corporate income tax rate corresponds to the tax rate for capital income. Such a tax was introduced in the Nordic countries at the beginning of the 1990s, where capital income is now taxed only moderately. A typical example is Finland, which levies rates of up to 55% on earned income, whereas capital income is taxed proportionally at 28%.

In all the Nordic countries the transition from the comprehensive to the dual income tax was combined with a broadening of the tax base, in particular by strengthening capital gains taxation. The focus of the reform, however, was based not on international aspects, but rather on the following arguments:

- In periods of inflation capital income taxes effect a taxation of fictitious (inflationary) profits. Although this problem also occurs under the dual income tax, it is less pressing due to the lower rate.
- The originally progressive capital income taxes only yielded low revenues owing to a host of gaps in the tax base.
- The inclusion of capital gains in the progressive comprehensive income tax did not appear achievable in the eyes of the politicians because of the high tax rates. This was a major reason for the introduction of a moderate, proportional rate scale for all kinds of capital income.

Furthermore, the notion that the taxing of capital as an internationally mobile factor was inefficient in terms of the national economy also played a role. However, as demonstrated several times, this argument applies only to source taxes on domestic capital – it does not apply to capital income taxes levied on residents. The Nordic countries continue to tax according to the residence principle, which means that the cut in capital income tax favours domestic and foreign investments alike and has little impact on the countries' relative attractiveness as business locations, if we leave out of account retained profits or excess foreign tax credits.

The main problem of the dual income tax is the disparity in the treatment of income derived from self-employment and dependent employment which would arise if one were to include the former in capital income. To prevent this, Nordic tax law provides for the computation of an imputed wage of manager-owners for the self-employed which is subject to the progressive rate of earned income tax. The experience gained in past years has shown that computing the imputed wage of manager-owners – and, in general, differentiating between earned income and capital income – gives rise to administrative problems. In addition, the companies and their employees attempt to convert more highly taxed earned income into capital income. The way this is generally done is that employees agree to forgo wage increases in return for profit-sharing arrangements.

C. Final withholding tax

The term "final withholding tax" is used in different ways in the literature and in practice. It is understood by most to be a schedular tax under which a relatively low, tax rate is imposed on interest and dividends. An intrinsic feature of the final withholding tax is that it is levied at source and does not form part of a resident's tax assessment; payment by the interest or dividend debtor has the effect of discharging other tax liabilities. Non-residents are either exempted from the final withholding tax or are subject to it only to a limited degree.

A tax of this type has been introduced under the name *Abgeltungsteuer* in Austria. It is levied at a rate of 25% on interest derived from securities and deposits at banking institutions and on dividends. The final withholding tax also counts as settlement of the inheritance tax. Non-residents only incur the final withholding tax on dividends; they are exempted from the final withholding tax on interest. Residents with a low personal tax rate can opt for an assessment with credits (relative final withholding tax).

The major difference to the dual income tax is the fact that, with the exception of interest and dividends, capital income – especially rents, income from patents and licences, and pure profits – is still subject to the progressive income tax rate. In this respect the point of the final withholding tax is not to bring about a general reduction in the tax burden imposed on capital income, but to allow a specific benefit in respect of income accruing to residents from portfolio investments. Because such investments are only loosely connected to domestic economic activity, the final withholding tax has more of a fiscal function, rather than serving to improve Austria's standing as a business location. The deduction of the tax at source, which rules out evasion in the case of domestic investments, is sometimes also intended to establish fiscal equity in the capital income domain.

The fiscal effect of the final withholding tax is double-edged and substantially dependent on the opportunities for evasion present at the time of introduction: it entails a loss of tax revenue if interest and dividends have been identified for the most part and have been taxed progressively at the outset. If this was not the case, two contrary individual effects arise with regard to residents:

- Residents who previously did not evade tax – irrespective of whether this was due to a lack of opportunity (bookkeeping requirements) or was based on moral considerations – enjoy a reduction in their tax liability, and tax revenues fall.
- Other residents, who previously did not declare interest and dividends and kept their capital at home, are hit by the final withholding tax, and tax revenues increase.

Finally, some people will doubtless attempt to avoid the final withholding tax by taking their capital out of the country; in respect of this income there were no tax revenues before its introduction and there are none after. The overall effect of the reform is unclear. All in all, it is hard to see how those prepared to commit tax evasion are going to be moved to honesty by the offer of a tax having a settlement effect for other taxes. This would only be plausible if the costs of tax evasion incurred by the taxpayers concerned were lower than the original tax rate, but are higher than the final withholding tax rate. Yet in the case of Austria the attempt to persuade non-residents to move to Austria using the final withholding tax as bait, especially as payment of the final withholding tax also discharges any inheritance tax liability, may also have played a role. Extra tax revenues may be generated by the extent to which this policy is successful.

D. Comprehensive business income tax

The comprehensive business income tax (CBIT) is a tax on corporations that is neutral in terms of their legal form. Its tax base covers, at least, the corporation's profits and debt interest paid[25]. However, if the tax really is comprehensive, the tax base includes all payments that are not earned income, i.e. any patent and licence fees or rents paid as well as profits and interest charges. In this case, on which the following considerations are based, the comprehensive business income tax falls due on the entire capital income at source according to a proportional rate scale. As for the dual income tax, the imputed wage of manager-owners is subject to the tax rate scale for earned income.

At the shareholder or partner level, the comprehensive business income tax cannot be credited but can be used in settlement of other claims. Dividends received or shares of profits from partnerships thus remain tax-free for the recipient. Thus, the comprehensive business income tax, too, constitutes a schedular tax with a proportional rate scale for capital income and a proportional or progressive rate scale for earned income. By a combination of payroll deductions and taxation of capital income at source, the majority of the tax revenue is paid in by corporations.

This method of collection distinguishes the comprehensive business income tax from the dual income tax; otherwise, the two taxes are identical in a closed economy, as the following example will demonstrate. Where corporation A pays interest from a corporate bond to individual B, A is obliged under the comprehensive business income tax to retain and transfer the capital income tax to the revenue service, while B does not have to declare the interest received. Under the dual income tax, interest is always paid out by A without any deduction, whereupon the recipient (B) has to declare the income and pay the tax.

It would not make economic sense to introduce the comprehensive business income tax on a unilateral basis, nor would it be possible under the law: the tax would affect non-residents, and it is questionable whether it would be credited abroad. Its introduction could possibly be in breach of existing double-taxation agreements which restrict the use of source taxes. At the same time, residents could continue to evade tax by investing abroad. Once again it becomes apparent that any plans aimed at the eradication of opportunities for tax evasion by means of taxing consistently at source have to be implemented at an international level for them to have any effect.

In this respect the comprehensive business income tax should instead be considered as a core element of the international tax system discussed in Section IV.C. The advantages it has to offer are totally dependent on the harmonisation outlined there. If all the (major) industrial nations agreed to implement this tax, and if tax rates, tax bases and taxation procedures were harmonised, the comprehensive business income tax would ensure capital export neutrality and would enforce the states’ tax claims against the recipients of capital income. On the domestic front, all capital income, irrespective of its country of origin, would be exempt from taxation for the recipient.

[25] The comprehensive business income tax was put forward in 1992 by the American Treasury Department as an alternative to the classical corporate income tax. The original concept proposed a constant tax rate of 31% for dividends and interest and a progressive rate scale with rates of between 15% and 31% for all other types of income. In contrast to this report, the main aim was not the resolution of international taxation problems, but the creation of finance neutrality.

VI. Comparison of approaches

Owing to the multitude of possible reforms and the even greater number of combination options, the following comparison deals only with those revisions of international tax law that the previous chapters showed were worthy of further consideration. They are the following six systems:

- Reinforcement of the comprehensive income tax by the taxation of world-wide income with the fewest possible omissions based on the residence principle; in short "residence principle".
- Consistent taxation at source by means of a comprehensive business income tax, supplemented by international tax harmonisation; in short "source principle".
- Unilateral transition to the interest-adjusted income tax while retaining the existing double-taxation agreements; in short "interest-adjustment".
- Combination of the above two measures; in short "source principle with interest-adjustment".
- Unilateral transition to the dual income tax while retaining existing double-taxation agreements; in short "dual income tax".
- Introduction of a final withholding tax on interest and dividends paid to residents in Germany; in short " final withholding tax".

The comparison rests on seven criteria which permit a relatively comprehensive appraisal of the systems. The criterion "international acceptance" is particularly significant for any unilateral measures introduced by Germany, which must be consistent with internationally-recognised rules. The criterion "international co-operation" pertains to the degree of co-operation necessary for the practical realisation of a particular system. The section "Tax competition versus tax co-operation" discusses the extent to which the systems permit or exclude fair tax competition. "Efficiency and neutrality" are criteria for the evaluation of the economic effects of the systems, including their effects on employment. Under the heading "Taxation according to ability to pay" the question is put as to whether the system in question reflects or conflicts with traditional concepts of fairness. The "Tax consistency" section refers in particular to the feasibility of the systems from an administrative viewpoint. Finally, the section "Conformity with European law" investigates the conformity of the systems with the basic values of the Treaty establishing the European Community.

A. International acceptance

German tax policy should not be inconsistent with internationally-accepted standards, for instance, with those specified under international law or in OECD conventions. Confining itself to measures which meet with approval abroad is in Germany's own best interests – not least because Germany is a country which, due to its economic significance, must take into consideration the relevant reactions from abroad. Practices which foreign countries perceive to be aggressive policies could prompt undesirable countermeasures or, possibly, imitation.

From this perspective, both the reinforcement of the residence principle, the transition to the dual income tax or the levying of a final withholding tax are unproblematic. Although these measures may cause annoyance to individual partner states, they are internationally-recognised practices which, first and foremost, pertain to the taxation of residents. International agreements that comprehensively enforce the source principle are accepted *eo ipso*.

Only a unilateral transition to the interest-adjusted income tax would appear risky. Countries that adhere to the traditional income tax would probably view the deduction of implicit own capital interest from the tax base, which would be admissible in Germany, as an aggressive policy. A shift of financial assets to Germany (in the form of finance companies) would be likely, associated with a suspiciously low rate of profit taxation, from the viewpoint of foreign countries. If the foreign countries did not implement counter-measures, large-scale international shifts and tax arbitrage would probably take place, leaving foreign countries with no option but to classify Germany as a tax haven in certain categories and, for example, to tax retained profits of subsidiaries based here.

B. International co-operation

The introduction of a final withholding tax and the transition to the interest-adjusted or dual income tax, being unilateral measures, do not require additional international co-operation. This is not the case on consistent implementation of the residence principle and the source principle.

With regard to the assessment of private capital income, the residence principle implies international co-operation in the form of an exchange of information. Although Germany could also unilaterally attempt a comprehensive assessment of private interest and dividends – by abolishing § 30a of the German Fiscal Code and recording cross-border payments – this would appear impractical, not least in light of the introduction of a single European currency, the abolition of inner-European border controls and the degree of economic integration in Europe.

On the other hand, more institutionalised exchange of information at European Union level could reduce tax loopholes, which will always exist in practice, to an acceptable level. The exchange of information must cover cross-border factor payments within the EU as well as payments to and from non-EU countries where these are not already participating, as is the case with Switzerland. Naturally, some individuals will continue to evade taxes, for instance, by taking cash into non-participating countries, though this will occur less frequently than the present widespread evasion by simply "forgetting". In a free country, international tax evasion is just as difficult to prevent as national tax evasion (e.g. work performed in the black economy) which probably plays a far greater role.

The main advantage of the source principle is that an exchange of information is not necessary if an agreement exists between all major industrial nations. All capital income is taxed in the source country through the comprehensive business income tax and is tax-free in the residence country. As explained in Chapter IV, for capital income this system requires a harmonisation of tax rates, tax bases and taxation procedures. This necessitates a greater degree of international co-operation than an implementation of the residence principle because the group of participants extends far beyond the countries of the European Union. If the agreement were restricted to the member states, the territory of the EU would have to be viewed as one nation unilaterally levying tax at source. For the reasons stated in IV.C.2, this is not rational. Thus, the agreement would have to cover all the world's major industrial nations.

If one differentiates between "co-operation by legislators" and "co-operation by administrators", a comparison of the residence principle and the source principle yields the following. At the legislative level, the co-ordination effort required is greater for the source principle because this system requires far-reaching amendments to national tax law. Because the imposition of withholding taxes on mobile capital is not in the national interest, the agreement must ensure that tax rate harmonisation is not undermined by generous arrangements such as deferrals or remissions. For the system of information

exchange, which serves to reinforce the residence principle, the agreement simply provides for obligations to supply information, whilst leaving the entire area of tax legislation in the hands of the nation states. At the administrative level, the degree of co-operation is higher in the latter case because revenue authorities regularly exchange information on a reciprocal basis.

A problem common to both systems is that although their agreement can be in the interest of all the parties involved, individual participants have an incentive to deviate from the spirit of the treaty: the failure to send out tax-audit tracer notes or to levy withholding taxes would enhance the attractiveness of the relevant country. In order to address this crucial ("free rider") problem, a corresponding treaty must provide for supervision and auditing capabilities and a procedure for sanctions against deviationists. An appropriate sanction in the case of source principle would be to operate a credit rather than an exemption system in dealings with countries who violate the agreement, once the breach has been established by a control committee.

C. Tax competition versus tax co-operation

The residence principle curbs tax competition. This is because residents cannot avoid taxation of their world-wide income by investing abroad; they can do so only by moving to another country. A change of residence to a low-taxation country, however, is not only associated with tax savings. It also means the taxpayer no longer benefits from the services provided by the high-tax country, not to mention the loss of personal ties. Only the source principle enables some taxpayers to ideally combine the benefits of residence in a high-taxation country with tax reliefs in the low tax country. According to the “tax savings industry“, most of those affected reject the option of moving abroad; in technical terms, the locational elasticity of the saver, in contrast to that of invested capital, is low as far as the tax rate is concerned.

Where the residence principle is applied, tax competition is less a form of “voting with one's feet“ and more a case of providing citizens with the opportunity to compare different combinations of public services and levies: in the area of taxes, this applies not only to the total tax burden but also to the tax structure. This competition between systems should be viewed as a process of discovery, offering benefits all round, its main advantage being the associated opportunity for reciprocal learning.

By comparison with the residence principle, the source principle intensifies tax competition and, in extreme cases, can result in a downward spiral of tax rates to zero. This happens because the countries attempt to attract mobile capital using fair or unfair practices and, if elasticities are high, every single country benefits from a further round of tax cuts. In sum, the countries realise hardly any revenue from the taxation of mobile factors and thus develop an objectionably strong interest in tax cartels.

The general opinion is that the source principle must therefore be bolstered by an international agreement if the taxation of mobile factors is to generate reasonable revenues on a permanent basis. Above all, the agreement should provide for minimum tax rates that will, in all likelihood, largely correspond to actual tax rates. This would eliminate tax competition in the area of capital income taxation. If the agreement is a treaty under international law, the participating states will only be allowed to structure the taxation of immobile factors. The public and also the business sector would to a large extent be deprived of influence in the remaining areas of tax legislation; in this respect the agreement would therefore involve less democracy.

Were the system to function, there would doubtless be a risk of taxes soaring at a supranational level, though the risk of violating the cartel agreement would admittedly have a curbing effect. Independently of this, an international agreement has the basic disadvantage of paralysing important aspects of tax policy. If, for example, changes to tax rates or tax bases were made subject to a majority or qualified majority vote, each reform would require broad international consensus. Above all, agreements on joint tax cuts are difficult to envisage under these circumstances.

D. Efficiency and neutrality

The effectiveness of the various approaches to reform constitutes a further important assessment criterion. Economic efficiency often goes hand in hand with neutrality of taxation, at least so far as business decision-making is concerned. Private households, in contrast, cannot be taxed without the occurrence of distortions, and there is generally not much point in merely trying to minimise the number of these distortions. In terms of efficiency, it is much more important to minimise the aggregate distortion arising from the tax system and to ensure that the production structure is disturbed as little as possible (production efficiency).

Reinforcing the residence principle facilitates capital export neutrality, thereby supporting the objective of production efficiency. This is perhaps the most important advantage of the residence principle. If the traditional comprehensive income tax is retained, decisions on whether to spend or save will continue to be subject to distortion and, moreover, savers will expect different net returns if there is no international harmonisation of tax rates or if capital income is taxed progressively. There is no empirical evidence to indicate whether this leads to more or less inefficiency in comparison with the inefficiency resulting from the distortion of the labour-leisure decision which is induced by the wage tax.

The source principle prevents distortions in the global allocation of savings (capital import neutrality). However, the source principle safeguards capital export neutrality, which is the more important, only if it is associated with a harmonisation of tax systems, especially tax rates. This also applies if the source principle is combined with the interest-adjusted income tax.

A unilateral transition to the interest-adjusted income tax while retaining the existing double-taxation agreements would have the following effects. Firstly, intertemporal decisions, especially the spend-or-save decision, would remain largely undistorted and many of the above-mentioned problems would no longer arise; in this connection, the term investment neutrality is used often. This system ensures capital export neutrality in respect of cross-border interest payments so long as these are not taxed in the foreign country either; if they are, excess foreign tax credits will occur because the interest is not subject to tax in Germany. As far as other capital income components are concerned, especially pure profits, the existing problems actually get worse as interest-adjustment makes it necessary to tax the remaining income at a higher rate.

Any assessment of the interest-adjusted income tax, assuming a given tax revenue, is therefore difficult: the elimination of one distortion is achieved at the expense of a narrower tax base, which necessitates tax increases elsewhere and intensifies the distortions there. The balance of these individual effects is impossible to determine in empirical terms.

The final withholding tax is unlikely to be associated with any efficiency gains because, firstly, there is no direct correlation between portfolio investments and real business activity. Secondly, capital export neutrality is established in this area by both high and low tax rates and even, paradoxically, by tax

evasion. Under the traditional income tax, interest income is taxed in full. Under the interest-adjusted income tax, it is not taxed at all. The final withholding tax is in this respect a compromise between these two forms of taxation. Because interest adjustment offers no clear efficiency advantages in comparison with the traditional income tax (see above), the same applies to the final withholding tax.

The situation with regard to the dual income tax is different. It specifically lowers the tax burden on domestic capital investments, whereas the final withholding tax is more lenient on capital income accrued by residents. The dual income tax eliminates many of the distortions mentioned in Chapter II which have been detrimental to Germany as a business location in the past. This regards excess foreign tax credits as well as the distortions resulting from exemption under non-harmonised tax rates. As far as the promotion of domestic investment and employment is concerned, the dual income tax performs just as well as consistent application of the residence principle or the source principle. Unlike the latter methods, though, it does infringe on capital export neutrality if double-taxation agreements remain unchanged and tax rates differ.

E. Taxation according to ability to pay

Under the ability-to-pay principle individuals with the same income are taxed at the same rate, and individuals with higher incomes are taxed at a higher rate, insofar as other personal circumstances are the same. The term therefore has a horizontal and a vertical aspect. As a postulate of fiscal equity, the ability-to-pay principle requires, in particular, that the individual tax burden is independent of the kind of income and of the location of the income source. This is the general consensus, although some people might replace the term "income" in the above definition with "consumption".[26]

As a central theme of fiscal policy, this understanding of the ability-to-pay principle is cited far beyond the German borders, even though doubts have recently been expressed all over the world as to whether it can hold its own in the tax competition. Attempts to differentiate the income tax according to degree of tax-base mobility are generally considered to be disagreeable but inevitable. However, those who believe that violations of the ability-to-pay principle must be tolerated due to the process of globalisation are oversimplifying the matter. If one recognises that tax rates in Germany have to be cut, there are in fact two fundamentally different ways of achieving this objective, and only one calls for a sacrifice of the ability-to-pay principle:

- The first involves creating schedules for earned income and capital income, with lower tax rates for the latter. Schedular taxes impose different rates on individuals with the same income and therefore violate the ability-to-pay principle.
- The second involves reinforcing the comprehensive income tax whilst abolishing all selective tax benefits. In this case the average tax rate can be lowered for all kinds of income without a fall in tax revenue.

[26] One member considers the above interpretation of the ability-to-pay principle to be inadequate because it does not go beyond the principle of equality and ignores the problem associated with the spread of the tax burden, even when indirect taxes and distribution objectives, which are reflected in the tax progression, are taken into account. This explains why it is inappropriate to conclude that even the interest-adjusted income tax conforms with the ability-to-pay principle. For example, this tax, which is not an income tax, amounts to individuals paying less tax in relation to income the more wealth they possess. It therefore constitutes a massive violation of traditional distribution policy objectives of income taxation.

The *Petersberg Declaration* of the former German government, which envisaged a reduction in the top tax rate to 39% and a substantial expansion of the tax base, shows that the second approach is not utopian. Nor would it be utopian to introduce a top tax rate 30% without foregoing revenue. All that is required is the political will to declare no loophole sacred and to scrap selective reliefs consistently. Even lower top tax rates would probably be achievable, especially as the *Petersberg Declaration* did not provide for any specific measures in the area of international taxation and ignored other important areas such as non-profit organisations or donations.

The Scientific Council would therefore like to state quite clearly that the present tax rates are not based on fiscal requirements but solely on the fact that the legislators seem to think they have to combine horrendous tax threats, which only exist on paper, with favours for practically every taxpayer. This is also true for international tax law, which mixes quite absurd tax rates with a multitude of tax loopholes.

According to current opinion – one exception will be considered in more detail below – the ability-to-pay principle can most effectively be realised by way of a traditional comprehensive income tax that is imposed without any loopholes on the entire world-wide income. In the light of the above arguments, any government that introduces schedular taxes should not try to justify them by pointing to international constraints but should openly admit that it cannot or will not close the loopholes in the tax base.

To summarise what has been covered thus far, the dual income tax, the final withholding tax and the source principle together with the comprehensive business income tax fare badly in terms of the ability-to-pay principle because they are schedular taxes. The residence principle comes off favourably, so long as the taxation of world-wide income does not simply become a prescribed norm, but is actually implemented.

The above-mentioned exception to the rule – that taxation according to the ability to pay is best realised by means of the comprehensive income tax – concerns the interest-adjusted income tax, which is not simply based on the creation of pragmatic schedules, but expresses an ethical concept. Whereas the aim of the comprehensive income tax is to impose the same tax amount on taxpayers with the same annual income, interest-adjustment aims at treating them equally over a longer period. It is an instrument for realising the concept that the present value of the tax payments made by the individual during his entire lifetime should only be dependent on the present value of lifetime income[27]. The question of whether this subtle understanding of equity can be made comprehensible to the general public, and whether it is an appropriate concept for a world with capital market imperfections, transformations and frequent tax reforms, cannot be answered here.

The ideas expressed thus far refer only to horizontal fiscal equity, so they should be concluded by looking at the vertical aspects. It is virtually impossible to make a scientifically based decision on whether income should be taxed progressively, proportionally or regressively, and it is even more difficult to identify "fair rate scales“ on a scientific basis. Views on what makes a fair scale are more dependent on personal or political value-judgements.

Nonetheless, the international reorientation of the tax system is also of importance for vertical fiscal equity, since progressive taxation of an individual's income, where it is desired, is only compatible with the residence principle. The source principle excludes general tax progression even in the case of

[27] The transition to this tax system and the treatment of inheritances are special problems that are not dealt with here.

exemption with progression[28]. Admittedly, a rate scale that is only indirectly progressive – involving a constant marginal tax rate and a basic allowance for the exemption of a minimum amount required for living – is compatible with the source principle where this principle is modified to the effect that the basic allowance is only granted by the residence country. Otherwise, an investor who spreads his capital across several countries would benefit from the exemption of his "minimum amount for living" several times over.

F. Tax consistency

Tax consistency and tax simplification are often two sides of the same coin, since many practical difficulties arise due to the inconsistent nature of the tax laws. A brief look at previous court rulings is enough to recognise that the majority of disputes heard in the fiscal courts are based on problems of definition, and problems of definition always occur when the law imposes different tax burdens on economically identical circumstances. In this respect tax consistency is not merely an end in itself; it also serves to simplify taxes. What is more, tax consistency also binds legislation to principles, thus creating continuity.

With regard to tax consistency both the reinforcement of the residence principle and unilateral transition to interest-adjustment are to be recommended. The same applies to a comprehensive business income tax levied according to the source principle, so far as it is furnished with a proportional rate scale and imposes a uniform burden on all kinds of income.

All the other reform options give rise to the fear that the much quoted fiscal chaos will be exacerbated still further. This becomes especially apparent in the case of the final withholding tax, the dual income tax and the comprehensive business income tax, so far as the latter is combined with a directly progressive wage tax. In all cases, the burden imposed on the taxpayer is not only dependent on total income, but also on the composition of this income. From an administrative viewpoint, precise definitions are necessary to ensure that the higher earned-income tax is not avoided. From the individuals' point of view, in contrast, it is precisely these opportunities for tax avoidance that appear attractive.

It is therefore to be expected (and evident in some countries) that the introduction of income schedules creates new or larger loopholes and problems of definition. Individuals who predominantly draw earned income and are unhappy with the tougher tax rates imposed on it are unlikely to have any qualms about attempting to redefine earned income as capital income. Management staff, in particular, will enjoy some degree of success because the boundary between earned income and capital income is extremely blurred in this area. The desired result can be achieved simply by exchanging fixed salary elements for warrants. The problem of definition is particularly complex in the case of the self-employed, whose earned income is not directly observable.

Compared with the comprehensive income tax, then, schedular taxes have a negative effect on tax honesty and cause a multitude of complications. It is not easy to explain why countries that undermine the principle of the income tax in this way do not abolish it altogether. For if one admits one's unwillingness to tax according to the individual's ability to pay, then scrapping the income tax and

[28] This does not apply if all countries involved use the exemption with progression method. However, this would imply assessing world-wide income not only in the resident country but also in each source country – which would neutralise the main advantage of the source principle.

raising other taxes correspondingly is the most consistent and almost certainly the least expensive way of going about it.

One final difficulty with the source principle arises because it calls for sources of income that can be assigned to a particular location; once receipts and expenditures become geographically separated, the principle can no longer be rigorously applied. Even today, this prerequisite is satisfied only in case of a classical permanent establishment, which, for example, buys raw materials and sells finished products. The evolution of modern forms of communication and the emergence of virtual markets make it questionable whether it will still be possible to identify where income is earned and expended in the future. Where this cannot be done, it will not be possible to apply the source principle, at least not without additional international agreements. The residence principle, for which only total world-wide income is of significance, is more robust from this point of view.

An example of the scenario described in the previous paragraph is a web-site selling computer games. Anyone with access to the Internet can order a game and pay by credit card. The games are likely to have been written by programmers who are spread all over the world and who communicate via the Internet. The necessary hardware can be located anywhere – it does not even have to be on the planet. If such businesses cannot be located by secure legal conventions, their taxation will have to be based on the place of residence of the participants.

G. Conformity with European law

When considering possible tax reforms, the question of conformity with European law has to be taken into account. The Treaty establishing the European Community provides only for harmonisation of indirect taxes. However, the establishment of economic and currency union possibly requires the harmonisation of direct taxes, too. Tentative steps have already been taken in this direction with the Directive on Parent Companies and Subsidiaries and the Merger Directive.

The Treaty is also significant for direct taxes because the member states must avoid blatant and concealed discrimination when exercising their tax laws and comply with all the basic freedoms guaranteed by the Treaty. With regard to capital income taxation, the free movement of capital (Art. 56 TEC) and the freedom of establishment (Art. 43 TEC)[29]. Although the Treaty specifically provides for varying tax rates according to the place of residence or capital investment, the different tax burdens may not constitute deliberate discrimination or veiled restrictions on free movements of capital (Art. 58 TEC). Furthermore, the member states have reaffirmed in a declaration that this regulation only applies to tax rules which were in force at the end of 1993.[30] Tax legislation which was introduced after 1993 must pay due regard to the basic freedoms.

It is difficult to assess the implications of these regulations for national tax policy: a broad interpretation of the basic freedoms or bans on discrimination could result in tax systems having to guarantee both capital export neutrality and capital import neutrality. However, as has been demonstrated on several occasions, this would only be possible in conjunction with a complete standardisation of tax systems. Such an interpretation would therefore contradict the fact that the Maastricht Treaty does not postulate

[29] The article numbers pertain to the Treaty establishing the European Community in the consolidated version of the Treaty of Amsterdam dated October 2nd,1997.

[30] Declaration No. 7 to Art. 73d TEC as amended in the Maastricht Treaty (now Art. 58 TEC).

a general harmonisation of direct taxes. Because both the residence principle and the source principle can be structured in such a way that they do not restrict the freedom of capital movements and freedom of establishment, both are likely to be consistent with EU law, even though they have very different consequences for the national tax systems. The same applies to the interest-adjusted income tax, the final withholding tax and the dual income tax.

However, as far as the corporate income tax is concerned, there are serious doubts with regard to conformity with European law. Although the member states are free to decide whether to operate a classical corporate income tax system or a system granting full or partial credits, the decision must remain within the limits of the bans on discrimination and restrictions. A violation of the Treaty could arise if a foreign national living in an EU country is not entitled to credit corporate income tax against his income tax liability in the same way as the citizens of the country concerned. The same applies in reverse to resident taxpayers who are only entitled to credits on corporate income tax paid in their residence country against their income tax. Both rules are existing law in Germany and the latter, at least, is held by the European Commission to be in violation of the freedom of capital movements.

Admittedly, the resulting consequences for tax policy are not at all clear because in both cases the alleged discrimination can be eliminated by both the source country and the residence country. Here it should be noted that international tax law always places the onus for the elimination of double taxation on the residence country. If this rule were also applied to the corporate income tax, the correct approach would be for the residence country to grant a credit in respect of the corporate income tax paid abroad, rather than reimbursing domestic corporate income tax to non-residents.

However, the central problem is not cross-border taxation as such but the fact that not all European countries operate a full credit corporate tax system. For as long as the member states have the right to organise their corporate income tax systems largely autonomously, discrimination in this area is simply unavoidable. Every selective correction of a particular point by the European Court of Justice will either create new inequalities or amount to a creeping harmonisation of direct taxes through the back door. If the member states wish to avoid this, they will have to get around to introducing a common corporate income tax system.

VII. Conclusions and recommendations

German international tax law is in need of reform. With its high tax rates Germany has put up conspicuous warning signs to foreign investors and given its residents a host of incentives for investing abroad. All things considered, the Scientific Council believes the tax wedge between Germany and the rest of the world creates a hostile climate for investment and employment; this is aggravated by a lack of consistency, which in itself makes for complications, inequities and inefficiencies (Chapter II).

Unquestionably necessary, a reform can either take the form of pragmatic measures that can be put into practice relatively quickly (Section A) or a fundamental re-orientation which, admittedly, would demand plenty of staying power. In the latter case there are two consistent solutions, namely a strict orientation toward the residence principle (Section B) or a strict orientation toward the source principle (Section C). The comparison of international tax systems undertaken in Chapter VI revealed that no system is superior in every respect; to this extent the decision in favour of going down a particular avenue is based on political value judgements. The major aspects for forming such judgements will be identified in advance of each of the following recommendations.

A. Pragmatic measures

A restriction to pragmatic measures – while essentially maintaining the existing international tax law – is to be recommended if the model solutions outlined in B. and C. are held to be unrealistic. Yet steps such as these and more long-term measures are not necessarily incompatible.

Probably the most urgent immediate measure is a comprehensive and drastic cut in individual and corporate income tax rates. This would considerably narrow the tax wedge between Germany and other nations that drives capital and jobs out of Germany. A major cut in tax rates would also remedy a variety of important further problems (such as the creation of excess foreign tax credits in conjunction with foreign investors) and alleviate the harmful effect of inefficiencies caused by inconsistencies in the tax law.

Such a tax cut would not lead to unsustainable revenue shortfalls if tax loopholes were scrapped at the same time. The Scientific Council advocates the concept "tax cut cum base broadening" to the extent that it is applied equally to all kinds of income, and emphatically advises against a selective application that concentrates on companies in the closure of loopholes. The resultant shift of the tax burden from individuals to companies would undoubtedly exacerbate the existing problems and run counter to the intended reduction in the number of jobless. What is more, a spreading of the tax rates of companies and individuals, irrespective of it possibly being in breach of the constitution, would create new problems and change nothing as regards the incentive for residents to invest their savings abroad rather than at home.

As a part of the rate cut under discussion, the scrapping of certain reliefs pertaining to foreign income is to be recommended. In the first instance these include the provisions at § 2a Paras. 3 and 4 of the Individual Income Tax Act, according to which losses originating abroad can be deducted from taxation even when the corresponding income is exempted. For economic reasons and in light of the proven susceptibility to abuse of this provision, the Council is of the opinion that it should be repealed. A *pro rata* limitation of the allowance in respect of interest charges on tax-exempt foreign income (§ 3c of the Individual Income Tax Act) is also consistent. Finally, § 8b Para. 2 of the Corporate Income Tax Act, which provides for a unilateral exemption of foreign capital gains, should also be abandoned and the so-called Foreign Activities Ruling, which exempts foreign earned income, should be annulled.

A final aspect concerns the introduction of a final withholding tax, a dual income tax or an interest-adjusted income tax. It is the unanimous opinion of the Scientific Council that the advantages and disadvantages of these alternatives do not especially affect international capital income taxation, which is why the problems associated with interest-adjustment, in particular, can remain open in the present report. As mentioned in Section V.A, the transition to an interest-adjusted tax has no clear economic effects in the closed economy; on balance it can bring both advantages and disadvantages. The same also applies to the world economy as a whole if the countries co-operate along the lines described below.

B. Orientation toward the residence principle

If German tax policy is to centre rigorously on the residence principle, it will be necessary for at least the member states of the European Union to agree on a greater exchange of information. This has the combating of international tax evasion as its aim; it consists of communications on cross-border capital income within the territory of the contracting parties as well as communications on payments made to and received from any non-participating country.

Where the residence principle is applied the residence country levies tax on the entire world-wide income of the individual or company, regardless of the kind of income and of the location where the income originates. The rate scales selected by different countries for an income tax such as this can by all means vary, without this giving rise to fears in respect of distortions in the international allocation of capital (capital export neutrality). The system thus permits taxation according to the ability-to-pay principle and also leaves enough scope for international tax competition. In order to preclude tax deferral strategies, the orientation toward the residence principle also necessitates moderate taxation of retained profits of foreign corporations, as discussed in Subsection III.B.2.

To date, it has not proved possible to establish the residence principle effectively. This is due to the fact that German revenue authorities are often unaware of income from abroad, in particular interest income, which opens the door for tax evasion. In this respect the international agreement on the verification of interest income described in Subsection III.C.1 constitutes the core element of this option. It is to be expected, but not necessary, that additional countries will enter into the agreement, especially the USA, who in any case send information on capital income to other nations on a regular basis.

Irrespective of the international agreement on the verification of interest income, an orientation toward the residence principle calls for the following individual steps:

- Interest income would have to be verified more thoroughly than hitherto domestically; for this reason § 30a of the German Fiscal Code (so-called "banking secrecy rule") would have to be annulled. Recipients of interest on outside capital would thus be treated just as self-employed and wage earners.
- The exemption rules established in double-taxation agreements would have to be replaced by tax credits. For the reasons outlined in Section III.C.2 this could be done by step-by-step renegotiations or with the aid of a tax treaty law.

The additional tax revenue originating from these measures would have to be used to fund tax cuts, because otherwise a fiscal environment of detriment to Germany as a business location would result. This is especially true of the latter proposal, the economic effects of which would likely be as follows: a general transition from the exemption to the credit method would take away the tax-related incentives to invest abroad instead of at home considered in Section II.C. The tax burden imposed on foreign income accruing to German residents is bumped up to the German level, taking away the fiscal incentive to invest abroad. In this respect, then, the tax levied in Germany has no influence on the investment decision. Parallel to this, tax revenues rise for two reasons:

- Firstly, German taxpayers pay the difference between the foreign and the domestic tax to the revenue authorities.
- Secondly, domestic investment is likely to rise following the closure of the gap between the foreign and domestic tax burdens and thus revenues from other taxes, especially the wage tax, will also climb. This indirect effect is practically impossible to quantify, but is possibly more significant than the direct effect.

If the tax cuts that go hand in hand with the measures under discussion lead to no overall change in the tax burden, corporate relocations and other forms of capital flight are not to be feared in the economy as a whole. Individual companies that benefit substantially from the exemption rule but then become subject to a higher tax burden may decide to relocate abroad; on the other hand, however, the burden on

other companies would be relieved. This is important especially with respect to small- and medium-sized companies, insofar as they were not able to make use of the exemption previously.

If the residence principle were to become established, the determination of exempted income, the activity clauses and the problems associated with § 2a Paras. 3 and 4 and § 3c of the Individual Income Tax Act would no longer be relevant. It would also be possible to dispense with the differentiation between active and passive foreign income, which is practically impossible to administer and susceptible to abuse. CFC taxation should be conditioned solely on the characteristic "unreasonably low foreign taxation". (CFC taxation means that foreign retained profits are immediately attributed to resident shareholders; see Subsection III.B.2 for details.) This would see the removal of several of the mainstays of international "creative tax arrangements".

Finally, the proposal to introduce a corporate income tax system within the European Union which allows cross-border credits of corporate income tax against individual income tax is only indirectly linked to an orientation toward the residence principle. A system such as this, whose basic features were outlined in Subsection III.C.3, would provide a method of taxing companies within the EU that is for the most part neutral as regards their legal form and would also repair the current capital market segmentation. It would encourage the economic integration of the participating nations, but also necessitate certain harmonisation steps in the area of corporate taxation.

C. Orientation toward the source principle

The ideal prerequisite for a consistent orientation of German tax policy toward the source principle would be world-wide agreement on a minimum capital income tax imposed at source. Realistically, though, the involvement of the major economic regions of Europe, North America and East Asia would suffice.

With any orientation toward the source principle, Germany would have to aim to bring about international agreement on the harmonisation of capital income taxes. In the long term such a system would have the following basic features: the participating states would tax capital income, but not earned income, at an internationally agreed minimum rate. Pure profits, rents, licence fees and interest, in particular, would be taxed in the source country (comprehensive business income tax, cf. Section V.D), with the investor incurring no tax in his residence country. National provisions such as § 2a Paras. 3 and 4 and § 3c of the Individual Income Tax Act would have to be annulled or amended, as they run counter to the source principle.

The international agreement would have to include stipulations in respect of taxation procedures and tax bases and specify rules and regulations for the pinpointing of income sources where not inherently obvious (as in virtual markets). In sum, it would be practically impossible to evade capital income taxes, because only revenues on which tax has already been paid would cross national borders; in this respect there would be no need to annul § 30a of the German Fiscal Code. The system ensures capital export neutrality within the participating states so long as tax rates are the same internationally.

It would not be prudent to restrict the system to the territory covered by the European Union, as interest flows to creditors in non-participating countries would have to be excluded from any deduction at source for the reasons given in Section IV.C. Conversely, interest inflows from non-participating countries would have to be verified. Owing to the obvious opportunities for avoiding taxation by investing in non-participating countries, the costs of controls at external EU borders would be just as

high as those incurred on widespread application of the residence principle. In sum, restricting withholding taxes to the territory of the European Union would bring together the major problem of the residence principle (need for exchange of information) and the major shortcoming of the source principle (need for international tax harmonisation). One advantage, though, would be the fact that companies would be taxed neutrally within Europe.

The situation is different where the nations participating in the system represent – measured by the yardstick of value added – the major part of the world. These include the large economic regions of Europe, North America and East Asia and, ideally, all the nations of the world. Such a large participating group can generally tax capital income at source without any harm. No special rules are put in place for interest payments made to countries not party to the agreement because only income on which tax has already been paid flows there. This makes tax evasion substantially more difficult and leads to the disappearance of tax havens. In dealings with non-participating nations, participating states should levy tax according to the credit method.

The logic of world-wide withholding taxes dictates the virtual eradication of fiscal autonomy in the area of capital income. Autonomy does, however, remain to some extent if countries select a higher tax rate than the minimum rate agreed. In addition, capital income tax generally shows no consideration for an individual's ability to pay because it is completely depersonalised. Having said that, each residence country has the following options in organising the income tax:

- Firstly, earned income can be subjected to a progressive rate scale. This involves abolishing the comprehensive income tax and necessitates careful distinctions between earned income and capital income.
- Secondly, the capital income tax rate could also be applied to earned income. This corresponds to the idea of a "flat tax" under which all income is subject to proportional or indirectly progressive taxation.

The Scientific Council favours the second option for the following reasons: Being a comprehensive income tax, the flat tax is easier to administer and more in line with the ability-to-pay principle than a schedular tax, which imposes a higher burden on the recipients of earned income than on recipients of capital income. The introduction of a flat tax at a rate of, say, 28% and an adequate basic allowance does not necessarily lead to a loss of revenues, so long as the legislation is sufficiently firm with respect to the scrapping of tax loopholes. Various degrees of indirect progression can be established by fixing the basic allowance. Generally, no international agreement is required in respect of the amount of the basic allowance; in fact, each country is free to select it according to the way it views vertical equity.

Yet the granting of a basic allowance by the residence country can cause problems if a citizen has no income in his residence country or if his income lies below the basic allowance: on the assumption that the source country taxes the income without taking into account the basic allowance, the burden imposed on the taxpayer is too high. A number of reasons speak in favour of imputing the result to the party concerned, but this view is at odds with European law. In this respect it would be worth considering a supplementary stipulation within the European Union forcing the member state in which the EU national earns the majority of his income to grant the basic allowance. This would necessitate a certain degree of co-operation between the revenue authorities of the countries concerned.

Finally, the taxation of business fits into the system perfectly, with profits being subject to the capital income tax rate in the relevant source country and with any profit distributions or capital gains

remaining untaxed in the residence country. The taxation of business is thus neutral with respect to legal form and finance terms. Payments between companies are booked to separate accounts, depending on whether tax has already been paid on the amounts concerned (e.g. interest) or not (e.g. payments for goods supplied). To guarantee correct allocation, a certain degree of ongoing co-operation between the finance authorities is necessary in this case, too.

In sum, the source principle prejudices a flat tax if the ability-to-pay principle in its horizontal meaning is to be maintained. A reverse argument does not apply, however, since it goes without saying that the flat tax could also be combined with the residence principle.

D. Conclusion

In the opinion of the Scientific Council, the core problems of international capital income taxation can be resolved only by consistent application of the residence principle or the source principle. The two models cannot be implemented in the short term because they necessitate a relatively high degree of international co-operation. Admittedly, closer co-operation between nations in the future will in any case be worthwhile or even, in view of the dramatic developments in international trade, indispensable.

The orientation toward a clear concept pointing the way out of the taxation jungle constitutes a basic prerequisite for the success of new forms of co-operation. For only consistent solutions can prevent the interests of day-to-day politics from exacerbating the fiscal chaos still further with ill-considered and inherently contradictory individual measures. In this respect, the individual measures outlined in Section A, important as they are, also leave the main problems of international capital income taxation unresolved. This is particularly true with respect to international tax evasion and the resulting distortions in the area of corporate taxation.

Those who believe that neither the residence principle nor the source principle can be realised with the degree of rigour called for by the Scientific Council may make a virtue out of necessity up to a point and, for the sake of fairness, advocate a dual income tax or a final withholding tax. If we take this argument one step further, however, the income tax would degenerate to a residual tax impacting primarily on recipients of earned income, which seems equally unfair, at least. Conversely, it follows that politicians – if they wish to maintain the traditional income tax – will have to go down one the above roads, no matter how littered with obstacles it may be.