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Tax Incentives for Foreign Direct Investment in the Tax Systems of Poland, the Netherlands, Belgium and France.

Beata Heimann

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Hrsg. von
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Universität Bremen

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LIST OF ABBREVIATIONS

ARP – Industrial Development Agency managing Special Economic Zones in Poland

BEF- Belgium Franc

CEEC – Central and Eastern European Countries

CIT – Corporate Income Tax

EDC – European Distribution Centre

EHQ – European Headquarters

FDI – Foreign Direct Investment

ZUS – Social Insurance Office

Abstract

The importance of Foreign Direct Investment (FDI) for the Polish economy in the transition period cannot be underestimated. At present the main arguments for attraction of FDI stress the importance of stable high FDI inflows for a sustained economic growth and modernisation of the Polish economy as it is believed that foreign investment help to increase the productivity of economic operations and the local workforce, encourage employment as well as stimulate innovation process and technology transfer.

The Polish success in attracting FDI in the past seems to come to an end, as the main driving force for the last few years was the privatisation process. As the privatisation process in Poland is almost completed a sharp decline in the FDI inflows in Poland in about two years' time is to be expected. At the same time tax breaks in the Special Economic Zones which have attracted a significant volume of foreign investment are to be scaled back considerably at the end of 2001. Moreover, tax competition between the Central and Eastern European countries for foreign direct investment which has been strong in the last decade will become even more intense in the near future.

Therefore, it seems inevitable for the Polish authorities to introduce changes in the treatment of the foreign direct investment in the Polish tax code and turn their focus towards attracting FDI with other means. Poland should define its position as an attractive location for all multinational companies which wish to operate in the Central and Eastern Europe. Interesting tax regulations concerning co-ordination, distribution and service centres in the Netherlands and Belgium and headquarters and logistics centres in France may be used in that respect as an example for creating successful tax regulations in attracting foreign direct investment in Poland. The paper presents recommendations for the improvement of the Poland's international location competitiveness for FDI.

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Beata Heimann

1. Introduction

Poland as one of the most advanced transition countries is striving to remain its very good international location competitiveness among other Central and Eastern European countries (CEEC) as far as the foreign direct investment (FDI) inflows are concerned. Foreign direct investment inflows continued to grow uninterrupted since the beginning of the transformation period so that according to the EBRD Transition Report, 1998 Poland attracted 40 per cent of all FDI flows to Central and Eastern Europe and the Baltic States. It pushed Poland onto the first place overall in the region with the total investment stock of US$ 28 billion in the year 1999. Moreover, in the year 2000 Poland has kept up its record of foreign direct investment inflows reaching the ceiling of US$ 9.3 billion, which amounted for one-third of the cumulative total since 1991.

As foreign capital is seen to facilitate the privatisation and restructuring of the industries in the transition countries, Poland already at the beginning of the transformation process has identified economic reasons for wishing to attract FDI, of which the most important are:

- attraction of incremental investment capital,
- enhanced access to western markets,
- new job creation,
- access to advanced management techniques,
- access to advanced technology, which stimulates technological adaptation and innovation and that leads to faster economic growth,
- facilitate privatisation and restructuring of the economy.

In Chapter 2 the importance of Foreign Direct Investment for Poland in the transition period will be discussed.

In Chapter 3 the present regulations in the Polish tax system concerning the objectives of attracting FDI will be presented. I will also try to answer the question whether the tax factors in Poland are strong enough to remain the high FDI rate in the future.
Among countries of the European Union, two countries: the Netherlands and Belgium have proved to attract successfully FDI inflows for more than two decades with their specific tax regulations. Also France encouraged by the success of its neighbour countries followed the example of the Netherlands and Belgium introducing in 1997 changes in the tax law.

In Chapter 4 the Belgian, Dutch and French tax incentives will be discussed, as it is believed that tax incentives are very often considered as very important factors while choosing the investment location.

I will concentrate in my discussion on the following three forms of companies:

- European Headquarters (EHQs), which are stand-alone establishments of foreign companies with the main task to co-ordinate activities of operational subsidiaries of the parent company and/or independent representatives (distributors/agents/vendors) in at least five European countries.
- European Distribution Centres (EDCs), which are stand-alone distribution facilities with the main function to store and distribute goods to at least five European countries.
- Shared Services Centres (European back offices), which are office facilities of multinational companies where operational office activities are being carried out for at least five European countries. These offices have as their main task to provide support services to the core business of the parent company.

The most important favourable tax arrangements in the Netherlands, Belgium and in France, which helped both countries to become European leaders (next to the UK) in establishing European Headquarters, European Distribution Centres and Shared Services Centres are as follows:

- ‘Cost-plus’ model, which allows to tax a ‘fictitious’ profit which is calculated as a percentage of the operating costs,

- tax exemption of some types of income, e.g. dividends and interest income (the Netherlands and Belgium),
- special rules for foreign executives and research scientists, and
- the application of Double Tax Treaties to extract profit from high-tax countries (the Netherlands).

In Chapter 5 I will show that the tax rules adapted by the Netherlands, Belgium and France, although controversial at some points, they are not contradictory with the EU regulations and objectives. The idea of harmonising direct taxes among the EU countries has been for the last three decades mostly for political reasons not followed in practice. Instead, the European Commission has dealt intensively with the problem of harmful tax competition. In 1997 the tax package was published, a part of which was the Code of Conduct to combat harmful tax competition. The Code of Conduct advised the countries of the European Union to take measures in order to encourage fair competition and set the criteria of harmful tax competition, e.g.:

- granting of advantages to foreign companies without them having economic activities in that state,
- advantages only for non-resident foreign companies, not available to the national business,
- rules for determining profits which derogate from internationally accepted rules (e.g. OECD),
- lack of transparency.

The special tax regulations for co-ordination, distribution and service centres have been examined by the European Commission, which could not find any illegal state aids in those tax arrangements. Therefore, it is expected that other countries of the European Union will implement similar tax regulations to attract these forms of investment.

In Chapter 6 the recommendations for the improvement of the Poland's international location competitiveness for FDI will be presented. They include both tax and non-tax instruments:

- implementation of the special tax rules for some types of investment,
- tax incentives for employment of foreign executives and scientists,
- provision of the stable and clear tax system,

- the possibility to obtain a definitive information about the future tax burden from tax authorities before the actual investment takes place,
- promotion of the investment opportunities in Poland and assisting foreign investors in the co-operation with tax authorities,
- improving other non-tax factors affecting FDI (legal and regulatory framework, macro-economic environment, infrastructure, education level, etc.).

The Polish success in attracting FDI in the past seems to come to an end, and therefore, in order to guarantee stable and high FDI inflows in the future (which are required for a sustained economic growth and modernisation of the Polish economy), the changes in the treatment of the foreign direct investment in the Polish tax code are inevitable.

2. The Importance of Foreign Direct Investment for the Polish Economy

Poland after the collapse of the communist regime and soon after it has decided to enter the transition path toward the market economy has identified the positive effects of FDI on the transformation process of the Polish economy. It is believed that foreign capital can facilitate the restructuring of the industry in the transition country such as Poland for the following reasons:

- **Attraction of incremental investment capital.** As a source of external finance, FDI complements domestic savings and encourages growth through investment financing. The local capital market in Poland in the early 1990s was in the first phase of its development and thus very often could not meet the capital requirements for large investment projects. Moreover, the local market of investment goods was underdeveloped resulting in the fact that the modern investment goods had to be purchased abroad, for which the hard currency was required. Therefore, FDI seemed to solve all these problems at once. Foreign investors having access to foreign sources of capital are not constrained by the underdeveloped domestic capital market or by the ability of the country to generate foreign cash flow from the export of domestic production. As a source of finance, FDI seems to be more stable than other types of financial flows (loans,

portfolio-investment) as direct investors show a longer-term commitment to host economies than lenders. Moreover, FDI is also easier to service than commercial loans, as profits tend to be linked to the performance and business cycles of the host economy.

- **Enhanced access to Western markets.** Foreign companies bring with them well developed distribution channels and knowledge required for sales (marketing expertise) to the global marketplace. FDI can provide a major benefit in this respect, in particular when foreign companies have established brand names and large distribution networks. Thus, the cost of entering the world trade market can be significantly reduced. And this in turn leads to promotion of the local export and increase of the foreign cash flow.

- **New jobs creation.** Foreign investment means very often the impact on employment in a host country through quantitative and qualitative effects.[1] That aspect of FDI is very much welcome in particular in the transformation period when the unemployment level in Poland grew rapidly after the political change in 1989 to reach the amount of 16.4 per cent in 1993[2] and there is a risk that it will total 18 per cent in the year 2001. The quantitative effects of FDI address the volume of employment. Not only FDI increases employment directly by setting up new foreign affiliates or expanding existing affiliates but also indirectly by stimulating additional employment in suppliers and distributors (depending on the intensity of local linkages). FDI can also preserve employment by acquiring and restructuring firms that otherwise would go bankrupt. The qualitative impacts of FDI on employment include wages, job security, better conditions of work and improvement of local workforce qualifications.

Foreign investors generally pay higher wages than domestic firms in similar activities (in particular in industries that demand higher levels of skills, technology and marketing and in export-oriented activities that need to ensure consistent quality and timely delivery). Moreover, foreign investors tend to offer greater job security because of their size, competitive strength and need for a stable workforce. They also provide for better working conditions than local firms. In particular, large foreign investors tend to

[1] World Investment Report, 2000, UN, p.181.
[2] Source: BCE Online, at:http://www.bcemag.com

comply with local and international standards and try to even them with the standards in their home countries. FDI tend to influence the employee skills in host countries through investing in employee's training and providing for traineeships. Employees may later leave foreign company and carry their skills to other firms of set up their own firms. Very often foreign investors induce or support local suppliers to train workers to meet their quality standards and influence local competitors or unrelated firms to improve their training practices. FDI influences also indirectly the labour market by setting high criteria for new employers (knowledge of foreign languages, IT skills, etc.). Such actions influence local education and training institutions which adjust their curricula and practices to the requirements of foreign companies.

- **Access to advanced management techniques.** Foreign companies when establishing operations bring with them advanced management techniques which enhance the efficiency and productivity in running the business. It also contributes to the improvement of professional qualifications of the local managers and staff employed by a foreign company.

- **Access to advanced technology.** A heritage of the old communist regime and centrally-planned economy took form of the outdated equipment and techniques, which were used by the Polish companies in the early 1990s. This reduced the productivity of employees and led to the production of goods of a lower standard which faced serious difficulties when competing with other goods abroad for export markets. And this in turn contributed to the difficulty to earn hard currencies. FDI seems to solve both problems as the investment goods are expected to embody advanced technology, which otherwise would be difficult to acquire, mainly for the following reasons: the rights to technology through licensing or other contractual arrangements are very expensive and they would in most of the cases require expensive foreign currency; the latest and most valuable technologies are very often not generally available on licence; transition countries may find it difficult to implement the mature technologies that are available by purchasing. Foreign companies instead bring with them advanced know-how and production techniques, provide the skills and knowledge needed for efficient implementation and provide an effective means of updating technologies quickly, which is important for countries

that lack the ability to improve and innovate on imported technologies. FDI can also provide positive spillovers: competition with local firms and co-operation between foreign companies and local suppliers and customers stimulate implementing advanced technology and innovation process, improvement of technological capabilities and increase in productivity among domestic companies.

- **Facilitate privatisation and restructuring.** The privatisation process requires in most of the cases large supply of capital, very often not available for the domestic companies. Moreover, the ability to analyse the economic potential of the privatised company is needed in order to make it prosperous in the future. Foreign investment addresses both issues; it has access to external sources of capital required for buying the privatised company and in the situation when further investments are needed to reorganise production and change product lines.

As highlighted above, the importance of Foreign Direct Investment for the Polish economy in the transition period and in particular as far as the stabilisation and growth objectives of the Polish economic policy are concerned cannot be underestimated. At present as privatisation and restructuring process in Poland comes to an end and other factors such as access to hard currency and modern investment goods lost their relevance, the main reasons for which the attraction of FDI are to be pursued is to enhance the productivity of economic operations and the local workforce, encourage employment, stimulate innovation process and technology transfer as well as enhance and guarantee the sustained economic growth. The experience of Poland to attract foreign investment with help of the tax system will be presented in the next chapter.

3. Tax Incentives in the Polish Tax System

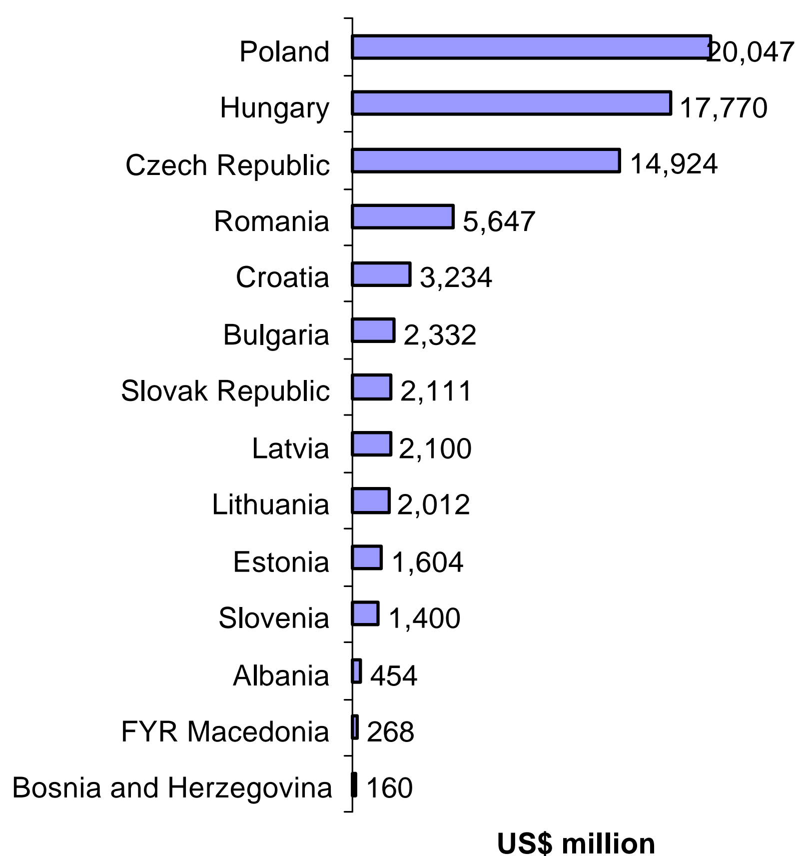
3.1. Poland in Tax Competition between Countries of Central and Eastern Europe

Tax incentives for investment seemed largely to have disappeared in most of the countries of that region by 1993-94, mostly as a result of the consultation of the transition governments with the OECD experts.

Experience among OECD countries has suggested that tax incentives are not an effective way to promote or direct economic activity. This experience has led to advising the economies in transition to avoid such incentives. However, the question whether the experience of OECD countries with developed product and capital markets may be relevant to transition countries whose economies are in the first phase of the development of efficient markets has caused much concern among the governments of Central and Eastern European countries. As a result tax incentives have started to reappear and to assume a new and increased importance after 1994. The tax competition proceeded in form of reduction of the nominal corporate income tax rate (Hungary ranks above other countries with 18 per cent CIT rate), accelerated depreciation, generous tax holidays or Special Economic Zones. Poland, Hungary and the Czech Republic have become leaders in the attraction of Foreign Direct Investment and at the same time keen rivals in the competition for foreign investment. Investments with the FDI-inflows of US$ 20 billion in the period 1989-99 pushed Poland into first place overall, Hungary placed second, with US$ 17.7 billion followed by the Czech Republic with a total of US$ 14.9 billion (see Figure 1). Only in 1999 FDI-inflows in Poland amounted for US$ 6.6 billion, whereas the Czech Republic and Hungary succeeded to attract foreign investment worth US$ 4.9 billion and US$ 1.4 billion respectively (see Figure 2). Another record FDI-inflows value noted Poland in the year 2000. According to the latest Investment Profiles 2001 of the European Bank for Reconstruction and Development (EBRD) foreign direct investment of US$ 9,3 billion in 2000 pushed Poland into first place overall, the Czech Republic placed second with US$ 4.5 billion, followed by Hungary with US$ 1.65 billion.[3] It is worth mentioning that in all these countries most FDI in the last two years originated from the privatisation process, which is almost completed. As a result, EBRD experts expect a sharp decline in the FDI level in the next two years.

[3] Investment Profiles 2001, Poland, Czech Republich, Hungary, EBRD.

Figure 1.Cumulative FDI-inflows in CEEC in 1989-99.



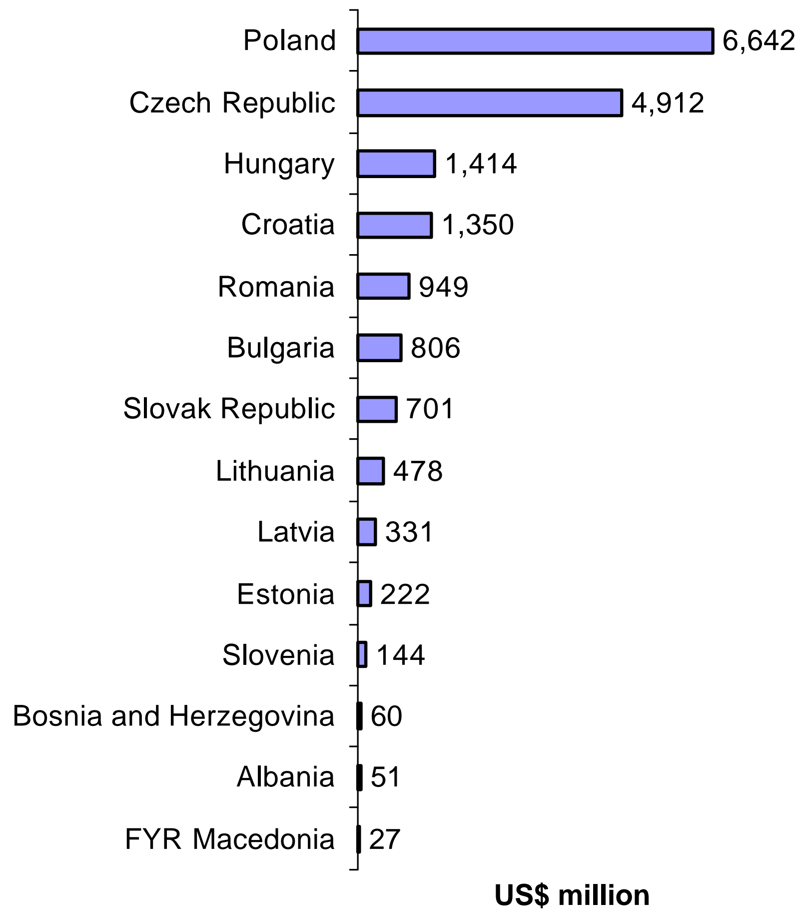
Source: Transition Report 2000, EBRD, p.74.

The tax competition between the Central and Eastern European countries for foreign direct investment has become more intense in the last decade as the common opinion expresses the view that in particular these three countries: Poland, Hungary and Czech Republic have equally very good growth perspectives and are at the same stage of the transformation process, which results in the fact that in general foreign investors are indifferent about the location choice between these countries unless the differences in investment incentives occur. Moreover, as Poland, Hungary

and Czech Republic belongs to the same region, which may be perceived by foreign investors as more or less a unified region. Investment in one country may serve as a production and export base for other markets of the region. For instance, General Motors, which has invested some US$ 560 million in Poland exports to Hungary, the Czech Republic and Turkey. The opinion is confirmed also by the empirical examples: car exports in Poland grew by some 20 per cent in the first nine months of 2000 and became Poland's leading export item. Fiat (Italy) alone is among Poland's biggest investors and is its biggest single exporter, with US$ 1 billion annual sales abroad.[4] All these factors result in the fact that Central and Eastern European countries compete with each other intensively for attracting the FDI inflows and the competition takes often the form of tax incentives.

[4] Poland Investment Profile 2001, EBRD, p.13.

Figure 2. FDI-inflows in CEEC in 1999 (net inflows in the balance of payments).



Source: Transition Report 2000, EBRD, p.74.

3.2. Corporate Income Taxation in Poland

The main features of the **Corporate Income Tax** in Poland will be presented below.

Taxable Income

The corporate income tax covers all incomes generated by legal persons incorporated in Poland. The following forms of doing business are subject to corporate income tax: limited liability company, joint-stock company and other organisational units without legal personality except from partnerships.

All corporate entities incorporated in Poland if their seat is located on the territory of Poland are deemed resident and as a rule they are subject to income tax on their world-wide income, whereas non-residents are taxed only on their Polish source income.[5]

The following sources of income are liable to tax: business income, interest, dividends, royalties, capital gains and lease income.
Agricultural and forestry activities are not subject to the corporate income tax.
According to the Tax Law it is possible to establish a Fiscal Group which may file a consolidated tax return offsetting any profits and losses within the group. Any losses made by the group may be carried forward to offset against the profits in the future years, in the same manner as for individual companies. A Fiscal Group is composed of a number of companies, each of which is either a limited liability or joint stock company in the sense of the Polish Commercial Code. The group is formed by filing an election with the Tax Authorities and it is required that the group exists for at least three years. Fiscal groups may only be established by companies with the seat in Poland and the share capital of each individual company or the average for each company totals zloty 1,000,000 (EUR 237,733). The following criteria must also be met: the shareholding company must have 95% direct ownership of the shares of the subsidiary companies which are members of the group, the subsidiary companies may not own share in the holding company or in the other subsidiary companies in the group and the registered share capital must be fully paid-up. If the conditions for forming a group are breached during its life, the fiscal group loses its status and henceforth the profits and losses of each member are calculated and taxed

[5] Ustawa o podatku dochodowym od osob prawnych z dnia 15 lutego 1992r., (Dz.U.2000 Nr 54, poz.654, Nr 60, poz. 703 i Nr 86, poz.958).

separately. Between members of Fiscal Group, no withholding tax is imposed on dividends paid by subsidiaries to the holding company.

The Treasury, the National Polish Bank, special purpose funds, old-age pension funds, investment funds, ZUS and local governments are exempted from CIT.

The Tax Law provides for exemption of 30 categories of income, e.g.:

- income of entities engaged in scientific, cultural, sporting, environmental protection, religious, political, social welfare, health protection and charitable activities,
- donations, subventions and surcharge from National Rehabilitation Fund for Labour Protected workshops (entities employing disabled persons)
- indemnities received,

Tax Rates

In the year 2001 the rate of the corporate income tax is 28 per cent, which is still one of the highest among other transition countries (i.e. Hungary 18%). However, according to the Tax Reform 2000 the CIT tax rate is to be decreased gradually within 5 years (since 2000 until 2004) by 12 percentage points and that means by more than one third of the level in 1999. In the year 2004 the final CIT tax rate is going to be 22% (see Table 1).

Table 1. The reduction of the CIT tax rate in Poland in years 1999-2004.

1999	2000	2001	2002	2003	2004
34%	30%	28%	28%	24%	22%

Source: Ministry of Finance, Reforma podatkow, August 1999, p.24.

Such a significant reduction of the tax rate tends to have a great impact on the location competitiveness of the country and is expected to stimulate the level of the foreign direct investment. The tax rate reduction is very much welcomed in particular in times of tax competition around the world and in case of Poland in times of capital tax competition between the transition countries, all of which need the inflow of the foreign capital.

Interest, royalties, capital gains and income from the rental of real estate are included in income subject to CIT.
Dividends from Polish companies are only subject to withholding tax and in the year 2001 the tax rate has been reduced from 20% to 15%, the tax is creditable against a taxpayer's Corporate Income Tax liability.
Dividends received from foreign companies when not exempted from Polish tax under a Double Tax Treaty are also subject to withholding tax at 15%.
On equity grounds as one of the elements of the income should be taxed on the same basis as any other elements, however Poland responding to capital-market integration of the world economies adopted a schedular tax system where different tax rates are applied to different income sources according to different tax elasticities (tax rate on dividends is lower than on other income) and moved away from global taxation where one tax rate is applied to aggregate income from different sources (the so-called Schantz-Haig-Simons principle). That step is fully justified when the following fact is taken under consideration: the degree of capital mobility is likely to increase further in Europe after the EMU is established and capital tax competition among Central and Eastern European countries will become even more intense.

Dividends and Distribution

Dividends are taxed by the payer withholding tax of 15%. No further tax is due. Between members of Fiscal Group, no withholding tax is imposed on dividends paid by subsidiary companies to the holding company.
Payments to non-residents in virtue of:

- dividends, interest, royalties and leasing are taxed at 20%,
- receipts from entertainment or sport activities - 20%,
- income derived by foreign ship operators transporting goods and passengers from a Polish harbour - 10%,
- income earned in Poland by foreign airline operators - 10%.

Deductions

The following business expenses are deductible as a cost of earning income: depreciation, interest on liabilities, provisions for bad debts,

exchange rate losses, mandatory social insurance contributions, cost of representation and advertising in mass media or in other way in public.
As the OECD tax experts point out Poland has different effective tax rates on corporate income depending on the source of financing, the legal form of the investor, and the residence status of the lender. [6] The option to deduct interest on liabilities as business expenses encourage companies to borrow whereas the withholding tax on dividends depresses the price of shares and thus discourages the floatation of new equity. It discriminates the companies who for different reasons (i.e. their size, level of development) are not able to obtain a bank credit and favours on the other hand large and established firms. This distorts investment decisions and incites companies to make decisions based on fiscal opportunities rather than on economic factors. Therefore, the OECD suggests that effective tax rates on various capital incomes should be aligned.

The following 3 categories of expenses are deductible from taxable income:

- donations for the benefit of legal entities, to socially worthy causes, e.g. in support of science, education and culture - but no more than 15 % of the income, or in case of religious worship, charity or environment protection - no more than 10 % income,
- the amount which according to the Polish Mining Law reduced the basic exploitation charge for mining minerals,
- the amount of the wage bill of the imprisoned persons employed in a taxpayer's company other than company belonging to the prison.

Depreciation

Due to the new Corporate Income Tax Law the number of depreciation schedules (from 63 to 10) has been considerable limited, which as for efficiency grounds is very much welcomed as it prevents tax manipulation and distortions in the allocation of resources.
Depreciation allowances are deductible expenses and are generally based on the straight line method, although accelerated depreciation and the declining balance method is allowed in exceptional cases: for buildings utilised in bad or deteriorated conditions, for industrial machinery utilised

[6] P.Lenain, L.Bartoszuk, The Polish Tax Reform, Economics Department, Working Papers, No.234, OECD, 2000., p.18.

more intensive than in normal conditions, for machines exposed to fast technical progress, for industrial machinery when the company in which the machinery is utilised is located in a gmina with a very high unemployment rate or recession or social degradation.
Inventory is valued at the lower of historic cost or market value. The cost of inventory may be calculated at standard cost, weighted average cost, or on a LIFO or FIFO basis.

Relief

Income earned by Polish resident taxpayers from sources abroad when is not exempted from Polish tax under a Double Tax Treaty is accumulated in normal taxable income and taxed at standard rates. A unilateral credit is available for the foreign tax suffered up to the amount of Polish tax attributable to that foreign source.

Tax incentives

There are various tax incentives to be claimed by enterprises located in special economic zones (SEZs). Economic entities who set up their business until the end of the year 2000 in one of the 15 existing SEZs are eligible for the following tax breaks and preferences[7]:

- complete exemption (100%) from income tax during half the total zone existence time (10 years),
- 50% tax break in the remaining zone existence time,
- recognition of investment outlays as income-generating costs in the tax year in which these outlays were made, for companies not taking advantage of tax breaks,
- the possibility of using increased fixed-asset depreciation rates, for companies not taking advantage of tax breaks,
- complete exemption from real estate tax

Investors building halls and other structures in the zone enjoy advantages stemming from the fact that the zone management has national and local governmental rights in relation to the construction law.

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[7] Special Economic Zones, ARP's Euro-Parks in the Lead, in: *'Polish Industry Insider'*, No 1 (17), January 2000.

Exemptions from income tax are granted to entities whose investments exceed a certain threshold (0.3 million - 1 million EUR), characteristic of each zone, or investors, which create a certain number of jobs (40 - 100 new jobs)[8].

SEZs appeared in particular to be a successful instrument to attract foreign direct investment. So far SEZs succeeded to attract nearly 700 investors, among them such companies as General Motors, Isuzu, Delphi and Toyota.[9] Until January 2000 they employed 18,000 people with the intention to increase the number of employees to 36,000-38,000 and the investment value totalled 5 billion zl (EUR 1,189 million).[10] However, the existence of the SEZs seems to be controversial in the perspective of the Poland's future accession to the EU. The EU decided in 1997 to abolish SEZs that exist on the territory of the EU countries in the next five to seven years. The EU expects from Poland that the SEZs are abolished until the end of 2001. In 2001 Poland amended the privileges granted to companies investing in SEZs, in order to adapt the rules for public assistance to meet EU regulations. According to the new regulations, the value of public assistance for an investor must not exceed 50 per cent of the value of the investment. Another novelty is the provision enabling local governments to impose real estate taxes on companies operating in the zones, or to exempt them. Investors already operating in SEZs will have their privileges prolonged.

As presented above, in Poland in the year 2001 the most important significant investment incentives for foreign investors seemed to be tax breaks in the Special Economic Zones (which are to be scaled back considerably at the end of 2001). It is expected that an important role in attracting FDI in the future will play also amendments in the corporate income tax rate, depreciation rules and tax code, which has been implemented as a part of the Tax Reform 2000. However, as mentioned before, the main driving force of the rapid FDI growth in recent years has originated from the privatisation process, and therefore, FDI flows are

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[8] Umstrittene polnische Sonderwirtschaftszonen, in: *Neue Züricher Zeitung*, 3./4. June 2000.

[9] Poland Investment Profile 2001, EBRD.

[10] Zmiany w specjalnych strefach ekonomicznych, in: *Rzeczpospolita*, 01.07.00.

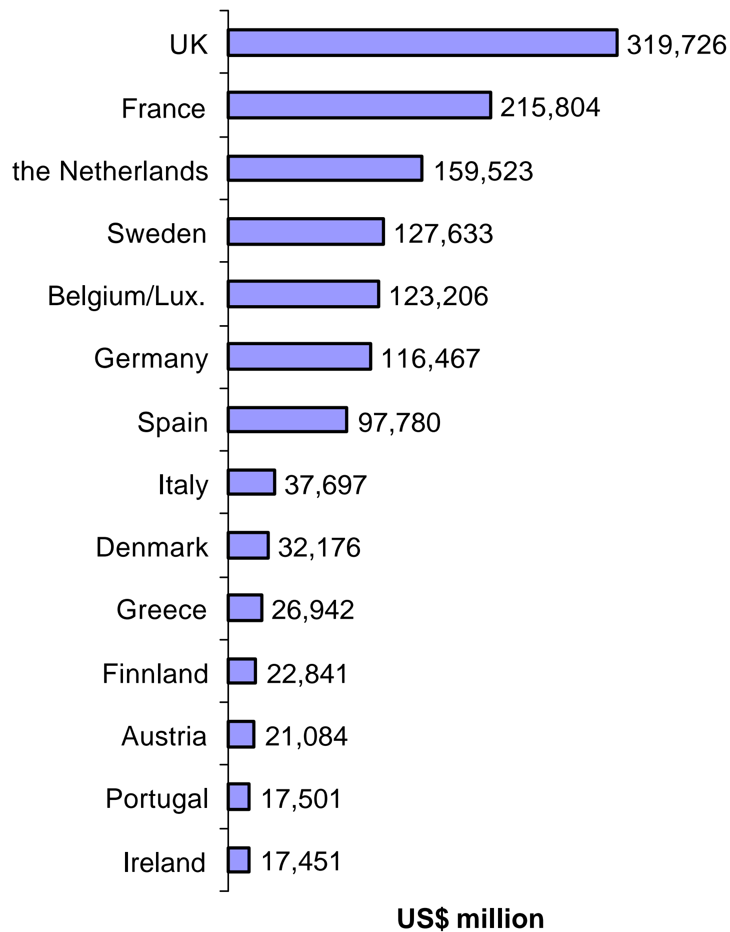
expected to decline once privatisation is complete. It is expected that a fall in FDI will occur in about two years' time.[11] For this reason and if we remember all the arguments for the importance of FDI to the Polish economy, it seems inevitable for the Polish authorities to turn their focus towards attracting FDI with other means. In the next chapter I will present successful methods of attracting FDI by the Netherlands, Belgium and France.

4. Special Tax Arrangements in the EU Countries

The international location competitiveness for foreign direct investment is a subject of concern also for well developed market economies such as countries of the European Union. The OECD statistics show that the international location competitiveness for FDI differ from each other among the EU countries and indicate that factors other than only the size or the economic weight of a particular country affects FDI inflows. In the period of 1990 until 1999 countries such the Netherlands and Belgium attracted more FDI than Germany or Spain (see Figure 3). Only in 1998 the FDI inflows to the Netherlands accounted for US$ 41,977 million (see Figure 4), just behind the UK (US$ 64,388). France with US$ 28,955 ranked the third place followed by Belgium (US$ 20,877).

[11] Poland Investment Profile 2001, EBRD.

Figure 3. Cumulative FDI-flows in EU-countries in 1990-99.



Source: Recent Trends in Foreign Direct Investment, in: Financial Market Trends, No.76, June 2000.

FDI inflow to the countries of the EU are important for the following reasons: the level of foreign direct investment influences directly and indirectly other economic factors, e.g. the employment level (e.g. in the Netherlands 19 per cent of all jobs created in 1996 came from foreign

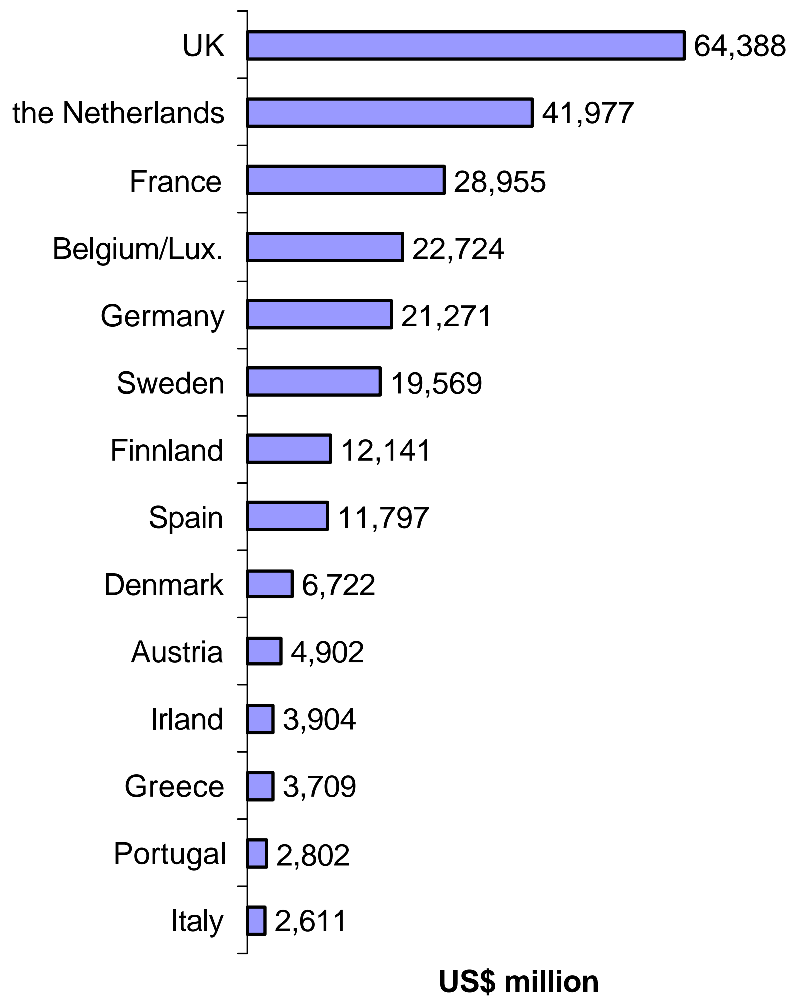
companies), tax revenues, research, innovation, technology, labour skills. By means of these factors FDI help create dynamic comparative advantages. In particular the following forms of investment stimulate dynamic comparative advantages: European Headquarters, European Distribution Centres and Shared Services Centres, which are attracted mostly by such countries as the UK, the Netherlands, France and Belgium:

- European Headquarters (EHQs), are stand-alone establishments of foreign companies which have as their main task the co-ordination of activities of operational subsidiaries of the parent company and/or independent representatives (distributors/agents/vendors) in at least five European countries. They co-ordinate the following activities: financial activities, strategy, market research, research and development (R&D), centralised advertising, procurement of information, representation at authorities and institutions.

- European Distribution Centres (EDCs), are stand-alone distribution facilities which have as their main function the storage and distribution of goods to at least five European countries. Next to tax aspects, factors such as infrastructure and good geographical location play a very important role in choosing the location for EDC.

- Shared services centres (European back offices), are office facilities of multinational companies which carry out operational office activities for at least five European countries. These offices (which are often physically separated from the headquarters) have as their main task the provision of services to support the core business of the parent company. The example of services are: reporting, controlling, cash management, IT-service, purchase, human resources, production planning, customer service.

Figure 4. FDI-inflows in EU-countries in 1999.

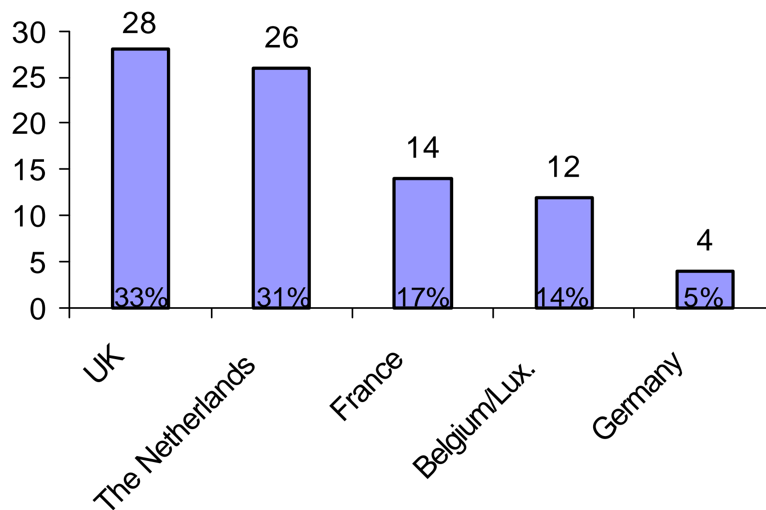


Source: Recent Trends in Foreign Direct Investment, in: Financial Market Trends, No.76, June 2000.

According to a study of the Buck Consultants International (BCI) in the period of 1991-1996 the Netherlands succeeded to attract one third (75 out

of 240) new EHQs which grounded in Europe.[12] In the years 1997-1998 around two thirds of EHQs were located only in two countries : in the UK (33% with 28 EHQs) and the Netherlands(31% with 26 EHQs). The rest of new EHQs were located in France (14 EHQs), Belgium (12 EHQs) and Germany (4 EHQs) (see Figure 5). In the Netherlands 30% of all foreign investment took place in the form of European Headquarters and Shared Service Centres, and 25% took form of European Distributions Centres.

Figure 5. Number of EHQs grounded in Europe in 1997-1998.



Source: Steuerliche Rahmenbedingungen für Internationale Firmenzentralen in den Niederlanden, Belgien und Deutschland, Booz, Allen & Hamilton, Januar 2001, p.11.

As far as European Distribution Centres are concerned, 57% of all EDCs of non-European multinational companies (American and Asian) in 1997 were grounded in the Netherlands, followed by Belgium (13%), Germany (12%), France (8%), the UK (5%) (see Figure 6).

Figure 6. Asian and American EDCs in 1997.

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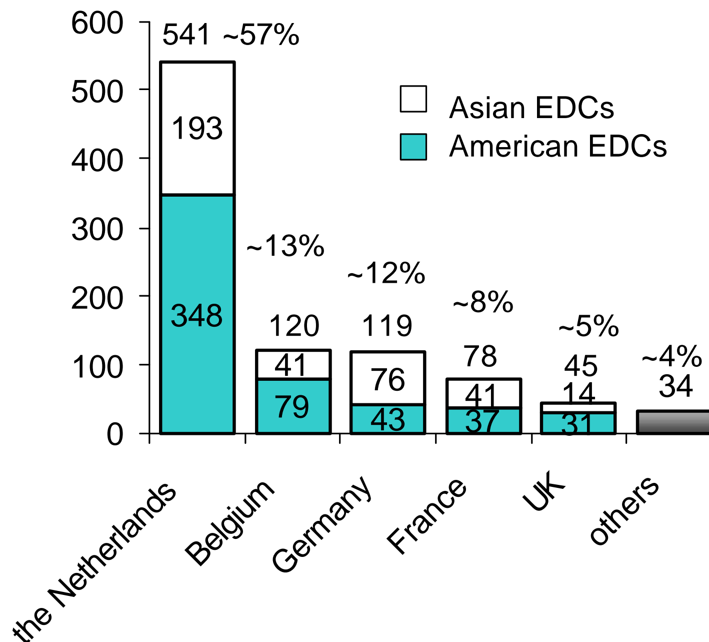
[12] Europe's Logistics Centres, Buck Consultants International, 1998, Corporate Location.



Source: Steuerliche Rahmenbedingungen für internationale Firmenzentralen in den Niederlanden, Belgien und Deutschland, Booz, Allen & Hamilton, Januar 2001, p.12.

Next to other general location factors such as infrastructure, education level and law regulations the most important factor making the Netherlands, Belgium and France so attractive for these types of FDI is the tax burden. In particular, the US and Japanese companies base their location decisions on quantitative factors (the top rate of personal and corporate income tax) and expected tax burden.[13]

Box A. Examples of location decisions in the Netherlands and in Belgium

European Headquarters

- Fujitsu Siemens Computers grounded its EHQ in 1999 in Amsterdam (co-ordination of operational activities in 25 countries)
- The US Web company LookSmart grounded its EHQ in Amsterdam in 1999
- Eaton shifted its EHQ with 70 jobs from London to Amsterdam
- Nissan shifted its EHQ to Amsterdam in 1996
- Chrysler grounded its EHQ in Brussels in 1996
- Nike grounded its new EHQ in Hilversum (the Netherlands)
- Procter&Gamble and Hankook shifted their EHQs from Frankfurt/Main (Germany) to Belgium and in the Netherlands

Shared Service Centres

- Duracell grounded its Shared Service Centres in Belgium in 1999 (investment value: US$ 40 millions)
- Wrangler grounded its Shared Service Centres for Europe in Sint Niklaas (Belgium) in 1998

European Distribution Centres

- Reebok grounded its EDC in Rotterdam in 1998 (350 new jobs were created)

The main features of the tax systems in the Netherlands, Belgium and France related to such forms of investment as: European Headquarters, European Distribution Centres and Shared Services Centres will be presented in the following chapter.

4.1. Tax Incentives in the Dutch Tax System

The most important favourable tax arrangements in the Netherlands which helped the country to become one of the European leaders in establishing European Headquarters, European Distribution Centres and Shared service centres are as follows:

- the possibility to obtain a definitive information about the future tax burden from tax authorities before the actual investment takes place,
- tax exemption of dividends and interest income
- Double Tax Treaty with the Netherlands Antilles,
- 'Dutch-Mixer' system,
- special tax regulations for particular types of companies,
- special tax regulations for inter-company interest expenses,
- special rules for foreign executives and research scientists,

Definitive information about the future tax burden

In the Netherlands the investor can obtain in most aspects of taxation a definitive information about the future tax burden from tax authorities before the actual investment takes place. Such a definitive information is valid and binding for both parties unless the basic facts concerning investment change. The regulation allows investor to calculate its tax obligation for the next coming years and provides for the risk reduction linked with investment. The option is often used by shareholdings or EDCs in the Netherlands. For the assistance of the foreign investors the Rotterdam Tax Inspectorate is responsible together with contact offices with power of attorney.

Tax exemption of dividends and interest income

Dividends and income on shares sale which the Dutch shareholdings receive from its subsidiary are exempted from the corporate income tax if the distribution of profits falls under the participation exemption enjoyed by the company receiving the dividend. The participation exemption is

applicable to both domestic and foreign shareholdings. A shareholding is deemed to exist if the taxpayer:

1. holds at least 5% of the nominal paid-up capital (a shareholding includes the related possession of 'jouissance' rights); or
2. holds less than 5% but ownership of the shares is part of the normal business conducted by the taxpayer, or the acquisition of the shares served a general interest; or
3. is a member of a co-operative; or
4. holds at least 5% of the share certificates in a mutual fund based in the Netherlands.

The participation exemption does not apply internationally when shares in the foreign corporation are held as a portfolio (passive) investment. Another requirement for the exemption is that the foreign company in which the shares are held is subject to a tax on profits levied by the central government in the country in which it is established (in practice it means that the rate of 1% would meet the criteria for exemption). Furthermore, the participation exemption is not applicable for participation in foreign 'passive' finance companies.
It is worth noticing that distributed dividends are very often taxed in the country of origin at low withholding tax rate (0-10%) according to Double Tax Treaties.
The application of the participation exemption together with other tax measures means that the Netherlands are perceived as an attractive location for shareholdings.

Double Tax Treaty with the Netherlands Antilles

Dividends distributed from the Netherlands to the Netherlands Antilles are with the withholding tax of 5-15% taxed:

- when the recipient is an individual or a shareholding of less than 25% in the company paying the dividend : 15%,
- when the recipient is a shareholding of at least 25% in the company paying the dividend and pays the corporate income tax in the Netherlands Antilles (5.5%) : 5%,
- in other cases: 7.5%.

As there is no withholding tax in the Netherlands Antilles, that special regulation is very often used by the Dutch companies when distributing

dividends. As a result, the effective tax rate for distributed dividends is only about 10%.

The 'tax optimisation' model may include other countries: profits from foreign subsidiaries are distributed to the Dutch shareholding and according to Double Tax Treaties and participation exemption they are exempted from tax. And then the parent company will distribute dividends from total profits to the Netherlands Antilles. As a result dividends are taxed only at about 10%.

The Dutch regulation concerning treatment of shareholdings has faced international criticism (not compatible with the EU regulations) and as a result the New Fiscal Framework in 1999 has been introduced. The new regulation is going to be unified with the requirements of the EU and OECD, though, the existing companies will operate according to the old rules until the year 2020.

Dutch-Mixer System

The Netherlands do not provide for special tax regulations concerning the accumulation of the income coming from foreign subsidiaries. Therefore, the shareholdings in the Netherlands are often used to offset profits coming from high-tax or low-tax (tax heavens) countries. It means that profits coming from countries where tax corporate rate is lower than the tax rate in the Netherlands (35%) are not taxed again in the Netherlands. For many of the multinational companies the Mixer-Model plays an important role in their tax optimisation policy.

Special tax regulations for some forms of companies

The Dutch special tax regulations for some forms of companies are the most important tax aspects of the international location competitiveness of the Netherlands for the multinational corporations. The regulations address the taxation of the following forms of companies:

- Headquarter Centres
- Distribution Centres
- Service Centres

For all these forms of companies the future tax obligations can be defined in advance using the 'Cost-plus' model.
In this case the company's profit is calculated as a percentage (5-25%)of operating costs. The exact percentage point is calculated individually on the basis of similar business relationships between independent parties. This fictitious profit is then taxed at the usual tax rate of 35%. Since 1995 the future tax obligations for these forms of companies can be bargained and defined in advance, they are bound for a number of years (usually for four years, and in some case longer).

There is also one specific regulation in the Dutch tax system and namely profit determination on the basis of a 'resale minus' calculation. The regulation is limited to situations concerning preparatory and auxiliary activities which also have a selling character and take place - at least on one side - between related parties.

This type of group activities, for example marketing activities not being the selling activity itself, may be eligible for this type of profit determination. An overall condition is that a third party price for the services rendered can not be found and that the actual resale minus percentage to be used by the taxpayer is based on indications found in the market for similar situations. Depending on circumstances such as the risk involved or the nature of the labour required, the actual percentage will vary between 1-3% in order to mirror what is found between non-related parties. No resale minus calculation is possible if the activity at hand is considered to be core-business. A ruling can be obtained from the tax-inspector confirming the applicability of the resale minus method and the agreement that the remuneration for services is at arm's length with The tax on the profit,

including the profit calculated on the resale minus basis, is levied at the standard corporate income tax rate of 35%.

Special tax regulations for inter-company interest expenses

Since January 1997 reserves for financial risks for multinational companies may be off set (80% of income on financial activities). Voluntary termination of the risk reserve can be undertaken at any time by filing a request to this effect. This type of release must take place in five equal instalments, all subject to tax at a special rate of 10%. During the five-year period, no further contributions to the reserve will be allowed but the releases regarding capital contributions will remain possible. Any finance income during this period will be taxed at 35% without the possibility of adding to the reserve. As a result, the rest 20% of profit is taxed at the usual corporate tax rate at 35%, which means that the effective tax rate for interest income is about 10%.

A compulsory release, taxable at the full 35% corporate income tax rate, will take place when the company is no longer subject to tax in the Netherlands (liquidation or a transfer of its fiscal domicile to another country). This taxable release is excluded from the finance profits and cannot be used to create a new reserve. Equally, failing to meet either the Netherlands substance or the foreign country conditions, or to meet any of the other conditions imposed by the law will lead to a compulsory release with the same tax consequences.

In the case of a compulsory release within the five-year voluntary release period, an additional tax of 25% will be levied on all voluntarily released instalments which have been subject to the special 10% tax rate, thereby effectively raising it to 35%. [14]

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[14] Council of the European Union (1999), Report from Code of Conduct Group (Business Taxation) to ECOFIN-Council on 29 November 1999, SN 4901/99, Brussel

Special rules for foreign employees: the 35% rule

A special allowance is granted to certain foreign employees who are assigned to a post with domestic employer (i.e. an employer established in the Netherlands, or an employer not established in the Netherlands who is obliged to withhold salaries tax on the salary paid to the employee). In the year 2001 Dutch employers may grant a special tax-exempt allowance of 30% (until the year 2000 the 35% rule applied), which is paid in addition to employees' salaries. [15] The allowance is calculated on the basis of the salary. Employer reimbursements of school fees for the attendance of children at international primary or secondary schools are also exempted from tax. Expenses incurred in connection with employment are reimbursed tax free. The allowance is applicable for a maximum period of 120 months.

In general, the main purpose of the allowance is to attract top managers and research scientists to the Netherlands. Due to that regulation the image of a foreign company as an employer with the location in the Netherlands is improved and the secondment of qualified employees to the Netherlands is made more attractive.

4.2. Tax incentives in the Belgian Tax System

Under Belgian tax laws, resident companies with legal personality and pursuing a gainful activity of business in Belgium, are liable to company tax at the normal tax rate of 40,17%. Dividends are taxed by the means of the withholding tax at 25%.
Belgium has also worked out several favourable tax arrangements for foreign companies:

- binding information about the future tax burden,
- favourable tax package for foreign companies,
    - special tax regulations for particular types of companies,
- special rules for foreign executives,

Binding information about the future tax burden

[15] Taxation in the Netherlands 2000, the Ministry of Finance in the Netherlands.

In Belgium the investor can obtain in most aspects of taxation a definitive information (so called rulings) about the future tax burden from tax authorities before the actual investment takes place. The criteria for special forms of companies which need to be fulfilled are also settled. Such a definitive information is valid and binding for both parties unless the basic facts concerning investment change. The regulation allows investor to calculate its tax obligation for the next coming years and provides for the risk reduction linked with investment.

Favourable tax package for foreign companies

Under certain conditions the Belgian tax law provides for some special tax rules for shareholdings:

- 95% of the amount of the dividends paid on shareholdings is deductible as Definitively Taxed Income (D.T.I.) from taxable profits.

As a result, the effective tax rate is about 2%. Although that rule does not comply with the EU 'parent companies and subsidiaries Directive', it is however commonly used.

The most important criteria to be met are:

1. Parent company holds at least 5% of shares (or BEF 50 million) in the subsidiary,
2. Subsidiaries are liable to corporate income tax,
3. Subsidiaries may not be subject to other special tax regulations (e.g. they may not be established in a tax heaven).
4. Losses from past years.
5. Operating losses are deductible, without prescription, from income in subsequent tax periods.
6. Company mergers and divisions, general or sectoral capital contributions.

As long as certain conditions are met, such restructuring operations may be carried out untaxed.

Special tax regulations for particular types of companies

The Belgium tax law provides attractive tax arrangements for the following three types of companies:

- Co-ordination Centres
- Distribution centres
- Service centres

Co-ordination Centres

The system of co-ordination centres is in Belgium widely used. A Belgian company or the Belgian subsidiary of a foreign company that carries on certain preparatory or auxiliary activities of an administrative or financial nature on behalf of the companies in the group are defined as a co-ordination centre. To qualify for these special arrangements, the co-ordination centre must form part of a group of companies with combined own funds of at least bfrs 1 billion, and a consolidated turnover of at least bfrs 1 billion.

The flat-rate profit the company earns is based on a percentage (8%) of the expenses and operating costs, excluding staff costs and financial charges, with minimum to cover any non-deductible expenses and charges, and any extraordinary or voluntary benefits it may be granted. The profit is then taxed with the usual tax rate at 40,17%.
It is calculated that the special tax arrangement for co-ordination centres reduces their tax obligation by about 95%.[16] Such a huge tax incentive led to the situation that many multinational companies have settled down in Belgium in form of a co-ordination centre (more than 370 co-ordination centres in the period of 1982-1996).
Co-ordination centres are also exempted from liability for withholding tax on movable and immovable property, as well as from tax payable on capital contributions.

[16] Belgium's Co-ordination, Distribution and Service Centres, Forum 187, 1998, Treasury Management International.

Distribution centres

In 1994 the institution of distribution centres was introduced in Belgium. Distribution centres perform on behalf of the members of their group a whole range of activities, such as purchasing, transport and delivery of goods and finished products, without any financial involvement in their sale.
Their profit is also determined at a flat rate of 5% (here staff costs inclusive).

Service centres

In 1996 the institution of service centres was introduced in Belgium. Service centres are similar to distribution centres, though service centres are more intellectual, providing information to customers or being passively or actively involved in sales.
Their profit is also calculated at a flat rate and depends on the form of activity:

1. operating costs of preparatory or auxiliary activities: 5%
2. operating costs of providing information to customers: 10%
3. operating costs of passive sale activities: 15%
4. up to 5% of turnover of active sales activities.

Special rules for foreign executives

Already since 1959, Belgium has granted favourable arrangements to company executives and directors temporarily seconded to Belgian companies. The tax is levied only on their income of Belgian origin, i.e. the pay they receive for services rendered in Belgium, and, where applicable, other income of Belgian origin. Moreover, the remuneration does not include a whole range of personal expenses refundable by the employer. The following are therefore tax exempt:

1. tax equalisation payments (indemnities paid to executives to offset the additional taxes they have to pay in Belgium),
2. school fees,
3. certain travel costs to the country of origin,

4. other salary supplements intended to cover the difference in the cost of housing and the cost of living between Belgium and the country of origin.

With the exception of school fees and non-recurring charges (removal expenses and the cost of furnishing a home in Belgium), such exempt reimbursements – which may take the form of a standard lump-sum refund or reflect specific sums provided the employer can show that they directly or indirectly cover the additional costs associated with the secondment of the executive to Belgium – are subject to a ceiling of BEF 450,000 which may be raised to BEF 1,200,000 in the case of executives in certain enterprises (inspection and co-ordination bureaux, scientific research centres or laboratories).

As in the case of the Netherlands, the above tax arrangements for foreign executives has focused on the aim to attract highly-qualified labour force and thus to improve the international location competitiveness of Belgium.

4.3. Tax incentives in the French Tax System

In 1997 France encouraged by the success of the Netherlands and Belgium has published the Instruction (Instruction of 21 January 1997) aimed at offering a favourable tax environment to headquarters and logistic centres. Although the French tax system provided already for a special status for headquarters and their employees, it was not competitive with tax systems in the neighbouring countries and as a result a number of multinational French and foreign groups decided to locate their headquarters and logistic centres in other countries which offered more favourable tax conditions, e.g. the Netherlands or Belgium.

The Instruction provides for the following tax arrangements:

- special tax treatment of headquarters and logistic centres, and
- favourable tax rules for expatriates.

Special tax treatment of headquarters and logistic centres

Headquarters

The regime is eligible for foreign and French multinationals and granted by virtue of an advance ruling. The nature of headquarters is to direct, manage, co-ordinate and control activities for the exclusive benefit of group companies in the following specific fields: administration, data processing services used for internal group management, strategy, human resources, communications, public relations, supply and collation of information, research and development. In addition, to encourage the development of financial activities in France, the headquarters' tax status was extended to undertakings in the banking and finance sector, for all the activities listed above plus for certain functions specific to the banking and finance sector: i.e. back office and financial analysis. Those services which headquarters render to companies outside of the group are taxed under normal rules. Services rendered by headquarters must, mainly, benefit group companies located outside of France.

Headquarters are liable to income tax at the normal rate (40%) but the tax base is fixed to a certain percentage of its accounted operating expenses. This percentage is determined by taking into account the nature of the activities and their operational structure. Headquarters must invoice their services to group companies at cost plus the agreed mark-up. The costs used to calculate the cost plus are the headquarters' day-to-day operating expenses. These costs include the various expenses incurred during a financial year (e.g. operating interest, depreciation, etc.) but exclude provisions for charges and corporate income tax. Operating results which are not strictly connected with the headquarters activity are taxed under standard rules (dividends, capital gains and losses on asset disposal). The basic costs are then increased by a margin negotiated with the tax administration, which corresponds to the profit level which would have been generated on similar services if supplied by an independent party. Generally, this percentage is equal to 6-10% of the operating expenses incurred by the headquarters and it may be revised if there has been a change in the nature of activities or in the operational structure.

Logistic Centres

Due to the Instruction in 1997 logistic centres were granted a special tax treatment in France, which are similar to those applied to headquarters.

A logistic centre may be organised as a French corporate entity or as the French branch of a foreign company. Unlike headquarters, they may not form part of a division of a French operating company or of a holding company. In addition, if the legal structure so allows, a logistic centre may coexist in the same structure as headquarters.

Their services must mainly benefit companies located outside of France. The role of a logistic centre is to render logistic services to group companies; all services rendered to companies outside of the group are taxed in accordance with standard tax rules.

The eligible activities of logistic centres are precisely defined by the tax Administration. They include for instance: stocking, labelling, packaging, distribution of products and corresponding administration for the enterprises of the group.

A logistic centre may only be involved in preparatory or ancillary activities. It cannot therefore perform activities normally inherent to manufacturing or marketing units.

The centres are taxed in a similar way as headquarters: on a cost-plus basis, the margin being negotiated with the tax administration with references to arm’s length operations.

Tax rules for Expatriates

Expatriates are defined as persons who were not domiciled in France, under the terms of French domestic law or tax treaties, during the year preceding their arrival in France, and who are employed in France for a period which will not exceed six years.

Tax rules apply to expatriates working for headquarters and logistic centres and in some cases working for structures other than headquarters and logistic centres.

Indemnities and expense reimbursement paid to expatriates working for headquarters and logistic centres are split into three categories, each of which is treated in a different way for tax purposes.

1. The first category of expenses is exempt from personal income tax and include expenses on: home trips (e.g. annual trip to the home country for the expatriate and family), cars (e.g. car registration costs, cost of obtaining a French driving licence), housing (agency fees for finding rented accommodation in France, moving and travel costs at the beginning and the end of assignment) and other (e.g. school fees for expatriate children, language lessons for the expatriate and family).

2. The second category allows for the possibility of income tax exemption for individuals, in respect of those indemnities and expense reimbursements assessed under standard corporate income tax rules at the level of headquarters or logistic centres. The advantages of that method are twofold: first, it allows for tax savings in that the corporate income tax rate is often lower than the individual's marginal income tax rate, and secondly the provision avoid the need for the employer to 'gross-up' tax and social security reimbursements.[17] Expenses are restricted to the following reimbursements: reimbursement of additional housing costs incurred on the expatriate's accommodation in France, and reimbursement of excess taxes and social security contributions (on expatriate's salary and not on world-wide family income). The second category is applicable only to expatriates who (apart from the fact that they should be employed in France for a period which must not exceed six years) were not domiciled in France, for the five consecutive years preceding their arrival in France.

3. The third category includes all those reimbursements and indemnities of a personal nature which are not included in categories 1 or 2. Examples of such expenses include expenses incurred for decorating an apartment or for a car purchase. Items falling into this category are taxable under standard tax rules.

Expatriates working for structures other than headquarters or logistic centres are exempt from income tax on those indemnities or expense reimbursements included in category 1 as described above.

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[17] Deysine-de Bouqueney, M. and Jouffroy, R., New Tax Developments to Encourage Foreign Investment in France : Headquarters, Logistics Centres and Taxation of Expatriates, in: Bulletin for Fiscal Documentation, May 1997, p.222.

5. Tax Competition in the European Union

With the development of the common market in the EU and the removal of legal and technical barriers to trade the tax differences between the countries of the European Union became even more important for investment location decisions. Therefore, the issue of tax competition between Member States has been the focus issue in the debates by the Commission for almost 30 years. However, the idea of harmonising direct taxes among the EU countries has been mostly for political reasons not followed in practice.

Whereas Article 99 of the original EEC Treaty provided for the Commission to '*consider*' the harmonisation of '*turnover taxes, excise duties and other indirect taxes in the interests of the Common Market*', there is no explicit provision in the Treaty for the harmonisation of direct taxes. Action in this field has therefore necessarily been based on more general objectives: freedom of establishment (Article 52) or the free movement of capital (Article 67) and the functioning of the common market (Article 100), which authorises '*directives for the approximation of such laws, regulations or administrative provisions of Member States as directly affect the establishment or functioning of the common market*'. In addition, Article 220 requires Member States to '*enter into negotiations*' for '*the abolition of double taxation within the Community*'. Most of the arrangements in the field of direct taxation, however, still lie outside the framework of Community law. Within these constraints, only limited action was possible at the Community level.

Instead, the European Commission has dealt intensively with the problem of harmful tax competition. Following the publication of 'Guidelines for Company Taxation' in 1990 (SEC(90)601) three already-published proposals in the field of company taxation were adopted:

- the 'mergers' Directive (90/434/EEC), which covered the treatment of capital gains arising when companies merge,
- the 'parent companies and subsidiaries Directive' (90/435/EEC), designed to eliminate the double taxation of dividends paid by a subsidiary in one Member State to a parent company in another. In the Article 5 of the Directive it is said that profits which a subsidiary distributes to its parent company shall be exempted from withholding tax if the parent company holds a minimum of 25% of the capital of the subsidiary. The

directive has been mainly addressed to shareholdings and European Headquarters and thus the profit shifting among the countries of the EU has been significantly simplified.

- The 'arbitration procedure' Convention (90/436/EEC), which introduced procedures for settling disputes concerning the profits of associated companies in different Member States.

In 1997 the tax package 'A package to tackle harmful tax competition in the European Union' was published, a part of which was the Code of Conduct.

The Code of Conduct advised the countries of the European Union to take measures in order to encourage fair competition and set the criteria of harmful tax competition, e.g.:

- granting of advantages to foreign companies without them having economic activities in that state,
- advantages only for non-resident foreign companies, not available to the national business,
- rules for determining profits which derogate from internationally accepted rules (e.g. OECD),
- lack of transparency.

Finally, the Commission proposed the creation of a 'follow-up Group' of national government representatives within which the day-to-day application of the Code could be discussed.

The idea of the Code was immediately accepted by both Parliament and Council, and the final text was adopted by the Council of Finance Ministers on 1st December 1997. The 'follow-up' Group was established by ECOFIN on 9th March 1998, and met for the first time on 8th May 1998, when it elected as its first chairman the UK Treasury Minister, Dawn Primarolo. It has therefore become known as the 'Primarolo Group'. The Group's first task has been to examine a list, compiled by the Commission largely on the basis of information supplied by Member States, of national tax provisions which fall within the scope of the Code. The Group decided to divide the initial list into the following five categories: intra group services, financial services and off-shore companies, other sector-specific regimes, regional incentives, and other measures. A further category covered dependent or associated territories. Two interim reports of the Code of Conduct Group were presented to the ECOFIN Council on 1 December 1998 and 25 May 1999 respectively (docs. 12530/98 FISC

164 and 8231/99 FISC 119). The Group has considered the list of potentially harmful tax measures in order to assess whether they affect or may affect in a significant way the location of business activity in the Community and has given a positive evaluation to 66 measures. The Group has also examined the tax treatment of special tax regulations for co-ordination, distribution and service centres in the Netherlands and Belgium and special tax regulations for headquarters and logistics centres in France, however no illegal state aids could be found.

In 1989 the Commission published a draft Directive for a common system of withholding tax on interest income (COM(89)60), levied at the rate of 15%. This was opposed by some Member States on the grounds that, based on the German experience in 1989, it would lead to a flight of capital from the Community. The proposal was eventually withdrawn, and a new one, to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community (COM(1998)295), has been presented within the context of the 'Monti package'. According to the coexistence model the rate proposed for the withholding tax is 20%; an alternative is to provide information on payments to the tax authorities of the saver's home state. However, so far the Member States has not reached agreement as on the one hand the UK wants to protect Eurobonds from the withholding tax and on the other hand Luxembourg and Austria are trying to keep the bank secret. For that reason it seems that the problem is not going to be solved in the near future.

The past three decades have shown that the Member States prefer to keep their sovereignty in creating the national tax system and set high value on the principle of subsidiarity. The principle of subsidiarity was not explicitly mentioned in either the Treaty of Rome or the Single European Act. It appeared implicitly in the Single European Act saying: *'Community shall take action relating to the environment to the extent to which the objectives ... can be attained better at Community level than at the level of the individual Member States'* (EC Treaty, Art. 130r(4)). The Treaty on the Establishment of the European Union broadened the provision: *'In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason*

of the scale or effects of the proposed action, be better achieved by the Community.' (EC Treaty, Art.3b).
It is therefore to expect that the tax development in the countries of the European Union will go more in the direction of tax competition rather than tax harmonisation as far as direct taxation is concerned.
The last statements of Frits Bolkostein the commissioner responsible for the EU common market suggests that there is no intention among the representatives of the EU countries to harmonise the corporate income tax and that means that the tax competition between the EU countries will become even stronger.[18] Success in attracting FDI through tax regulations concerning co-ordination, distribution and service centres by the Netherlands and Belgium have already caused the relevant changes in tax regulations of other countries of the EU (e.g. in France) and it should be expected that countries of Central and Eastern Europe will soon follow.

6. Conclusions and recommendations for the Polish tax system

The importance of Foreign Direct Investment for the Polish economy in the transition period and in particular as far as the stabilisation and growth objectives of the Polish economic policy are concerned cannot be underestimated. At present the main reasons for which the attraction of FDI is to be pursued are to enhance the productivity of economic operations and the local workforce, encourage employment, stimulate innovation process and technology transfer as well as enhance and guarantee the sustained economic growth.

The Polish success in attracting FDI in the past seems to come to an end, as the main driving force for the last few years was the privatisation process. As the privatisation process in Poland is almost completed a sharp decline in the FDI inflows in Poland in about two years' time is to be expected. At the same time tax breaks in the Special Economic Zones which have attracted a significant volume of foreign investment are to be scaled back considerably at the end of 2001. Moreover, tax competition

[18] Die EU-Kommission will den Steuerwettbewerb verstärken, *Frankfurter Allgemeine Zeitung*, on the 23th Feb. 2001.

between the Central and Eastern European countries for foreign direct investment which has been strong in the last decade will become even more intense in the future.

Stable high FDI inflows are still required for a sustained economic growth and modernisation of the Polish economy. Therefore, it seems inevitable for the Polish authorities to introduce changes in the treatment of the foreign direct investment in the Polish tax code and turn their focus towards attracting FDI with other means. Poland should define its position as an attractive location for all multinational companies which wish to operate in the Central and Eastern Europe. Interesting tax regulations concerning co-ordination, distribution and service centres in the Netherlands and Belgium and headquarters and logistics centres in France may be used in that respect as an example for creating successful tax regulations in attracting foreign direct investment. The recommendations for the improvement of the Poland's international location competitiveness for FDI are presented beneath. They include both tax and non-tax instruments:

- implementation of the special tax rules for some types of investment (co-ordination, distribution and service centres) following the example of the Netherlands, Belgium or France. Before copying 'ready solutions' from those countries, the total effects of possible changes on the increase of foreign direct investment inflows in Poland and on the budgetary receipts in form of taxes should be examined;

- the possibility to obtain a definitive and legally binding information about the future tax burden from tax authorities before the actual investment takes place, which will reduce the investment risk significantly as far as the future tax obligation is concerned;

- tax incentives for employment of foreign executives and scientists as it is common in the Netherlands, Belgium and France. Though, the Dutch option in form of a tax-exempted allowance calculated on the basis of the salary seems to be less bureaucratic. Other non-tax instruments for the assistance when the secondment of the foreign executives and his/her families takes place should also be considered (job permit, foreign driving licence, international schools for children, etc.);

- provision of the stable and clear tax system. The tax system is Poland is very often viewed as unstable. The frequent amendments in the tax law in the past decade made investors unable to foresee the future tax burden. Only in the period of 1992 until 2000 the Polish tax law on corporate income tax was changed 45 times. Many case studies show that transparency of the tax law and administrative certainty are often ranked ahead of tax relief. Uncertainty over the tax consequences of FDI increases the perception of risk and thus discourages capital flow. This factor is particularly important for long-term, capital-intensive investments.[19] And that form of investment Poland wants to attract. Therefore, it is important to remember that only stable tax system is going to cultivate the investment climate and improve the international location competitiveness of Poland;

- Active promotion of the investment opportunities in Poland (through international conferences and workshops in Poland and abroad, informing press conferences for foreign journalists) and assisting foreign investors in the co-operation with tax authorities; and

- improving other non-tax factors affecting FDI (legal and regulatory framework, macro-economic environment, infrastructure, education level, etc.). A consistent legal and regulatory framework that is compatible with private sector activities and the operation of foreign-owned companies should be established, for instance in the field of protection of the property rights. As far as macro-economic environment is concerned, instability in the level of prices and the exchange rate makes business planning difficult and increases the level of uncertainty and the perceived risk of FDI, tending to discourage investment flows. Moreover, access to inputs (e.g. production factors at a competitive price) and infrastructure are also key non-tax factors influencing FDI. Traditional infrastructure (transport, telecommunication) as well as education level (IT confidence, university degree, knowledge of foreign languages) play also a significant role.

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[19] Clark, W. S., Tax incentives for Foreign Direct Investment: Empirical Evidence on Effects and Alternative Policy Options, in: Canadian Tax Journal, 2000, Vol. 48, Issue Number 4, p.1141.

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