INTERNATIONAL ENVIRONMENT OF THE TAX SYSTEM FOLLOWING SLOVAKIA'S ACCESSION TO THE EUROPEAN UNION

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As a result of the globalisation phenomenon, individual economies are becoming ever more interconnected and influenced by the international environment. The collapse of the Iron Curtain, subsequent possibility to conduct business freely and the free movement of capital expanded international economic co-operation. Economic borders continue to weaken and international economic integration deepens. This process also affects the tax systems of individual countries, since some coordination of tax systems is essential for eliminating barriers that taxation can cause. On the other hand, countries can attract into their jurisdiction taxpayers from other countries through differences in their respective tax systems.

In connection with this issue a group of authors is presenting a series of articles on the Slovak Republic's tax system. This first part deals with the international environment of the tax system following Slovakia's accession to the European Union (EU).

The Slovak Republic's tax system is currently influenced primarily by two factors - harmonisation of tax legislation in the framework of the EU and coordination of tax policy in the framework of the Organisation for Economic Cooperation and Development (OECD), the most important results of which have been international double taxation treaties.

HARMONISATION OF TAX SYSTEMS WITHIN THE EU

A different approach is applied in the EU in respect of direct and indirect taxes. The reason lies primarily in their impact on the single internal market. Differences in the regulation of direct taxes as a rule do not bring about any significant deformations in the working of the single internal market. Therefore, member states retain significant independence in the field of direct taxes, and are themselves responsible for their national legal regulation. On the other hand, the creation of the single internal market, being distinguished by the free movement of goods and provision of services, required the introduction of neutrality in the field of indirect taxes, through their significant harmonisation.

Indirect taxes

In the field of indirect taxes it was thus necessary to undertake more significant harmonisation than in the case of direct taxes. The different regulation of taxation conditions by indirect taxes would otherwise, via the influence of end production prices, have significantly deformed the working of the EU single internal market. Therefore Article 93 of the Treaty Establishing the European Communities anticipated the harmonisation of tax regulation via turnover tax, excise duties and other indirect taxes.

Value-added tax

Value-added tax was introduced universally throughout the EU as a replacement to various turnover taxes applied by individual member states. The cumulative effect of turnover taxes was to create barriers to international trade within the European Communities, significantly influencing the free movement of goods and the creation of the single internal market. The advantage of value-added tax is the visibility of the tax content at each level of the production and distribution chain. Value-added tax is applied directly in proportion to the price of goods and services at each level of production and sale on the added value created. This means that the tax neutrality of transactions in framework of the internal market of the country, between individual member states and with countries outside the EU is ensured, because the tax burden is borne equally both by goods and services regardless of the length of the production and sales chain.

The basic instrument in the harmonisation of value-added taxes in the EU has become the Sixth Council Directive of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover tax (77/388/EEC), as amended several times. The Directive contains regulation on value-added tax in the scope of the VAT regime, defines economic activity, taxable persons, taxable activities, the place of taxation, chargeable event, chargeability of tax, the tax base, basic exemptions from tax, conditions of the right to deduct tax, etc.

The harmonisation of legislation in the field of value-added tax thus regulates a uniform basis by this tax, where it provides several deviations, e.g. in the case of use of used goods, works of art, antiques, collectors' items and transactions with gold. The current system of the application of value-added tax is founded on the specific assessment of transactions between taxable persons, performances in favour of private persons and performances not subject to tax or exempted from it.

A tax liability in general relates to two categories of transaction - the supply of goods and the provision of services. The supply of goods or services to another EU member state is no longer considered as an import or export, but as a chargeable event subject to value added tax.

The final goal of value-added tax harmonisation is the application of the principle of taxation in the country of origin of the event. Nonetheless, it is difficult to apply this principle in practice, because its implementation could cause marked differences in the tax revenues of individual member states. It would require the reallocation of tax revenues between the countries of origin and the countries of consumption, which means coordinated legislative changes in all member states in order to introduce a clearing system for such reallocation. Therefore the country of destination principle applies as a temporary solution to determining the place of a chargeable event. We presume that this "temporary" solution will probably still be in operation for a relatively long time.

Determining the place of a chargeable event on the basis of the country of origin principle has since 1993 been applied only in the case of private persons. This means that goods purchased by a citizen of a member state in another member state is subject to the same tax regime as in the case of residents of this other member state. Goods imported by a private person are no longer subject to tax in the case of their transfer to the home member state. Exceptions to this rule exist, for example in the delivery sale or in the purchase of new motor vehicles.

On the other hand, the principle of taxation of taxable persons on the basis of the country of destination means that the consumption of goods and services intended for taxable persons is taxed in accordance with the legislation of the country of consumption at the tax rate valid in the given country. This principle, however, partially disrupts the use of various fairly low value-added tax rates in individual member states. In the case of business subjects thus the application of value-added tax in accordance with the country of destination principle leads to the fact that the single market remains to a certain extent fragmented.

The Sixth Directive lays down two fundamental principles concerning the application of tax rates: firstly, imported goods should be subject to the same rate that applies to supplies of similar goods within the member state, and secondly, the level of the tax rate applied to output should be such as to cover the tax deductible on the input.

The Sixth Directive also governs the number and level of value-added tax rates. Member states are obliged to apply a basic tax rate of at least 15%. At the same time they also can apply one or two reduced tax rates, at least, however, at the level of 5%. Zero, or extra low tax rates below 5% are permitted temporarily. In the framework of the harmonisation process there have likewise been cancelled too high tax rates and their recommended maximum level is 25%. This regulation has led to a reduction in the number of tax rates and likewise also to the regulation of tax rate levels in individual member states.

Due to the need for a high degree of value-added tax harmonisation in the EU the process of approximation of the Slovak legislation in this field was monitored in detail by EU bodies during the accession process. The result is a new value-added tax system corresponding to the requirements of European harmonisation, where, however, in the Slovak Republic a transitional period applies, for example, to a higher turnover threshold for compulsory value-added tax registration. Since the new legislative regulation on value-added tax came into effect only upon 1 May 2004, we presume that in practice application will highlight several needs to trim down the regulations of the new act.

The obligation to harmonise legislation in the field of value-added tax has given rise to several court cases, where individual member states have not set their legislation in accordance with the provisions prescribed by the Sixth Directive. Aggrieved business entities have several times successfully contested initiations of national court proceedings that have led to important decision of the European Court of Justice. Slovak subjects now also have the same possibility.

Excise duties

A high degree of harmonisation of excise duties is likewise essential for the working of the single internal market. Harmonisation in this field concerns mainly three objects of consumption - tobacco and tobacco products, spirits and mineral oils. In the future there is also expected taxation of other commodities such as electricity.

A tax liability in principle arises through introducing

goods subject to excise duties into tax free circulation. The principle of determining the place of taxation is essentially identical to that in the case of value-added tax. For persons subject to excise duty the country of destination principle of taxation is applied. In the case of the transfer of already taxed goods by a natural person for the purposes of personal consumption from one member state to another member state the country of the goods origin principle applies, meaning that on the basis of the transfer of goods by a natural person a tax liability no longer arises.

Tax rates are determined by individual member states, while complying with the minimum rates set by the respective harmonisation directives and regulations. The varied approach to taxation as regards excise duties results also from cultural differences, where the taxation of beer and wine can be given as an example. The application of differing tax rates has as its consequence trade advantages arising to several countries, especially in border regions, for example Luxembourg is known among motorists for its cheap petrol.

Even despite the high degree of harmonisation in the field of excise duties, member states continue to apply their own unharmonised taxes ("green taxes") on certain products.

In the Slovak Republic's tax system the same system applies for the field of excise duties as that for value-added tax. The high degree of harmonisation necessary for the working of the EU internal single market required the adjustment of excise duties pursuant to the mentioned fundamental harmonisation principles. Slovakia currently applies a transitional period agreed during the accession process, including the progressive increase in excise duty rates on tobacco and tobacco products to the minimum level valid in the EU and different taxation conditions on domestic distilled spirits.

Direct taxes

Responsibility for tax policy in the field of direct taxes lies with the individual member states, which in some cases use deregulation of tax policy transferring the responsibility for it to the regional level.

Harmonisation in the field of direct taxes is permitted only in case of their negative influence on the working of the EU internal single market. In the field of the taxation of companies the EU therefore has two basic goals. The first is to support the principle of free movement and free establishment and the second is to create measures for eliminating harmful tax competition between the countries (described in more detail in the next part). In order to improve the working of the single internal market and free establishment, at present four valid directives in the field of direct taxes have been adopted:

- Directive No. 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States of 23 July 1990, cancelling withholding tax in the case of the transfer of profit between a subsidiary and parent company within the EU.
- Directive No. 90/434/EEC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States of 23 July 1990 governing the restructuring of companies in the EU. The capital revenue arising in consequence of a merger / division of companies registered in the EU is not subject to corporate income tax.
- Directive No. 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States of 3 June 2003 cancelling withholding tax from interest payments from bank deposits administered in a different member state.
- Directive No. 2003/48/EC on taxation of savings income in the form of interest payments of 3 June 2003 regulates the information obligation in the taxation of interest revenue from bank deposits administered in a different member state. This directive will become effective as of 2005.

The issue of direct taxes is one of the few fields where the European legislation is adopted unanimously. It is for this reason that in practice there is only minimal harmonisation.

There have, however, been numerous attempts at closer harmonisation in the field of direct taxes. One of them was the Ruding Committee study, prepared in 1990. The results of the study showed that individual countries show large differences in their systems of taxing juridical persons, in particular in determining the tax base, the level of tax rates, in the taxation of capital gains, the provision of tax relief and similarly in the field of double taxation. The Ruding Committee subsequently recommended a greater degree of corporate income tax harmonisation, especially concerning incomes flowing from one country to another and also recommended the unification of the three basic attributes of income tax - determination of the tax base, level of tax rates and administration of taxes. Nevertheless, all such proposals have for the time being been blocked by certain member states in the Council of the European Union.

Even despite the fact that several EU member states are against any sort of harmonisation in field of direct taxes, the provisions of the basic treaties on

fundamental freedoms and the prohibition of discrimination in this area allow efforts for harmonisation to continue. These provisions can under certain circumstances replace conflicting or discriminatory provisions of national regulations governing direct taxation.

A significant supporter of further harmonisation has, through its defence of fundamental freedoms, been the European Court of Justice. On several occasions it has decided on the illegality of various provisions of member states' legislation, not only in the tax field. In practice the European Court of Justice has shown in many cases that the regulation of direct taxes cannot be at variance with the principles upon which the EU is founded. In connection to this the European Court of Justice prohibits in particular discriminatory taxation, the limitation via taxes of the freedom of establishment, and discriminating tax restrictions upon departure from a member state.

The issue of the harmonisation of direct taxes is today one of the most burning problems of the EU. The draft EU constitution currently being prepared, which is to replace the establishing treaties applicable hitherto, give European bodies significant competences also in the field of direct taxes. Some member states such as Great Britain and Ireland and many of the newly-acceded states are however fundamentally against any form of harmonisation of direct taxes.

Arguments in favour of harmonisation include the creation of a stability among tax systems, the mitigation of international double taxation and the limitation of tax loopholes. Existing proposals count on the harmonisation of the income tax base, where the tax rate would be set by the individual member states themselves, or, conversely, count on uniform tax rates, where determining the tax base would remain in national competence.

Arguments against harmonisation of the tax systems are in particular the existence of tax competition needed to create pressure for efficiency in the spending of state funds and excessive political and administrative expenses connected with the harmonisation of tax systems and rates. The unification of tax systems could harm the EU as a whole, because it may have the consequence of a search for tax preferences outside Europe, which may cause an unwanted outflow of capital.

Tax competition between countries

Free movement in the framework of the single market give individuals and companies the right to choose the member state in which the EU citizen will live and work and where a company will conduct business. In accordance with the principle of taxation on the basis of residence this at the same time means choosing a country in which the worldwide incomes of the individual will be taxed. In the case of companies to which the principle of residence applies, income from taxation of their profits is gained by that state, in which the company has its headquarters or registered office. As for persons as well as companies, in selecting a member state they are often motivated, among other factors, also by reducing their overall tax burden.

From the above it results that the advantages of the single market can lead, and to a certain extent also do lead, to tax competition between member states, the specification and analysis of which is a problem currently under discussion also in connection with the accession of new countries to the EU.

Tax competition is created through differing construction of the tax base and differing levels of tax rates in the tax systems of individual member states. Tax competition is also affected by the versatility of tax systems. The idea of tax competition is the effort to attract economic activity into a country at the expense of other countries by means of a preferential tax regime.

In this context the question arises whether tax competition can be harmful and if yes, from what degree of independence between tax systems does this competition begin to be harmful. An important aspect in assessing the harmfulness of tax competition is, for example, the fact whether equal taxation conditions are created for all taxpayers in the given tax jurisdiction, as there is a difference between whether a state tries to create a tax system supporting the business activity of all subjects in its territory, or whether special regimes are created for the taxation of incomes of specific companies only, earning their revenue in particular (or exclusively) from economic activity outside the country. The second scenario is typical of most tax systems classified as tax havens.

The fact is that a decrease in incomes to the state budget should lead to a restriction of public sector expenditure. Many EU member states however for political reasons have a state expenditure structure that is almost incapable of reform. For this reason a discussion has begun in the EU on the harmfulness of tax competition and certain member states are misusing this term to create pressure on other member states, in particular those newly-acceded. Many of them, paradoxically as a results of the accession process, have more transparent tax systems with a lower tax burden than old member states (even if, obviously, also the tax systems of newly-acceded states, including the Slovak Republic, have their shortcomings, and in some cases large deficits).

In order to prevent tax competition, on 1 December 1997 the Council of the EU adopted a package of measures to counter harmful tax competition, containing three basic parts:

- the code of conduct of business taxation,
- measures for removing withholding tax from interest payments and royalty payments,
- measures for unification in taxation of savings.

The code is a key part of the package of measures. Its main aim is to limit the unwanted consequences of tax competition in general and reverse the growing taxation of the workforce. Concurrently, it defines those measures which do lead to harmful tax competition. In assessing them it is necessary to monitor whether the tax advantages are provided only to non-residents, or whether they are provided without real economic activity in the given state, or whether the procedures for determining profit are based on internationally accepted principles.

The code requires the subsequent revision of the legislation of the individual member states and the cancellation of tax competition regimes. It imposes upon the member states the obligation of the mutual notification of existing and proposed tax measures falling in this field. The code is not legally binding, being only of a recommendatory nature. Nevertheless, it is important in a period when several countries are developing more and more pressure for eliminating tax competition by means of harmonisation in the field of direct taxes.

The second part of the package of measures for removing harmful tax competition comprises a draft measure for removing withholding tax from interest and royalty payments. Withholding taxes on these incomes have a negative effect on business entities (in particular expenses connected with the tax administration), on cashflow and sometimes lead to double taxation. For this reason the package of measures for limiting harmful tax competition contains a proposal for their elimination, which resulted in the now effective Directive No. 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, and which was adopted on 3 June 2003, with effect from 1 January 2004.

Harmonisation attempts of the EU in the field of personal income tax are very rare. The last part of the package of measures for limiting harmful tax competition concerns the taxation of savings. The aim of this measure is to ensure the uniform taxation of savings within the EU. Possible interventions concern also the limitation of the tax discrimination of persons in the case of working or investing in a different country.

The tax competition between the member states of the EU constitutes only a part of the worldwide tax competition. The EU faces tax competition not only between individual member states, but also in relation to other economies around the world.

In 1998 a fight against tax competition was declared also by the OECD, which in June 2000 published a list of undesirable tax regimes within the OECD and non-member countries, which it considers as uncooperative tax havens. Member states of the OECD undertook to remove or modify these regimes by 31 December 2003. Non-member countries which undertook to cooperate with the OECD are to modify their tax regimes by 31 December 2005, where each year they should undertake steps leading toward remedying the current state of affairs. Otherwise they could face counter-measures, not only of a tax nature. The list of undesirable tax regimes concerned also certain EU member states.

The other side of the above process is the endeavour to increase the intensity in the information exchange with countries providing preferential tax regimes.

On the basis of measures adopted at the level of the EU and OECD it can be said that individual economic groupings are trying to coordinate the national legislations of member states with the aim of applying common procedures in limiting tax competition considered by them as harmful. It is questionable, however, whether transparent tax competition can be considered as harmful, and if yes, whether it is possible to estimate to what extent it is so.

DOUBLE TAXATION TREATIES AND THEIR ROLE IN INTERNATIONAL TAXATION

The incomes of business entities which are parties to international economic relationships are often subject to double taxation. The attempt to tax the same incomes by two states occurs for several reasons, the most frequent being an overlapping of the principles of limited and unlimited tax liability (i.e. on the basis of residence and the income source). Other causes of double taxation can be differences in the definition of individual types of income or disunity in the definition criteria of the limited and unlimited tax jurisdiction and its chargeability in individual states.

Measures for restricting double taxation can essentially be divided into national (unilateral) and international.

Unilateral national measures are applied in the framework of own (national) tax regulations, which primarily determine tax liabilities, the types of tax, and

also define who, when and in what amount will be taxed. A unilateral national measure means that if the income of a resident has already been taxed abroad, this state in some way takes account of this in determining the resident's national tax liability.

The basic instrument of international measures for limiting double taxation are international double taxation treaties. Their purpose is to coordinate the tax systems of two states so the case of double taxation does not occur and the processes of international trade and investment, the free movement of persons, goods, services and capital across national borders are facilitated. Double taxation treaties lay down the method of taxation of individual types of income, i.e. they determine which incomes are taxed only in the state of the recipient or only in the state of the source, or respectively through a combination of the two methods in both states. A further aim of such treaties is to restrict tax loopholes.

The OECD has created a "model double taxation treaty", which serves as a model for specific taxation treaties between individual countries. It is used in particular by economically advanced countries. The procedure in concluding specific taxation treaties according to the OECD model enables the use of a uniform system and terminology, facilitating the interpretation and application of double taxation treaties.

Double taxation treaties contain a set of rules construed to ensure their aims. Usually they have the following structure:

1. articles determining the scope of the treaty,
2. articles containing definitions of terms,
3. articles delimiting the income taxation,
4. other articles – specific and concluding provisions.

The articles of the first point define the territorial scope, persons and taxes to which the treaty relates.

Articles forming the second point comprise basic definitions of terms contained in the treaty, necessary for ensuring its functioning. Some of the most important definitions are those of residency and permanent establishment (i.e. determining those corporate incomes of the resident of one state's business in another state that latter is entitled to tax).

The articles of the third point comprise the core of every double taxation treaty. They differentiate various types of income (the object of the treaty), determine the relationship of the object of the treaty to the subject of the treaty (i.e. to persons entitled to benefit from the treaty), and stipulate to what extent may each of the countries concluding the treaty subject these incomes and capital to taxation and in what way can international double taxation be removed.

Double taxation treaties as a rule divide incomes into the following categories: (a) income from real-estate assets, (b) profits from businesses, (c) dividends, (d) interest payments, (e) royalty payments, (f) profits from the theft of property, (g) incomes from employment, (h) incomes of artists and sportspersons, etc.

Articles of the fourth point contain special provisions including principles of equal treatment (non-discriminatory measures), provisions on mutual agreement, provisions on the exchange of information and also the date when the treaty enters into force, and possibly also lapses from force.

The influence of double taxation treaties lies in the significant modification of the application of domestic legislation of states in the taxation of foreign persons and conversely of incomes of residents flowing from sources abroad. It is however necessary to take heed of the fact that it is not possible to impose a tax liability simply on the basis of a treaty. This means that the taxation of foreign persons is always based on domestic tax legislation and the respective articles of double taxation treaties are applied subsequently. Double taxation treaties however have precedence over provisions of a local income tax law. The fact that the Slovak Republic has double taxation treaties concluded with all member states of the OECD underlines their significant impact in the field of international taxation of Slovak subjects abroad, or foreign persons in Slovakia.