

Harmonization of Corporate Income Tax (CIT) in the EU - Achievements and Challenges

Fitore Morina¹, Bedri Peci²

Abstract: This paper provides a framework of the tax systems of CIT - Corporate Income Tax in the EU. This paper treats the concept of CIT according to the OECD, EU directives and Kosovo legislation. It aims to identify gaps in the current Kosovo legislation and the tendency to increase the harmonization of the tax systems in EU, especially, in view of the direct taxes. The theory of international tax law counts some methods used in the case of the relocation of the source of income from countries with high tax rate in countries with the lower tax rate. However, determining the level of taxation in this area is the exclusive issue of Member States in harmony with the principle of subsidiarity. With the aim at securing sustainable economic development and growth in the EU, within the framework of their strategy some changes were proposed regarding the elimination of all legal and fiscal barriers that hinder the full integration of the national systems of member states into the common market. The CCCTB initiative is considered a major step towards aligning the EU tax systems. So, the purpose of this article is to demonstrate the level of harmonization of the tax systems in EU, using the comparative, empirical, normative and logical methods, to conclude the role of CIT in the tax systems.

Keywords: Taxable income; tax harmonization; direct taxes; tax systems

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1. Concept of Corporate Income Tax (CIT)

Within the framework of tax systems of contemporary states, the Corporate Income Tax (CIT) is also an important financial instrument for financing public needs. CIT, enters the group of direct taxes, hereby taxable income are deducted, within and outside the jurisdiction of a state. Taxable income is the difference between gross income for a taxable period and allowable deductions (No.05/L-029). According to the OECD, CIT is defined as the tax that is collected in net profit of enterprises and is calculated as: gross income minus allowable deductions (OECD).

¹ Teaching Assistant, PhD Candidate, Department of Financial Law, Faculty of Law, University of Prishtina, Kosovo, Address: Agim Ramadani Str.p.n., 10000 Pristina, Kosovo, E-mail: fitore.morinal@uni-pr.edu.

² Associate Professor, PhD, Department of Financial Law, Faculty of Law, University of Prishtina, Kosovo, Address: Agim Ramadani Str.p.n., 10000 Pristina, Kosovo, Corresponding author: bedri.peci@uni-pr.edu.

A corporation can exercise its economic activity in many countries at the same time, thus getting the status of Multinational Corporation, geographically extended to some jurisdictions. Mainly these companies extend their activity in two dimensions: *the first dimension* is the one that is dependent on the possibility of strategic investments and *the second dimension*, is the expansion of the market beyond national borders (Raffaele, 2007, pp. 118-120). According to today's economic trends, Corporations are developing their day-to-day economic activity in locations, the so-called tax paradise (Raffaele, 2007, pp. 118-119) or in offshore centers, because they are affected by the tax rate applied to dividend income, interest and other payments. After many efforts to harmonize direct taxes a minimum harmonization of direct tax systems has been reached, and based on adopted directives the EU states have signed several agreements on abolition of double taxation. Hence, the search for adequate methods for taxable of their income is necessary because of the role that this tax form plays in national economies.

The theory of international tax law counts some methods used in the case of the relocation of the source of income from countries with high tax rate in countries with the lower tax rate, as follows (Raffaele, 2007, pp. 34-38):

- *Method of Profit Shifting Strategy* - This method is mainly used when the parent Company displaces a part of the income to the Company's same branch but in another country where the lower tax rate of CIT is applied;

- *Method of Transfer Pricing* - This method is applied in Kosovo and with transfer price means the price set by taxpayers when selling, buying or sharing resources with other persons. The transfer price is considered to be the adverse price to the market price (Brian & Michael, 2002). In Kosovo, the open market value is determined by the uncontrolled comparative price method which is considered as the preferred method of the OECD and can be used for the transfer of tangible, intangible assets and utilities. This method is used by companies that want to avoid the high rates of CIT in the country where they are doing their business. (Matei & Pîrvu, 2011) This method enables the transaction price to be determined with the companies belonging to the same group. Multinational companies use the transfer of price for all their transactions, whether for purchasing goods or services. An adequate example for illustrating this method is: Company X, avoids tax payment in state A. Buyers of Company Y, which is located in State B, determines the sale price of manufactured products, which undoubtedly affect the final profit outcome because the effects of the tax rate in State B are lower than in State A. In this way, companies that are interconnected (operating as multinational companies) will not pay CIT or will pay less. (Brian & Michael, 2002) This method is related to the arm's length method which requires that the goods and the service price that is transferred should be adjusted in that form reflecting the price determined

independently by the companies that have no connection between themselves (so they do not operate within the same group); (Raffaele, 2007)

- *Capital Method/Corporate Debt* – According to this method, entities operating in countries where lower tax rates are applied and give loans to companies operating in countries where high rates of CIT are applied, automatically switch income from the interest rate of loans to countries with lower tax rates and thus lowering the profit for the countries applying high rate of CIT. (Needham, 2013)

- *The Method of Payment of Intangible property (non-material)* - The use of this method is considered when it comes to intangible property, in cases where the owner of that right determines the price of intangible property. A price that more or less reflects the value of wealth. Multinational companies are often accused of avoiding paying taxes using the price for instance of the purchased brand (Brian & Michael, 2002):

-*The Method of Joint Stock Companies* - These companies extend their activity to some jurisdictions and benefit from states that offer lower CIT rates;

- *The Method of Hybrid Entity* - This method is present in those states where the so-called dual residence of companies is allowed operating their activity in two jurisdictions and in one state there is the headquarters and in the other state, for example, the management site.

As hybrid entities (Brian & Michael, 2002) mainly refer to limited corporations by guarantors or refer to legal agreements that in a jurisdiction are treated as a Corporation while in another jurisdiction as a partnership. (Brian & Michael, 2002)

- *The method of Corporate channels* - According to this method, companies use money channels offered by countries that apply the preferred taxable rates and through this channel invest in the economies of different countries, for example in 2010 in Russia as the top investor was Cyprus with 28% of total investments. (Needham, 2013)

2. The Structure of the CIT in the Tax System of Kosovo

Within the Kosovo tax system is also the Corporate Income Tax (CIT). Like any other tax form, also CIT serves to collect public revenues. In the structure of revenues according to types of taxes, during the year 2015, participation of CIT in total revenues was 31.2%.

Table 1. Revenues realized by CIT in the period 2013-2015

Type of tax	2013	2014	2015
CIT	65,924,379	65,818,313	74,639,926

Source: Work report-January-December-2015 – TAK

Kosovo's undefined political stand by 2008 certainly influenced on the design of the Kosovo Tax System. The economy develops, the informal sector shrinks, while the tax-evading sector expands, thus limiting potential collection. (Lopez, 2017, pp. 107-126) Legislation from the CIT field in Kosovo dates back to 2004, with the adoption of Regulation No. 2004/51 by the Special Representative of the Secretary-General who had the authority based on Resolution 1244 (1999) of the United Nations Security Council of 10 June 1999. Under this regulation, taxpayers were considered corporations, business enterprises operating with public and social property wealth, non-governmental organizations registered by UNMIK and permanent enterprises of non-resident persons (UNMIK/REG/2004/51). Pursuant to Article 3 of this Regulation as a tax entity for resident taxpayers is income taxes in Kosovo and abroad, while for non-residents are only income taxes in Kosovo. The biggest amendment in Kosovo's legislation occurred upon the declaration of independence (2008), whereby the Law on Corporate Income Tax was approved and the tax rate of CIT decreased from 20% to 10% (Nr. 05/L-029). Pursuant to Article 6, paragraph c, within the exempted income from CIT is also the dividend that is received by a resident taxpayer in Kosovo, a resident company that has paid Kosovo's taxable corporates' income. While with the Law of 2015 as an exempted income is: "paid or received dividend for a resident and non-resident person."

Also: "interest from financial instruments issued or guaranteed by the Kosovo Public Authority paid to resident and non-resident taxpayers" is foreseen under the 2009 Law and the 2015 Law as exempted income.

By this Regulation (UNMIK/REG/2005/51) as well as with the 2008 Laws, the allowed expenses are not mandatory described, while for deductions allowed for public interest activities as expenses up to the maximum of 5% of the taxable income calculated before deduction of expenses, whereas with the Law of 2015 allowable deductions are from 10% of the taxable income calculated before this contribution is deducted. Representation expenses with the Regulation and the Law of 2008 and 2009 were allowed up to 2% of gross income, while with the 2015 Law were limited to 1% of gross annual income. According to the Law of 2015 for the amount of up to 500 Euros treated as bad debt, the initiation of proceedings in the judicial bodies is not required, while the issue of initiating court proceedings was not regulated by the Regulation. With regards to the application of the devaluation of tangible property in both Regulation and the Law is divided into three categories but the difference stands at the allowed amount as a deduction for depreciation in the special tax period to the third category, according to the Law of

2009 and 2015 was applied to 10% while with the Regulation and the Law of 2008 was 15%. As an applicable method in the case of avoiding double taxation, the tax credit method continues to apply. According to the Regulation and the Law of 2008, Insurance Companies collected seven percent (7%) of gross premiums during the tax period, while under the Law of 2009 and 2015, 5% of gross premiums were deducted whereas non-governmental organizations by 10% on income from business activity as with the Law of 2008 and 2009, while according to the Regulation the Nongovernmental organizations have been deducted by 20%. Taxpayers with a gross annual income up to 50,000 are obliged to pay the tax every three months, the difference between the Regulation and the Laws of 2008 and 2009 of the applicable tax rate is based on the gross income received from services and professional activities, crafts, entertainment and similar have been increased by 5% according to the Law of 2012 and 2015 to 9%, while the gross income for quarterly rent by the Regulation was 16% while with the Law of 2008, 2009 and 2015 was 10%. In 2007, with the amendment of the Regulation supplemented by Article 1A regulating the meaning of a permanent unit or a fixed business site where the business activity of a non-resident person is carried out entirely, a meaning which is the same and according to the Law of 2009 and 2015 as permanent units, pursuant to Article 29 includes: each management place, branch, office, factory, workshop, mine and every oil or gas source, stone quarry or exploration site of natural resources. The direct effect of corporate income tax on wages can be identified in a bargaining framework using cross-company variation in tax liabilities, conditional on value added per employee (Arulampalam, Devereux & Maffini, 2012, pp. 1038-1054).

3. Legal Basis of CIT under the *acquis*

In the EU legislation, including its founding treaties, one can not find an exclusive provision in which direct taxes or taxable income are regulated. Legislation deriving from the CIT field is usually based on Article 115 TFEU, a provision authorizing EU institutions to adopt directives enabling the approximation of laws, regulations or other administrative provisions of the Member States which will help towards the functioning of the common market. Pursuant to Article 113 of the TFEU, Member States are authorized to negotiate the adoption of measures to obligatory harmonize legislation on indirect taxes and the necessary extension of harmonization in the field of competition to eliminate – avoid unfair competition implied among the Corporates. Pursuant to Article 110 of the TFEU, Member States are prohibited from direct or indirect imposing on the products of the other Member State of higher taxes than domestic products, thereby preventing unfair competition and promoting fair competition. Article 55 of the TFEU requires Member States to provide the same treatment to nationals of other Member States

in the case of participation in the capital of the firm or the company. This legal basis has been used by Member States to enter into bilateral agreements in the field of direct taxation rather than to achieve a higher level of harmonization of direct taxation in the EU. The EU Member States since foundation to date have expressed a skeptical attitude towards the harmonization of direct taxes, in particular the CIT, while retaining tax sovereignty and delegating limited prerogatives at the central level of EU (Nicodème, 2006). Tax rates and informality depends on the degree of tax enforcement and the level of credit market development in an economy (Mitra, pp. 117-127).

The political and economic arguments presented by the skeptics of the full harmonization of direct taxes are (Nicodème, 2006):

- Lack of democratic legitimacy in the context of representation of the people of member states in EU institutions represented by maximen: *“No taxation without representation”*;
- Redistribution of revenues proportionally within the Member States;
- Harmonization of direct taxes requires the achievement of stabilization policies through the budgetary frameworks of Member States and at the same time the common definition of public policies, whereby public expenses will also increase.

Direct taxes, in the tax structure of the EU Member States have a different participation in the total income collected from taxation. A higher participation of direct taxation has Denmark to 67.4%, followed by Ireland, Malta, England and Sweden, which collect between 40% - 50% of direct tax revenues. (EC, 2016)

4. Harmonization of CIT with EU Directives

Efforts to harmonize CIT date back to the Neumarkt Report of 1962. In 1990, the European Commission prepared a guideline with regard to CIT in the EU, under the heading Guidelines on Company Taxation, foreseeing measures to be undertaken at the Community level with regard to the development and full integration of the national economies of Member States into the common market. According to the plan prepared by the EC, the harmonization of the CIT system should be based on the principle of subsidiarity and the establishment of conditions for the free movement of persons, goods, services and the capital. The common market is required that on the basis of the proposed plan to be opened for companies that carry out transnational transactions and sign agreements on eliminating double taxation. According to the EC, the most appropriate solution to the establishment and harmonization of the CIT system is the establishment of triangular and multilateral relations between Member States. The measures to be implemented under the EC to increase cooperation between the corporations of

different countries and preserving financial interests of the Member States have been presented as a package of draft directives as follows: *Merger Directive* ; *The Parent Companies and Subsidiaries Directive*; *The Arbitration Procedure Convention*. Hereby Arbitration Procedure, disputes arising in the event of disagreements between related companies and in cases of double taxation will be resolved.

1. *The Merger Directive* is not exempted from CIT but the postponement of capital taxation (Dankó, 2011). Later the need to amend this Directive was raised with regard to the reorganization of companies of Member States which started combining or merging capitals at Community level. This new economic operation should be in harmony with the EU founding treaties, and therefore in this new economic order it appeared the need for approximation of member states legislation from the CIT field and the elimination of all obstacles preventing the establishment of multinational companies stretching across many countries. In order to fulfill the legal framework, in 2001 the Regulation on the Statute of European Companies (SE) was adopted, with the provisions of which it is possible to establish and manage companies within the EU and their equal treatment with local companies.

The Member States have an obligation to apply the provisions of SE Regulation in the national legislation. Under this regulation, a company can be established within the Community territory in the form of European Public Company with limited liability (Societas Europaea or SE), which has an essential capital of €12,000, divided into shares and is a legal person.

The registration office and the head office of the SE can be located in the same country, but according to Article 8.1 can also e.g.; such office to be transferred to another member state, a transfer which does not result in SE liquidation or establishment of a new legal entity. Legal procedural issues related to SE functioning, under Article 10, will be dealt with based on the laws of the member states, where the SE has its registration office. In 2003, the Regulation on the Statute for the European Cooperative Society (SCE) was adopted – Cooperatives were considered as the first group of legal entities differing from other economic agents. This type of cooperative organization is characterized by the organizational structure, control and distribution of net profit for the financial year.

2. *The Directive on Parent Companies and Subsidiary Companies*

This directive applies to cross-border profit distribution between parent and subsidiary companies of EU Member States (Raffaele, 2007, pp. 22-23). The status of a company is determined by the minimum capital that must be owned within a company in the other member state. The status of a parent company is attributed to a company of the member state that meets the conditions for being appointed The Company of the EU Member State that must, under the law of a member state, be

considered resident of that state for tax purposes and in the cases of agreements for double taxation elimination, as well as being subject to CIT in the respective member state, and is not likely to be a tax-exempt company, while the last condition relates to the minimum stock of 25% of the capital of the company located in the other member state. With the amendment of this Directive in 2011, in terms of regulating entity, remained the same with respect to the exempt from CIT of dividend and profit paid by subsidiary companies for parent companies and the elimination of double taxation on income of parent companies.

3. The Directive that applies to the issues of Interest and Payments of honorarium on deed in the companies operating in EU.

Under this Directive, it was established a common system of interest taxation and payment of honorariums on deed to the companies that are interrelated between them and operate in the EU member states, with a view to eliminating the double taxation from the interest of financial instruments and payment of honorariums to the member state, where they are generated. In the member state where the company, making the payment of interest and honorariums, is resident, is considered as the state of the source of such payments (Raffaele, pp. 27-30). Under this directive the permanent unit is considered as payable only if the payment is an expense within the tax deductions for the permanent unit established in the member state, the same shall not apply if the permanent unit is established in the third member state. In all other cases, the permanent unit is beneficiary of interest and honorarium payment when it is directly related to, when the income from those payments represent the permanent unit as subject to the tax in the Member state. In cases when two companies are affiliated with the parent company established in a third country, e.g. in Kosovo, this directive does not apply. The state of the source payments is not obliged to pay these forms of payment, e.g.: Payments that are treated as distribution of profit or settlement of debts under the laws of the state of the source of income etc. Today, the role of Companies that choose to operate on the basis of CCCTB will operate on the basis of the legal framework taxation throughout the EU area under the *one stop shop* principle.

The impact of CCCTB on doing business for companies operating their economic activity in EU is very high, ranging from the possibility of calculating their profits throughout the EU, based on a common legal framework and selecting the most appropriate place in terms of the needs of the business concerned by removing all the fiscal and legal barriers that existed within the national taxation systems.

There are three scenarios that identify the role of CCCTB in the EU common market economy 1. *Common Corporate Tax Base (optional CCTB)*: meaning resident companies in the EU and the permanent EU entity have the option to choose that calculation of Tax base be made in compliance with common rules instead of opting for a separate corporate tax system. This model is known as

separate accounting. 2. *A Compulsory Common Corporate Tax Base (compulsory CCTB)*: that means all eligible companies resident in the EU and a permanent EU entity are required to calculate the tax base in accordance with common rules throughout the EU, therefore, the new common rules will replace corporation tax systems in member states. 3. *A optional Common Consolidated Corporate Tax Base (optional CCCTB)*: implying that the common rules established for calculating the tax base throughout the EU will be offered as an alternative to member states. Therefore, resident companies in the EU and permanent EU units have the possibility that companies that are their property outside the EU apply CCCTB rules. This model is known as all-in all-out.

5. Conclusion

Undoubtedly, *the CIT harmonization* in the EU space plays a significant role in the economic growth and sustainability of EU. Therefore, the recent innovations in terms of consolidated tax base under the CCCTB enables taxation of companies or group of companies on the basis of total income in all countries, besides that the most important implication is that economic losses in one country will be compensated by the gains realized in another country. The CCCTB strategy enters in the fiscal policy group that provides measures for eliminating fiscal barriers and simplifying legal procedures in order to facilitate the operation of companies in the common market. The EC in October 2016 reviewed the CCCTB in order to increase competition within the companies and proposed the implementation of innovations in two phases. In the first phase, it is proposed that the tax base should not be optional but be made mandatory for most multinational companies and in the second phase, conditions will be created that under the CCCTB will enable companies to enjoy the same benefits with regard to financial treatment (debt - bias in taxation), will encourage a solid financing structure and greater economic stability.

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