Business Restructuring

a Threat to German Tax Revenues

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International business restructuring is a subject which in the age of globalisation needs hardly a justification to be dealt with in a scientific seminar.

Under the term of “International business restructuring” a number of legal rules and tax planning techniques are summarised which enable the tax payer to transfer business activities cross-border into another country. Obviously such transfers are in a practical sense only feasible if they can be effected in a tax-neutral way – a transfer at market value would create such a high tax burden for the transferor that such a move would be impossible for economic reasons.

Cross-border business restructuring has become a major issue only over the last decade. There can be identified a number of reasons why only now this issue emerged, however, all these reasons are connected with the issue of Globalisation. Historically a business which operated close to the customer enjoyed substantial economic advantages, such as close communication links to the customer, low transportation costs, detailed knowledge of the market and its needs and so on. Therefore the industry had built in each major market a production and sales platform and served its customers from within this market. The organisation of the industry was truly national.

With the development of a globalised industry this situation has changed dramatically. The reason for this change is that the business succeeded in building an infrastructure which made the location of the production of goods and local closeness to the customer a less and less important factor. The container traffic has reduced transportation costs dramatically to such an extent that for example, the transportation costs from China to Europe per unit of product do not really matter compared with the final selling price. The internet and e-mail enables a quick and efficient communication irrespective of the location of the enterprise and the customer. New business structures do emerge, even virtual markets, e.g. in financial services, where this new infrastructure enables a 24-hour-business. To cope with this development the business developed virtual organisations where it hardly can be said where the entrepreneur is located – example are again financial services, where you can have business structures where the decisive people, who work together in the same deal, may be located in Frankfurt, London, New York, Tokyo and Singapore.

This new infrastructure enables the business to offer their products and services on a worldwide basis irrespective where the production plant or the people providing the services are located. Purchase offers are sent in via Internet, the product is produced somewhere in the world and transported by the cheap container service around the globe to the customer. In addition, the globalisation has changed the taste of the customers so that close contact to the specialities of the local market becomes less important. So are globalised product and trade marks like Coca Cola and McDonalds some of the most successful business concepts in the world.

If, due to these reasons, the closeness of the business to the market and the customer is not any longer an important factor, the door is open for the business to look for a new location for their activities. The decision where to locate a business, a production plant, a selling activity is than dominated by cost aspects – other factors have lost importance. Historically, an enterprise operating in a certain market and being subject to a certain cost structure had to stand the competition of other enterprises who were located in the same market and had to operate under a similar cost structure. For example, a German manufacturer had to take into account only competitors who operated in Germany as well or in adjacent countries like Benelux and France – all of these enterprises had more or less the same cost structure. In a globalised business world, however, each European business is faced with competition from all over the world, and that means from low-cost countries like China and India. European enterprises can therefore only survive if they struggle for the lowest cost level possible.

For Germany as a state with a high cost and high tax level this development is threatening in a high degree. After the fall of the iron curtain Germany is bordered on the east by states which have a low cost and low tax structure. These states like Poland, Czech Republic, Slovakia, Slovenia and Hungary are member states of the EC, they have a good infrastructure comparable to that of Germany, a stable political and legal system and offer lower labour and social security costs as well as lower tax rates than Germany. Not surprisingly there is a strong tendency of businesses to shift the production base in these countries. One recent and very striking example in the recent years is that of the production of mobile phones by Nokia. A couple of years ago Nokia had built a very modern und efficient plant in the German town of Bochum, partly financed by high subsidies by the German government. Now they have closed the plant and transferred the production to Romania due to lower cost level. The surprising issue is that the German plant operated very successfully and was profitable; however, the new plant in Romania offered even higher profits. This example shows that business is prepared to shift production and jobs light-heartedly to locations which promise the best profits and that the location for a business in many cases depends on cost levels only. These cost levels are not only made up by labour costs and costs of the social security system but also by tax costs. The necessity of the business for lower costs to be able to meet competition results therefore in a tax competition of the states.

In former times Germany had defended himself against this situation by high legal exit barriers for the business. High exit taxes were introduced which made a move from Germany into a foreign country economically expensive. Certain rules of our corporate law made it virtually impossible for a company to shift its head office into another state. Tax laws introduced a sort of “exit tax” which in many cases was unbearable. We will hear more about these barriers in the presentations. In the same direction worked economic barriers such as insufficient infrastructure, the lack of a skilled workforce in the low-cost countries and high transportation costs. These barriers which sometime have called to create a “fortress Germany” are more or less gone and destroyed by the legal and economic development. The cause of this development is, beside the development of a globalised economy, the European Community. The European Treaty, Directives of the EC as well as decisions of the European Court of Justice have made any legal “wall” against the exit of companies ineffective. The European treaty guarantees free movement of businesses and of capital. Directives to be mentioned are the Merger Directive, which allows cross-border merger and the move of the place of management.

The European Court of Justice has made with his decisions a number of German laws against exit of companies or against transfer of profits into a foreign country inapplicable, at least within the European Community. These decisions are namely Überseering, Lasteyrie du Saillant, Cadbury Schweppes and Sevic. The European Court of Justice has repeatedly decided that the protection of the own industry, of own jobs and own tax revenues are no sufficient reasons for restrictions of the basic freedoms. In addition, Customs are not longer a tool to enforce a production of goods in the own state. With the economic development I have mentioned in the beginning, namely the low transportation costs and the world-wide communication network, an economy like Germany is open to all sorts of attack from producers from low-cost countries. German enterprises have therefore very often only the choice to loose out in this competition or to move the production in these low-cost countries as well.

The effects on Germany are at least twofold, which to some extent are connected with each other. On the one side, the German tax revenues are under threat. This development weakens Germany's ability to finance its costly social security system and to fight against an economic crisis like the present one. The nightmare of a German Finance Minister is the Freedom of Capital, which in the European Treaty is guaranteed world-wide. If the European Court of Justice would apply this freedom to States outside the EC under the same terms as to EC member states, capital could flow easily and without any barrier even into tax heavens. It is the strong hope of tax officials in Germany that the European Court of Justice would accept barriers to protect the own, i.e. in this case, European tax base against an erosion in favour of non-member states.

On the other side the transfer of production into another country results in a loss of jobs, increases the number of unemployed people, reduces the tax revenues and, in addition, increases the costs of the social security system. So Germany sometimes feels to be caught in a sort of vicious circle (circulus viciosus).

This situation has a complicated political and, even more far reaching, a constitutional effect. Politically it is difficult to find a clear standpoint regarding the issues mentioned. On the one hand, Politicians look to the funds under their own control and advocate legal rules to protect the own revenue base. Recently Germany has introduced very tough rules against tax havens. On the other hand, Germany has always benefitted from integration in a world wide business community and especially from the European Community. Therefore, Germany is a strong supporter of economic integration. But than Germany has to face the fact that the economic development of the Middle and East European member states will result in higher competition for the German industry and will happen in some respect at the cost of the German labour market and German tax revenues.

In the long run more threatening is however a constitutional issue. So far the relationship between the state and the taxpayer, be it a business man or a private person, is based on a sort of "contract social". The state provides the infrastructure and the services required whereas the taxpayer pays the bill. The political justification for the participation of the state on the income of the taxpayer by means of taxation is the participation of the tax payer in the process of formation of the political will by his vote. He can elect that party whose proposition of services offered and taxes asked for suits him best. In a democratic state, on the other hand, the government once elected by the majority of voters has the right to force the minority to contribute to the costs of the political promises done in the election even if this minority would have preferred a different policy. The democratic process justifies the tax burden levied by government and parliament on the tax payer – "no taxation without representation". The tax payer has therefore only the "voice option", i.e. to utter his view in the different elections on local, state, federation and, nowadays, on union level, or, more informally, to influence the policy of the government by lobbyism.

The globalised environment has changed this relationship to some extent dramatically. The tax payer nowadays has not only the "voice option" due to participation in the elections but he has in addition an "exit option". He can within the European Community freely move to another state if he feels that his own state asks too much money as taxes from him or spends money on services and infrastructure he feels he does not need it. That does not only apply to businesses and corporations but also to individuals – quite a number of elder people leave Germany every year to run a life in a region with better weather and climate conditions, especially Spain. More important however is the possibility for enterprises to escape a fiscal pressure which is felt to be too high. The minority of tax payers which would have preferred lower tax burden at the cost of a lower level of infrastructure and services in the country they operate in have now not to comply with the wishes of the majority but they can choose another country with the level of taxes and services provided which suits their needs better. The business is therefore not forced any longer to accept the result of political decisions but they can escape them. The state on the other hand cannot be sure that he will be able to carry out his decisions because the underlying facts may quickly change due to emigration of the business as reaction to political decisions unfavourable to them. To some extent the "contract social" I have mentioned can now be terminated. There are virtually no ways and means for the government to fight against this development – against the forces of the market each government is helpless.

As an effect, the industrialised states are forced, I believe the first time in history, to stand the competition of less developed countries who attract investments by lower cost levels, and that means lower tax levels as well. The result is tax competition which in some cases may prove to be disastrous for the revenues of a State, and may even, as it was sometimes formulated, end up in a “race to the bottom”. There is the risk that the industrialised states like Germany loose the ability to finance their social security system. On the other hand, the state becomes vulnerable against requirements from the businesses, which sometimes can be called pure blackmail, to tailor-make the tax system to the needs of the business or to loose the industrial basis. How a constitutional system can cope with decreasing financial means and therefore social security level on the one hand and high pressure on political decisions from the business on the other hand is an open question.

I hope I have sufficiently explained to you why the issue of business restructuring is presently the tax topic which gets the highest political attention in Germany. That this is not only an issue in Germany shows the fact, that also the OECD has started to discuss this issue and has established a working group to develop proposals I hope that this seminar will give us some better views into this issue and the alternatives a State may have in the present globalised environment.