THE ROLE OF EUROPEAN COMMISSION AND EUROPEAN COURT OF JUSTICE IN DEVELOPMENT TOWARDS HARMONIZATION OF CORPORATE INCOME TAX IN THE EU

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The purpose of this paper is to analyze the controversial issue of corporate income tax harmonization among the EU Member States from the point of view of the main participants in this area, namely the European Commission, whose initiatives have been being continuously opposed by the Member States; and the European Court of Justice, which is making a significant input in solving the issue of EU direct tax coordination.

The issue of corporate income tax harmonization has been a controversial topic for already half a century, and despite a long history of initiatives and reports on the subject, it seems to have been little correlation between the time spent for negotiations and EC legislation adopted as a result. Today the EU countries still operate their own national corporate income taxes, with only limited co-ordination between them; however with the accelerating process of globalisation of trade and investment in general, increasing integration of economic activity as a result, political and now geographical changes in the EU are placing greater pressures on the different national corporate tax systems for a reform, which makes the dispute of corporate tax harmonization an interesting topic for investigation and analysis.

Apparently, there seems to be a deep-set structural conflict in the European Union integration process. On the one hand, the European Commission, with its legislative initiatives on the EU level aiming to achieve integration, or harmonization, of market conditions all over Europe. On the other hand, the EU Member States and their decision-making process, which has predominantly been more national in direct tax questions. Failure in achieving a compromise in this area poses a question what are the reasons for Commission’s malfunction and whether it is the right institution to bring the issue to a close.

On the other hand, the lack of progress on the legislative front in direct tax harmonization, coupled with the requirement of unanimity, has resulted in the European Court of Justice with its increasing number of cases on company taxation becoming more effective than the European Commission at removing direct tax obstacles to cross-border economic activities within the EU. Consequently, the Court, although not being a traditional player, proves to be the driving force behind European direct tax harmonization.
In conclusion, having both players at hand on the one side and the EU Member States with their “no taxation without representation” principle on the other side, it is questioned whether any institution (legal or judicial) in the EU is in a position to undertake the task of harmonizing corporate taxation in order to reach the Lisbon target to become by 2010 “the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion”.

The structure of the paper is as follows. First, an introduction to the political and economic debates is given where the problem is presented as it is, together with possible reasons and drivers for harmonization of corporate tax systems in the EU. In the third chapter relevant legal basis that exists up to date is laid down – also forming a basis for further discussion in chapter four of the EU Commission’s procedural developments, legal documents and initiatives in their historical perspective, which concern harmonization of corporate income tax. This gives the background for tracing the Commission’s aims and reasons for being determined enough in getting closer to achievement of direct tax harmonization in the EU, as well as for considering possible reasons of its failure to find the compromise with the Member States on the issue. Chapter five focuses on the relevant case-law of the EU Court in company taxation as an alternative (or complementary) tool for removing direct tax obstacles to cross-border economic activities in the European market. Finally, in the closing chapter six concluding remarks are being made regarding the role of both institutions in development towards corporate tax harmonization in the EU.
2. Background for discussion

2.1. Political and economic prerequisites for direct tax harmonization

The European Union was set up half a century ago with the purpose of achieving deep economic integration. Despite the remaining differences in integration among the Member States, the initiative has generally proved to be successful. However, in the European Union with now 25 Member States there still exist areas where the national laws are not coordinated, the implications of which are believed to hamper cross-border economic activity and distort efficient functioning of the single market. Company taxation is one of the aforementioned areas, where, despite of the long history of European Commission initiatives with its ambition to harmonize national corporate tax systems, like indirect taxes, - little progress has been achieved.¹

The issue of corporate income tax harmonization (harmonization of the corporate tax rates, tax base and national tax regulations) has been a controversial topic for already half a century, and thus received much attention in theoretical literature as well as in the policy arena. Within the European Union, on the one hand the Euro-sceptics emphasize the importance of subsidiarity and Member States’ sovereignty in corporate tax matters. They argue that tax competition is efficient, as it forces governments to charge efficient tax prices for public services. On the other hand, Euro-harmonizers point to the welfare costs of tax competition which can be found “harmful”: high national corporate income taxes may create fiscal externalities on neighbouring countries and encourage tax avoidance. Thus, without tax coordination national governments may choose inefficient tax rates, either too low or too high, which could lead to one of the possible outcomes (not necessarily the only one), when all countries end up with inefficiently low tax rates (i.e. the result of ‘race to the bottom’²).

European Commission, as mentioned, seeks to achieve a greater degree of tax harmonization in order to reduce what it considers to be harmful tax competition and to eliminate tax evasion. While its initiatives being supported by most of the Member States (particularly Germany and France), Commission’s proposals have often provoked strong reactions from the “welfare countries” like the

¹ See chapter 4.
² A ‘race to the bottom’ in case or corporate taxation is a zero tax or an atrophy of institutions and states, in general. Normally, the ‘race to the bottom’ fear is one of the arguments against any form of tax competition.
UK and Ireland. From the abovementioned follows that there is a deep-set structural conflict in the European Union integration process. Besides, the unanimity requirement when dealing with the direct tax issues in the EU has been making it impossible to achieve any fruitful results in Commission’s attempt to legitimise direct harmonization measures. Finally, the accelerating process of globalisation of trade and investment, as well as political and geographical developments on the EU level have also created new challenges for national corporate tax systems.

2.2. Reasons for the necessity of tax harmonization in common markets

Whether or not Commission’s initiatives for approximation of corporate tax systems are accepted by the Euro-sceptics, there is a number of significant disadvantages of the existence of separate corporate income tax systems within the EU, that need to be focused upon and resolved. They all cover implications to cross-border trade, establishment and/or investment activities. In particular, differences in direct taxes lead to the following situations:

1. Inefficient allocation of capital due to tax consideration.

Ideally, in the common market taxes should not constitute an obstacle, in other words, should be neutral and not influence the decisions about the allocation of resources. Differences in corporate income taxes among the EU Member States can be an incentive for companies to alter their behavior in order to minimize their tax burden. Location of capital investment, in particular, may influence the choice of a subsidiary or a parent company location, and even the decision whether to undertake transnational, as opposed to domestic, investment.

However, the role of the national corporate taxation conditions should not be exaggerated and interpreted in a misleading way, as taxation conditions is just one of the many aspects being considered by a company, when choosing a location of investment abroad. Besides, as insightfully noted by Jiménez, “the fact that company taxes are relevant for company investment decisions do not necessarily imply that company taxes are largely distorting those decisions”. Company taxes

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3 European Commission initiatives (that are supported by Germany, France, Belgium, Italy) are opposed by the UK, Sweden, Ireland and Luxemburg, as they are keen to protect their low corporate tax rates. (EU fails to agree qualified majority voting for Tax, Hartmann Jurgen, International Tax Review, Feb. 2001, Vol. 12, Issue 2, p. 3)
may determine an investment decision when, for instance, the non-tax factors of the alternative national states pre-selected for investment are almost equal.

(2) Distortion of competition between undertakings from different Member States due to different tax burdens.

Differences between the effective tax burden in the Member States, beside affecting the location choice of resource allocation, may also affect international competitiveness of the companies located in different states. Thus, two different companies, competing in the same market, may face two different tax rates. And although the national tax regimes are designed in more or less integrated systems (when, for instance, high tax rates would correlate with a narrower taxable base and vice versa), the studies show that the tax rates tend to be an important factor for the differences in the tax burden.7

Broad differences of the tax rates in the EU among the Member States8 may have an effect not only on behavior of companies, which would want to exploit differences between tax rules and tax rates in different countries to reduce their tax bills; but also on behavior of governments, which may engage in competition to attract mobile forms of investment by offering lower corporate tax rates or special regimes favouring certain business activities.9

The perfect example would be Ireland with its preferential corporate tax rate for the trading companies. Ireland has been using taxes to attract some sectors of industry already from 1934.10 For a small and open market as it is, the attraction and maintenance of foreign direct investment is critical for the success of the Irish economy. This reality has also been important when shaping its corporate tax system. Reforms to Ireland’s corporate income tax rate, which came with its EU membership, have resulted in application of a 12.5 percent corporate tax rate to all trading profits, and 10 percent applicable to certain manufacturing/trading activities, by this further improving Ireland’s attractiveness as a location for higher risk activities.11

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8 See Appendix 2.
The famous 10 percent corporate tax rate has been introduced in 1987 as a special tax regime in order to attract significant foreign direct investments by multinational enterprises. It applies to the companies operating in the International Financial Service Center (IFSC) located in Shannon region and is only possible to the companies licensed by the Industrial Development Agency (IDA), which gives authorization to beneficial investment projects to the Irish economy and local employment. Availability of this tax rate will cease on 31 December 2010 for manufacturing generally, and on 31 December 2005 for the IFSC and Shannon based projects. It is worth noting that this regime constitutes a State aid within the meaning of Art. 87 of the EC Treaty\textsuperscript{12}, however it also falls under the definition as ‘harmful’ under the Code of Conduct for Business Taxation\textsuperscript{13}. The problem of interpretation nevertheless is solved in favor of Ireland (which, as other Member States, has a right to veto any Commission initiatives leading to unfavorable change in its corporate tax system), as the primary goal of the IFSC regime can be considered not attracting international investors by affecting their location decisions, but the economic development of the specific area.\textsuperscript{14}

\textbf{(3) Cross border double taxation due to different tax systems.}\n
Lack of coordination between different corporate tax systems among the Member States may give rise to double taxation where the shareholder is subject to full income taxation in his country of residence. Although the issue of double taxation is dealt with in bilateral and multilateral double taxation agreements between some of the Member States; some Member States with some third countries; and even by EU Arbitration Convention for a limited period\textsuperscript{15}, - some “overlaps” still exist for the multinational companies operating in some Member States.

Among the number of other possible drivers for European corporate tax harmonization exist both economic and political incentives, which include the launch of Euro as a single currency and successful operation of the European monetary Union (EMU); national tax reform initiatives (Germany and France tax reforms and initiatives to substitute unanimity with qualified majority voting in direct tax issues and to take steps towards harmonizing minimum corporate taxes); EU

\textsuperscript{12} See section 3.4. State aid in chapter 3.
\textsuperscript{13} For the details on the Code of Conduct see chapter 4, section 4.5.
\textsuperscript{14} \textit{EU and OECD to Fight Harmful Tax Competition: Has the Right Path Been Undertaken?} C. Pinto, Intertax, Vol. 26, Iss. 12 [Kluwer Law International 1998]
\textsuperscript{15} EU Arbitration Convention 90/436/EEC on the elimination of double taxation proposed in 1990, came into force on 1 January 1995 having been ratified by all the contracting states. However, it was applicable for a period of five years only and therefore ceased to be effective on December 31, 1999. The EU Arbitration Convention is still not applicable not all EU Member States have ratified the 1999 extension protocol yet.
enlargement; globalization making the capital more mobile; as well as EU initiatives to prevent unfair tax competition, in combination with the developing case-law of the ECJ in the area, etc.

2.3. Desirable harmonization

So, harmonization to some degree or rather “closer coordination”, as highlighted by M. Monti, of national corporate systems is believed to solve the aforementioned problems and complete the picture of the effective functioning of the single market.

A number of theories have been developed and studies conducted to find out the degree of desirable harmonization and its characteristics. It is outside the scope of this paper to discuss the theoretical models suggested by the economists, however following the line of the EU Commission initiatives (which has been taking into consideration economic theories when developing its legislative proposals), one may note how the applied approaches of the measures suggested have been changing, given the strong opposition over an extended time. Harmonization of corporate income taxes, first suggested as full, then gradually softening its shape, after a long break followed with the focus set on coordination and mutual approximation of the Member States’ tax systems. With the recent breakthrough as the Code of Conduct, harmonization of corporate taxation was suggested essential only when it was recognized as ‘harmful’ to the fair competition conditions of the single market; and the latest focus has been being set on the introduction of a consolidated corporate tax base and Commission’s focus on “coordination” as opposed to harmonization of the corporate tax systems among the EU Member States.

However, the use of the “coordination” expression might just be a more diplomatic way of referring to tax harmonization. As insightfully noted by L. Hinnekens in his analysis of the Monti Report,16 ‘tax coordination’ term often emphasizes subsidiarity, while the use of term ‘tax harmonization’ is becoming increasingly less popular, especially when dealing with national authorities. However in fact “harmonization and coordination are nowadays often used interchangeably referring to both legislative and non-legislative action by the respective Community institutions” to the effect of approximating Member States’ tax systems (also for the purposes of not only completing the common market).

Whatever shape the EU Commission’s policy takes, it is anyway clear that inaction is not a viable option in this subject. The question is how it is possible to reach the solution, given the mentioned deep-set structural conflict of the interests in the European integration process. In order to investigate that question, the essentials of the basis for the corporate income taxation, that exists in the EU up to date, must first be considered.
3. Legal basis for EC corporate income taxes and instruments to eliminate the resulting distortions to the common market

In the question of a legal basis for the corporate income taxation the Treaty is one major difficulty itself. Since corporate income tax is a direct tax, the issue of the EU’s competence to harmonize tax on income from corporations needs to be examined against the more general background of the harmonization of direct taxes.

3.1. Treaty Limits

In the EU, responsibility for tax policy lies mainly with the Member States, and the European Union plays only a subsidiary role on taxes and social security contributions. Its aim is not to standardise the national systems of taxes, but to ensure that they are compatible, not only with each other, but also with the aims of the Treaty establishing the European Community.

Indirect taxes require a high degree of harmonization, as they affect the free movement of goods and the freedom to provide services. Therefore in the field of indirect taxation the Treaty of Rome provides a relatively sound legal framework in Articles 90-93, and an agreement between the Commission initiatives and the Member States has easily been found.

In case of direct taxes the Treaty does not specifically call for them to be aligned. Some aspects of direct taxation do not in fact need to be harmonized or coordinated at all and are left entirely to the discretion of the Member States, in accordance with the principle of subsidiarity. Therefore the EC Treaty has provided hardly any legal base for direct taxation at all. The Member States are just merely required to obey in the exercise of their direct taxes the following general principles of the Treaty:

− They must not impede the freedom of movement of persons, businesses and capital, as well as the freedom to provide cross-border services; (Arts. 29, 43, 56, 49). Under this also fall requirements not to distort conditions of competition through the provision of tax breaks and

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17 Taxation and Customs Union, Background to where we are now. europa.eu.int/comm/taxation_customs/taxation/company_tax/background.htm
relieves to national businesses in the form of state aid as opposed to general measures of taxation; (*Art. 87*)

- They must not infringe the central principle of EC law prohibiting discrimination on the grounds of nationality in areas falling within the scope of the Treaty. (*Art. 39.2*)

- They must follow the five harmonization directives adopted up to now: Mutual Assistance Directive, Merger directive, Parent-Subsidiary directive, Directive on taxation of savings income in the form of interest payments and Directive on interest and royalty payments.

These principles are to be discussed in this chapter in more detail, and the content of the Directives will follow up in chapter 4. As for now, it suffices to note that these principles help to achieve the main task of the Community, as formulated in Art. 2 of the EC Treaty, to establish “a common market and an economic and monetary union” and “promote throughout the Community harmonious, balanced and sustainable development of economic activities […]”.

**Articles 2, 3 and 4**

In order to achieve this common market, the EC must accomplish a number of “common policies or activities referred to in Articles 3 and 4” (*Art. 2*), like approximation of laws of Member States to the extent required for the adequate functioning of the common market (*Art. 3 sub h*). Widely divergent tax systems (including corporation taxes) between the Member States may distort the establishment or functioning of the EC common market. Therefore, to the extent necessary, the national laws must be amended, along with other measures taken aimed at eliminating those distortions.

From this it follows that in spite of the lack of reference in the EC Treaty precisely to corporate taxation, there is a theoretical connection that exists between corporate taxes and the concept of the EC Common Market. In order to understand better this connection and its impact to the legal basis for the corporate income tax in the EU, the concept of the common market, as the one that the EC the Treaty refers to, will be first described in short.

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18 This link was identified in the early stages of the EC’s existence and supported by some commentators and official reports, like, for instance, the ‘Neumark Report’ in 1962. (See chapter 4, section 4.2.1.)
The Concept of Common Market

The EU Commission created the legal concept of a ‘common market’ (which is set up in the Treaty of Rome), basing on an economic one - Jiménez suggests an innovative comparison between them.\(^{19}\) In any case, achievement of a common market involves the concepts of ‘positive’ and ‘negative’ integration, where negative economic integration consists of the “removal of discrimination between the economic agents in the different Member States” and positive integration involves “the formation and application of coordinated and common policies in order to fulfill economic and welfare objectives other than the removal of discrimination”\(^{20}\). According to the economists, the concept of a common market should not be reduced to only prohibiting measures, but also involve coordination or harmonization of certain policies.\(^{21}\) Thus, the creation of the common market would not only require the removal of obstacles to the free movement of products, services, capital and labor, but also through measures of a positive character (i.e. coordination or harmonization).

It is interesting to note on the example of EC policy regarding indirect taxation, where the prohibition of levying discriminatory indirect taxes upon products from other Member States (in the form of EC Treaty Article 90) – a negative measure – was not enough to achieve the common market. Positive integration (in the form of directives\(^{22}\)) was needed in order to eliminate distortions to the free movement of goods caused by the cumulative indirect taxes in force in the Member States.

However, originally, the Treaty of Rome did not define the common market as a concept. It simply laid down its goals (Arts. 2, 3), a period of time in which the common market was to be realized\(^{23}\) and a number of articles oriented towards the removal of discriminations or obstacles for free circulation of goods, workers, services and capital\(^{24}\), and one article about the approximation of

\(^{19}\) Jiménez (1999), Chapter 1.
\(^{20}\) Positive Integration and Negative Integration: Some Problems of Economic Union in the EC, Pinder (1968), World Today, No. 24, pp. 90, 98.
\(^{23}\) According to Art. 14 (ex 7a) sub 1, this period expired on 31 December 1992.
\(^{24}\) EC Treaty, Arts. 23-31 (for free movement of goods); Arts. 39-42 (free movement of workers); Arts. 43-48 (right of establishment for individuals and companies); Arts. 49-55 (free provision of services); and Arts. 56-60 (free movement of capitals).
harmonization of Member States’ legislations that may impinge upon the “establishment or functioning of the common market”\textsuperscript{25}. From the point of positive/negative type of integration, applied in economic theories, these measures are mainly of a negative character. Yet, as Jiménez suggests, inclusion of Art. 94 to the Treaty proves that its drafters foresaw elements of possible positive integration during the process of establishment of the common market, calling for harmonization of the Member States’ legislation in this subject.

As the Treaty did not give a clear definition for the common market, EC Commission and European Court of Justice were left to delimitate this concept. Jiménez suggests an insightful analysis on the developments on this issue, which are not of a value in this paper. The outcome, however, is as follows: the EC Commission and ECJ, the legal doctrine together with economic theory agree upon the concept of the common market and consider that for its establishment both negative (removal of discrimination) and positive integration tools (the adoption of harmonizing measures aimed at formation and creation of common policies) are important.\textsuperscript{26} However, the question of whether positive or negative integration is of a higher necessity when dealing with direct taxes, is open for discussion, and I will come back to it when describing legislative means to eliminate corporate tax distortions to the common market.

A notice should also be made about the term of ‘internal market’ (or ‘single market’) in comparison with the ‘common market’ concept. Economists tend to have different opinions about whether the ‘internal market’ concept is narrower than the ‘common market’.\textsuperscript{27} In this paper I will consider both concepts equivalent, as both of them refer to elimination of barriers to the free movement of goods, services, persons and capital, as well as to the maintenance of the conditions of fair competition. In addition, both of the concepts encompass negative and positive instruments and thus are equivalent in practical terms for the purpose of this paper.

So, to conclude, it can be said that the EC Treaty does have some influence on the Member States’ corporate taxes: the goals of eliminating inefficient and distortive company taxes are somehow to be

\textsuperscript{25} EC Treaty, Art. 94.

\textsuperscript{26} Jiménez bases his conclusion on analysis of references to the ‘common market’ in the “Neumark Report” (1961), White Paper on the Common Market (1985); Cases: Consten and Grundig v. Commission (1966); Polydor v. Harlequin (1982); Schul (1982). Single European Act complicated the idea of the ‘common market’ by bringing up the concept of the ‘internal market’. In the end, the ECJ ruling in Titanium Dioxide case confirmed that both concepts were equivalent in practical terms, and both encompassed the notions of negative and positive integration.

\textsuperscript{27} See Jiménez overview of the economists’ elaboration of both concepts in Towards Corporate Tax Harmonization in the EC: An Institutional and Procedural Analysis, p. 6.
found in EC Treaty Articles 2, 3 and 4. However, those provisions are too abstract and vague to be used as a legal basis for harmonization of corporate taxes.

Article 94 (and 95)

In addition to the EC Treaty Articles 2, 3 and 4, EC Treaty Art. 94 contains a more concrete legal basis for action regarding direct taxes in general and corporate taxes in particular. This article endows the Council, acting unanimously on a proposal from the Commission, to issue directives for the approximation of laws, regulations or administrative provisions of the Member States that directly affect the establishment or functioning of the common market. Art. 94 served as a legal basis for the directives regarding corporate taxation: Mutual Assistance Directive\(^{28}\); the Merger Directive\(^{29}\); Parent-Subsidiary Directive\(^{30}\); Directive on taxation of savings income in the form of interest payments\(^{31}\); and Directive on interest and royalty payments\(^{32}\). Many more proposals based on Art. 94 have been submitted by the Commission, but were later either withdrawn or were never adopted.\(^{33}\)

Art. 94 requires unanimity of votes on decisions by the Council. EC Treaty Art. 95, inserted by the Single European Act in 1986, lists a number of exceptions to these requirements, providing for *qualified majority* decisions on matters concerning the establishment and the functioning of the single market. Art. 95 could also be potentially used as the legal basis for harmonization measures of taxation in the EU, if it were not for paragraph 2 of that article.\(^{34}\) The second paragraph limits the scope of the Article 95.1 by saying that the latter will not apply to tax measures: “Paragraph 1 shall not apply to fiscal provisions, to those relating to the free movement of persons nor to those relating to the rights and interests of employed persons”.

Member States do not wish to relinquish their power to veto any proposed direct tax measures while melding their national tax sovereignty in the Community. So, it is only Art. 94 which remains to be

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\(^{28}\) 77/799/EC Directive on mutual assistance of Member States’ competent authorities in the field of direct taxes, OJ L336 27.12.77, p. 15. See also chapter 4, section 4.3.2.

\(^{29}\) 90/434/EC Merger directive, OJ L225 20.8.90, p. 1. See further chapter 4, section 4.4.2.


\(^{33}\) See further chapter 4 on the historic overview of Commission’s corporate taxation harmonization initiatives.

\(^{34}\) Jiménez (1999), p.15.
a direct legal basis for the harmonization of direct taxation. And because of this, tax matters can only be decided unanimously. The issue of unanimity in direct taxation is one of the cornerstones of the hot debates concerning tax harmonization in the EU.

**Article 293**

In connection with harmonization of direct taxes, reference can also be made to Art. 293 of the EC Treaty, in which Member States are held, to the extent necessary, to enter into negotiations with each other with a view to securing, among other things, “the abolition of double taxation within the Community”. On the basis of this article, a Convention on elimination of double taxation in the case of correction of profits of associated companies was adopted.\(^{35}\)

**Article 308**

Finally, Article 308 of the EC Treaty provides for the Council, acting unanimously on a proposal from the Commission, to take the appropriate measures necessary to attain the objectives of the Community, “if action by the Community should prove necessary and if the EC Treaty has not provided the necessary powers”. This article, among others, has formed the legal basis for the EC regulation on the European Economic Interest Grouping (EEIG), which also contains a provision on the tax treatment of an EEIG. Art. 308 also underlines the intention of the EC requiring that Member States have fiscal measures approved in advance by the Commission, which can have an impact on the realization of tax-harmonization or of a common policy.\(^{36}\)

### 3.2. Legislative means to eliminate corporate tax distortions to the Common Market

In order to shortly summarize and derive conclusions from the previous section about the actual and potential legal basis for harmonization of corporate income taxation in the EU, the focus of the following discussion could be set on what legislative means originate from the articles of the Treaty applicable to the direct taxation for eliminating corporate tax distortions to the common market. Generally, Art. 249 lays down the legislative means available to fulfill the objectives of the Treaty – these are regulations, directives, decisions and opinions. The Commission contributes to the legislative process by initiating the measures proposed; the European Parliament merely delivers its

\(^{35}\) Council Regulation 90/436, OJ L225 20.08.90, p. 10.

opinions on them; and the Council, the legislative body of the EU, actually adopts Community measures.

Art. 93 provides the legal foundation for measures harmonizing indirect taxation and allows it to do for the Council in the form either of regulations or of directives. In effect, regulations are the instruments of more unification rather than harmonization, as they take immediate effect as law in every Member State. And even with indirect taxation, the choice of the regulation for harmonizing purposes in matters of taxation is not popular with the Member States, as, clearly, it limits the freedom of the State (its national parliament) to modify the scope of the regulation or add provisions to it. Directives, on the other hand, are binding to the Member States only regarding its final result and leave to the national authorities the choice of form and methods of its implementation.

As regards harmonization of direct taxes, Art. 94 only provides for directives. Actually, it may be considered that it is the inapplicability of Art. 95 in direct tax matters that leaves ‘directive’ the only legal binding instrument for harmonization of direct taxation: whereas Arts. 93 and 95 (for indirect taxation) refer to ‘provisions’ and ‘measures’ – encompassing, therefore, ‘regulation’ as a legislative measure, – the only legal basis left for direct taxation. that Art. 94 only refers to is ‘directives’.

Recommendation may also be used by the Commission (and they are actually used) in the field of direct taxation, but they are not binding, although they may have their influence on the case law of the European Court of Justice.

Art. 293 provides for still another instrument – the ‘convention’, when the Treaty promotes for the Member States to come to a common agreement on a given tax matter so that to achieve the Community goals; this instrument, however, is even less effective than the ‘directive’. To date only one convention (90/436 on arbitration and abolition of double taxation) has been concluded on this basis in the field of direct taxation. However, for the limited period of five years that it was applicable (from 1 January 1995 until it ceased to be effective on 31 December 1999) not a single

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39 The most important Commission Recommendation on direct tax matters is the one on the tax treatment of frontier workers (94/79/EC Recommendation of 21 December 1993 on the taxation of certain items of income received by non-residents in a Member State other than that in which they are resident, OJ L39 10.02.94, p. 22).
decision has been handed down, principally, because to date in most Member States the national arbitration commissions were still not established under the Convention. At the moment, the EU Arbitration Convention is still not applicable, as not all EU Member States have ratified the 1999 extension protocol yet.

It is clear that the legal effect of adopted measures depends only on the form of the measure (in our case, regulation or directive), rather than the article of the Treaty it is based on. But it is the wording of the Treaty that determines the choice of this measure and probably the type of the voting required to adopt this measure (namely, qualified majority or unanimity).

However, there are also other provisions in the EC Treaty that may have an effect on national systems of corporate taxation. These articles are mainly of a restricting character that provide for elimination of limitations to or discriminations against the free movement of goods, free movement of persons, free movement of establishment, free provision of services, free movement of capitals and state aid (to be discussed in the following sections of this chapter).

So, holding that the above-mentioned distinction between negative and positive integration is also present in the case of corporate taxation, the conclusion can be made that the distortions to the common market of different national corporate laws are to be eliminated:

1. through positive measures: elimination of restrictions of national corporate laws by harmonizing Member States’ legislation on company taxation; and
2. through negative measures: by strict rules on the elimination of discrimination contained in the EC Treaty that the Member States must abide.

That is, as previously defined, both the legal doctrine of the EC Treaty and the case law of the ECJ agree that for the establishment of the common market both positive and negative integration tools are important.

However, from the early strategy of the Commission concerning elimination of corporate tax distortions it follows that the Commission was more oriented on positive integration measures (i.e. harmonization attempts) only. The outcomes of this strategy will be discussed in the next chapter, but for now it suffices to note that, probably, positive integration is not the sole and maybe not the
most important factor in the process when combating tax impediments in the proper functioning of the Common Market. Negative integration is especially important in direct tax matters because national tax systems constantly distinguish to a certain extent between resident taxpayers and non-resident taxpayers, whereas the EC Treaty forbids both overt and covert discrimination of undertakings and nationals of other Member States.

Thus, the question of whether positive or negative integration is of a higher necessity when dealing with direct taxes is open for discussion.

3.3. Fundamental Freedoms

The existence of the common market is to be supported by the abolition of all obstacles to the free movement of goods, persons, services, and capital between the Member States (Art. 3.1.C). Notwithstanding the virtual right of the Member States to retain their national sovereignty in the field of direct taxation, this includes abolition of obstacles to these freedoms caused by national tax measures. In practice this means that the four freedoms – the principles laid down in the EC Treaty – represent a negative integration measure to achieve the common market without barriers.

The ECJ used the doctrines of direct effect and supremacy in applying the rights to four freedoms. The judicial doctrine of direct effect provides for a presumption that Community legal norms must be regarded as “the law of the land in the sphere of application of Community law”41. The principle of supremacy completed the direct effect doctrine by ensuring that in case of conflict between Community and Member States’ norms, the former will prevail.

One can conclude, together with Jiménez, that these judicial doctrines had a great impact on the Community’s legal administration, in the way that while ensuring that the (negative) EC Treaty freedoms provisions are fully and primarily applicable in the Member States, the Court is able to stimulate positive integration.42

It is on the “freedoms” provisions that proposed measures for corporate tax harmonization are sought to be made. The four freedoms encompass two principles: the right of free circulation across

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the borders within the EU and a prohibition of discrimination on the grounds of nationality or origin.

The principle of non-discrimination is one of the cornerstones of the EC Treaty, since it guarantees the Community goals set up in the Treaty Arts. 2, 3. It is set up with a general character of Art. 12, and the most fundamental provisions of the EC Treaty, like the four freedoms or state aid, demonstrate this principle in a practical way. The ECJ has interpreted what discrimination means in EC law: it exists “when similar situations are treated differently or different situations identically”. Moreover, the ECJ has pronounced that “the rules regarding equality of treatment … forbid not only overt [or direct] discrimination by reason of nationality but also covert [or indirect] discrimination by reason of nationality which by the application of other criteria of differentiation, lead in fact to the same result”. Therefore, according to the Court, criteria of differentiation, such as the place of origin or residence, which as a rule disadvantage the foreigners or foreign products as a result, may in practice constitute direct discrimination on the ground of nationality.

The Court’s jurisprudence on non-discrimination has been especially important regarding direct taxation and corporate taxes, because it differs from the concept of discrimination of OECD Model Tax Convention Art. 24, which is based on distinction between residents and non-residents. Unlike the OECD Model, the EC Treaty does not emphasize residence to reveal discrimination, but considers, whether the situations for residents and non-residents of a Member State are comparable: if they are, then discrimination may not exist unless it can be objectively justified.

Free movement of goods encompasses in the EC Treaty prohibitions of:

   a) custom duties and measures having equivalent effect (Art. 25);
   b) quantitative restrictions on imports and exports and measures having an effect equivalent to quantitative restrictions (Arts. 28-30);
   c) exclusive rights on imports or exports and adaptation of national commercial monopolies (Art. 31);
   d) state aids affecting intracommunity trade (Arts. 87-89)
   e) tax discrimination through indirect taxes (Arts. 90, 91)

Most of these provisions are important when studying tariffs, custom duties and indirect taxes. Because of that, in this paper focus will be placed on the provisions affecting company taxes, which concerns Articles 28-30 of the EC Treaty about prohibition of quantitative restrictions on imports and exports and of all measures having equivalent effect.

There are two possibilities for justification the prohibition of non-tariff barriers: Art. 30 and “the rule of reason”. Art. 30 allows restrictions on intra-Community trade, even if they distinguish between imported goods and domestic goods, in case they are justified on the ground of “public morality, public policy, public security, protection of life and health of humans … protection of industrial and commercial property”. These measures are permitted as long as no harmonizing Community measures to protect these interests have come into force and as long as they are not an unnecessary duplication of safety measures already existing.

However, the Court allows restrictions under “the rule of reason”, a concept developed by the Court itself in the Cassis de Dijon judgment. Justifications for trade restrictions are not recognised under the rule of reason, however, if the national restrictive measure distinguishes between domestic and imported goods.

One of the cases decided by the ECJ, which illustrates the effect of the free movement of goods on the national tax systems, is Tax advantages for newspapers publishers case. It concerned a French tax measure allowing publishing firms to form a tax-free reserve for the acquisition of equipment or buildings necessary for the publication of their production, or deduct from their taxable base any expenditure incurred for that purpose. In addition, according to French law, the publishing firms did not benefit from these tax advantages for the part of their publications printed abroad. The Court has considered that this French tax incentive encourages French publishing companies to print in France, which clearly amounts to an obstacle to intra-Community trade, because it hinders the import of the products printed in other Member States. Thus, the French tax provision was regarded as a prohibited measure having equivalent effect as a quantitative import restriction, violating EC Treaty Art. 28. The importance of this case is that it placed tax incentives under the scope of Art.

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46 Case 120/79 Rewe Zentrale AG v. Bundesmonopolverwaltung für Branntwein [1979] ECR 649. The rule of reason test consists of five steps of questions under which the national restrictive measure is analyzed seeking for justification, including the appropriateness and proportionality of this measure.

28, from which it can be concluded that Treaty freedoms may limit the Member States’ tax powers in the field of direct taxation.\textsuperscript{48}

Freedom to provide services (Articles 49-55). On the basis of Art. 50 this freedom has a complementary character to the free movement of goods, persons and capital. It is needed as a separate category, as the cross-border provision of services may as well happen without exchange of goods or without establishments across the border. The freedom to provide services encompasses the right to enter and to sojourn in the territory of another Member State and a right to be treated in the same manner as nationals. The most famous case on direct taxation and freedom to provide services – \textit{Safir} (C-118/96), where the Swedish system of taxing foreign insurance companies was challenged as discriminatory. Here the Court concluded that a Swedish rule imposing a tax on persons paying premiums to a life assurance company established in another Member State, designed to compensate for the yield tax payable by Swedish institutions, discouraged individuals from taking out policies with companies not established in Sweden and created an unjustified obstacle to the freedom to provide services contrary to Article 49 of the Treaty.\textsuperscript{49}

Free movement of persons: free movement of workers (Articles 39-42) entails the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration, and other conditions of work and employment. As previously mentioned, the non-discrimination principle does not allow covert discrimination either: for instance, the place of origin or residence of a worker may as well have effect of discrimination on the grounds of nationality.

\textbf{Free movement of persons: freedom of establishment (Articles 43-48)}

Like other freedoms, the freedom of establishment rests upon the non-discrimination principle. It is vital for elimination of barriers to a more effective utilization of available resources (e.g. entrepreneurial and organizational skills of the nationals and companies of another Member States) in the enlarged market. The freedom of establishment first of all prohibits the restrictions to the freedom for a national of one Member State to establish on the territory of another Member State. That prohibition also applies to restrictions on the setting-up of agencies, branches or subsidiaries.

\textsuperscript{48} The trend in this case was later confirmed and reinforced in \textit{Avoir Fiscal} case - on Art. 43.

The abovementioned provisions, laid down in Art. 43 of the EC Treaty and the followed by the other articles of that chapter of the Treaty, can be commented on the following. First, as regards the types of the companies which are beneficiaries of the right of establishment, it is clear that the Treaty is very liberal: the definition of the ‘companies or firms’ in the second part of Art. 48 is broad enough to cover all corporate businesses (whether civil or commercial, public or private). They just have to be set up under the law of a Member State and have a business character.

Second, Art. 43 contains the distinction between the right of primary and secondary establishment: that is, (1) to take up and pursue activities as self employed persons and to set up and manage undertakings; and (2) to set up agencies, branches or subsidiaries in other Member States.

The last ones constitutes secondary establishment, as the legal person establishing such brunch remains where it is.

Third, as suggested by Wouters\(^{50}\), the right of previously mentioned secondary establishment poses a question, whether the types of secondary establishment named by Art. 43 are exhaustive or not. From the case-law it follows that they are not. In the German insurance judgment\(^{51}\), the Court held that

> “an insurance undertaking of another member State which maintains a permanent presence in the Member State in question comes within the scope of the provisions of the Treaty on the right of establishment, even if that presence does not take the form of a branch or agency, but consists merely of an office managed by the undertaking’s own staff or by a person who is independent but authorized to act on a permanent basis for the undertaking, as would be the case with an agency”\(^{52}\).

Finally, a problem can arise when trying to determine whether a company from another Member State is discriminated against contrary to Art. 43, since the EC Treaty does not specify any relevant test to be held for this conclusion. It only mentions three criteria in Art. 48 (registered office, central administration and principal place of business) to specify which companies can enjoy the freedom of establishment. As the concept of discrimination involves the concept of ‘nationality’ of the company in question, these three criteria also suggest implications of that issue.


\(^{52}\) Ibid. para. 21.
Art. 43 gives a right to the “nationals of a Member State” to benefit from the freedom of establishment. In case with natural persons, the question of their nationality is to be decided by the law of the Member State that confers the nationality, and other Member States have to abide by that decision\textsuperscript{53}. However, as concerns legal persons, the question of their nationality is not that easy to solve. In connection to that, Art. 48 of the EC Treaty provides:

“Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter [the Chapter on freedom of establishment], be treated in the same way as natural persons who are nationals of Member States”.

Thus, in order to benefit from the provisions of the freedom of establishment, the company must be formed in accordance with the law of a Member State and conform to one of the three possible connection criteria with the Community: it must either have its registered office, central administration or principal place of business within the Member States. Already the fact that there are three alternative connection criteria, placed on equal footing, reflects that there is a disparity in what the Member States consider to be relevant connection criteria between a company and the national territory\textsuperscript{54}. In the perspective, it presupposes mutual recognition of the companies, considered being nationals of their Member States by one or other criteria. The need for mutual agreement and generally the fact of disparity is further confirmed in Art. 293, where among other conditions it is mentioned that “Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals… the mutual recognition of companies or firms within the meaning of the second paragraph of Art. 48…”.

In the EU there are two principles, describing the connection of a company to the Member State: the incorporation of the company and the real seat of the company (siege reel or the head office).\textsuperscript{55}

These are two conflicting criteria, and each of them points to the company’s valid law, i.e. the basic legislation governing the company’s affairs. For countries following the incorporation principle the law governing a company is the law of the place of incorporation; and for the countries following

\textsuperscript{53} In Case C-369/90 Mario Vicente Micheletti and others v Delegación del Gobierno en Cantabria [1992] ECR I-4239 the EC Court has ruled that, for example, it is not permissible for one Member State “to restrict the effects of the grant of the nationality of another Member State by imposing an additional condition for recognition of that nationality with a view to the exercise of the fundamental freedoms provided for in the Treaty”.


\textsuperscript{55} Currently there are nine Member States that follow the seat principle and six follow the incorporation principle (the Netherlands, the United Kingdom, Ireland, Denmark, Sweden and Finland.)
the seat principle, the law governing the company must be the law of the place of its real seat. Under the ‘real seat’, the place of the central management and control of the company is usually understood; however, it is not excluded that interpretation of this concept may also vary somewhat.

In practice, it is a common case that the seat of the company is where it is incorporated. Yet, in an integrated and globalized economy as the EU finds itself in, a phenomenon may occur, when the place of the seat and the place of incorporation do not coincide. This situation may affect the freedom of establishment and, as it presupposes mutual recognition of companies by Member States, which can practice different principles, it gives rise to a number of cases drawn before the ECJ. Besides, it is also interesting to investigate the relevant case-law on this subject in order to comprehend, which of the principles the EC Court tends to second in its rulings.\(^\text{56}\)

It is obvious that the incorporation principle favors the mobility of companies, as centers of management and control may be moved across the borders without a need to re-incorporate. On the other hand, this principle sets a possibility for creation of pseudo-foreign companies, which may not have a link to the country of their incorporation other than incorporation itself, so that to make use of the lax company laws of that Member State and/or to avoid the application of more strict rules in the country of their business. As the States may have an interest in attracting companies, apprehension arises that the incorporation principle may lead to competition among the Member States to have the most attractively lenient company laws (including company tax laws). This competition, however, may lead to what is called a ‘race to the bottom’\(^\text{57}\).

On the other hand, the real seat principle ensures a closer link of the company to the State, where it operates, and thus tends to protect domestic interests. However, as the case-law shows\(^\text{58}\), it may also entail obstacles to the free movement of companies. Analyzing the relevant case law, one can pose oneself questions: whether these obstacles fall under the provision of Art. 43, i.e. infringe the freedom of establishment; and if affirmative, are any justifications possible?

As regards corporate income tax, Daily Mail case (Case 81/87) together with other cases are to be studied in detail later in chapter 5. Concerning possible justifications regarding restriction to the freedom of establishment, we can run a few steps forward and say that from the EC Court’s ruling

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\(^{56}\) See further chapter 5, section 5.3.1.

\(^{57}\) A ‘race to the bottom’ in case or corporate taxation is a zero tax or an atrophy of institutions and states, in general.

\(^{58}\) See further cases in chapter 5, section 5.3.1.
to the *Centros* case\(^{59}\) it follows that “imperative requirements in the general interest such as aims of protecting public and private creditors and preventing fraud may be possible justification grounds”.

Coming back to the Art. 293 and the problem of mutual recognition, it is needed to note that as the two conflicting criteria are used to determine the nationality of a company, it also affects the issue of changing its primary establishment. Again, the situation is clear for a natural person, as his/her nationality is not questioned. As for the companies – apart from the European Company\(^{60}\) – they are creatures of national law and exist only as legal persons governed by national law. And in order to coordinate their transfer, “Member States shall … enter into negotiations with each other … [in order to agree upon] the retention of legal personality in the event of transfer of their seat from one country to another…” However, these negotiations are provided for only “so far as is necessary”, i.e. to the extent that the Community legal instruments intended to facilitate freedom of establishment, and thus are not always likely to attain that objective.

As has been insightfully noted,\(^{61}\) it is quite paradoxical that several EU countries have resolved the division between the main seat and the registration criteria, by entering into Treaties with third countries, while not having resolved the matter internally, within the EU. In fact, this question of recognition of a legal person between the Member States in the EU has been left quite unsettled, except for the European Company Statute and the Fourteenth Directive (Coordination Directive relating to transfers of registered offices, based on Arts. 44(1) and (2)(g) of the Treaty).\(^{62}\) And the Court itself concluded that a legislative effort is needed in this field in order to implement the freedom of establishment in the manner intended by the Treaty.\(^{63}\)


\(^{60}\) *Societas Europaea* – see further chapter 4, section 4.6.3.


\(^{62}\) At the present stage in the development of Community law and of the case-law of the ECJ in particular, the Commission departments are planning to prepare separate legislation governing transfer of the registered office (see Commission’s Action Plan of 21 May 2003, IP/03/716 and MEMO/03/112).

\(^{63}\) More precisely, a legislative effort or an international convention: as the Court stated in *Daily Mail* (Case 81/87) (para. 23), “It must therefore be held that the Treaty regards the differences in national legislation concerning the required connecting factor and the question whether - and if so how - the registered office or real head office of a company incorporated under national law may be transferred from one Member State to another as problems which are not resolved by the rules concerning the right of establishment but must be dealt with by future legislation or conventions”.
To sum up, apart from the abolition of double taxation, Art. 293 mentions in its third indent three sets of problems related to cross-border establishment of companies (with first and second being discussed above):

1. the mutual recognition of companies or firms [...],
2. the retention of legal personality in the event of transfer of their seat from one country to another, and
3. the possibility of mergers between companies or firms governed by the laws of different countries.

No conventions on any of the three subject matters have been concluded on the basis of Art. 293\(^4\).

**Free movement of capital and payments (Articles 56-60)**

The right of establishment of undertakings implies the need for the free movement of capital, as cross-border establishment of undertakings usually entails cross-border capital movements. Therefore Arts. 56-60 of the EC Treaty ensure the free movement of capital and payments, according to which, all restrictions to this freedom are abolished, both between Member States and between Member States and third countries (Art. 56). In addition, the Council Directive EEC/88/361\(^5\) supplements liberalization of capital movements, under which the Member States are supposed to unconditionally abolish all restrictions to the free movement of capital within the Community (Art. 1). After 1 January 1994 the EC Treaty Art. 56 “constitutionalized”\(^6\) these provisions within the EU and added that this obligation applies to capital movements between the Member States and the Member States and third states.

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\(^4\) On the basis of Art. 293, a Convention on the Mutual Recognition of Companies, signed on 29 February 1968 has never come into force due to the non-ratification by the Netherlands. A draft convention on international mergers of 1973 never got further than some negotiations either.


\(^6\) I borrow this term “constitutionalize” about including the capital freedom principle into the EC Treaty from Jiménez, as it perfectly describes not just the fact of the provision “legalization”, but also suggests the difference of the treatment of a Directive and a Treaty article as a means for a legal basis.
Freedom of payments is a complementary freedom to the other fundamental Treaty freedoms, since the provisions of the free movement of payments prohibit any restriction or discrimination to the transfer of funds necessary for the exercise of the four fundamental freedoms.

Article 58

Notwithstanding the provisions laid down in Art. 56, Art. 58.1 retains for the Member State the right “to apply the relevant provisions of their tax law which distinguish between tax-payers who are not in the same situation with regard to the place where their capital is invested” (Art. 58.1 (a)) and “to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation […]” (Art. 58.1 (b)).

For analysis of the first and second part of Art. 58.1, it makes sense to take a look at the previously mentioned Council Directive EEC/88/361, where the freedom of capital movement derives from. Art. 58.1 (b) largely draws on Art. 4 of the Directive, although it adds that the Member States are allowed to apply restricting measures on the free movement of capital and payments, “which are justified on the grounds of public policy or public security”. This formulation reminds the justification of the free movement of goods in Art. 30, which is allowed on the ground of “public morality, public policy, public security…” and confirms the continuity of the Treaty and the Court’s former jurisprudence that discrimination may be permitted in an area like tax law (for instance, in the case Cassis de Dijon, where the effectiveness of fiscal supervision is one of the public interest exceptions that justify restrictions to EC Treaty Art. 30, and in Avoir Fiscal\textsuperscript{67} case, where discrimination may be permitted in an area like tax law).

The meaning of Art. 58.1 (a) is more difficult to interpret. Its provision to distinguish between taxpayers who are not in the same situation with regard to the place where their capital is invested allows some commentators to conclude that, in derogation of the principle of non-discrimination, Art. 58 legitimizes, to a certain extent, different tax treatment of resident and non-resident taxpayers, and of domestic and foreign-source investment income, at least as far as the freedom of capital is concerned (Art. 58.3).\textsuperscript{68} In other words, Art. 58.1 (a) allows discrimination in the field of

\textsuperscript{67} See further section 5.3.2.

direct taxation. To amend this statement, I would agree with Jiménez, that paragraph 3 of Art. 58 does not permit to confirm their announcement, as it constitutionalizes the jurisprudence of the Court on non-discrimination: “The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Art. 56”. Besides, Arts. 2 and 3, which lay down the preservation of the acquis communautaire, support this conclusion.

Concluding remarks

As previously mentioned, the EC Court decisions concerning the free movement of goods in Tax advantages for newspapers publishers case and the freedom of establishment in Avoir fiscal case suggest a conclusion that the EC Treaty freedoms may limit the Member States’ tax powers in the field of direct taxation. It would be in our interest also to consider the situation, where, on the other hand, the Member State’s national tax laws can possibly impact the Treaty freedoms and thus present one more reason for harmonizing capital taxation within the EU. In case of the free movement of capital, the question arises, for instance, whether maintaining low-tax jurisdictions within the EU would impact this freedom.

The German withholding tax experience gives a clear example of a positive answer to this question. The announcement by the German Government in October 1987 to introduce a 10 percent withholding tax immediately resulted in massive capital movements, mainly in the direction of the Luxemburg banks. Since the economic situation in Luxemburg banks had not changed overnight, it gives the idea that the reason for the sudden attraction of Luxemburg was purely tax-driven.

The next question to consider is whether the provision of the free movement of capital has been affected in this example. The main purpose of this freedom is to combat restrictions imposed by the Member States on investments made by their residents in another Member States. The logic of the EC Treaty expresses the principle of economic liberalism, when capital ought to be invested where it yields most. As Steichen believes, the freedom of capital movement does exist in today’s sophisticated financial markets, even though there are low-tax jurisdictions within the EU. This statement is argued by the fact that whereas in the past there was a link between the savings of a

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given country and the investments made in that country, the situation in today’s EU is more a case of the total savings of EU residents financing investment projects in the EU, regardless of their exact location. From this it follows, that the case for harmonizing capital income taxation on the grounds of the freedom of capital movement appears to be rather weak.

3.4. State Aid (Article 87)

A common market presupposes accessibility and unity of the market. However, public, along with private law impediments can pose distortions to normal conditions of competition in the common market. The main public law impediments to competition are national measures discriminating against foreign products, services, work and capital. The fundamental EC Treaty freedoms make sure those distortions are opportunely pre-empted.

However, public law provisions may also restrict competition conditions through State aid for national economic activity and State monopolies. The latter are subject to the same competition rules as for private monopolies (Art. 10 and Art. 86(1) of the EC Treaty; besides, the Treaty provisions against private restrictions to competition (such as prohibitions on cartel agreements, abuse of a dominant position, dumping practices – Arts. 81, 82) also apply to public undertakings.

Public restrictions of competition through State aid are regulated by the Treaty Arts. 87-89. Generally, the provisions of public funds, subsidies or other form of aid to national undertakings is considered a necessary instrument of government policy. The purpose of such aid may be, for example, to attract investment into areas that are economically underdeveloped or where the existing industries are declining; or to improve the efficiency of the undertakings in a given industrial sector; or to encourage the development of new high-technology industries requiring substantial expenditure on research and development. However, granting State aid is liable to cause difficulties in running the normal competition conditions in the common market. Therefore, the measures are taken to regulate that – as it follows from Art. 88, control of State aids is the exclusive competence of the Commission; in addition, the EC Court has also made some important input on the subject as well.

Art. 87 sets out the principles on the basis of which compatibility of State aids with the common market is judged. As the Court has observed, “the aim of Art. 87 of the Treaty is to prevent trade
between Member States from being affected by advantages granted by public authorities…”\(^{71}\). Paragraph (1) of the article lays down the general principle that State aid falling under the broadly defined criteria is incompatible with the common market. Paragraph (2) gives a list of exceptions—the forms of State aid compatible with the common market; and paragraph (3) provides with discretionary exceptions. For the purposes of State aid Treaty definition only paragraph (1) of Art. 87 will be discussed further in more detail.

From Art. 87(1) it follows that the form of the aid granted is irrelevant. It can be subsidies, low interest loans, cheap energy supply for certain sectors, as well as tax relief. It becomes a more often case that national investment incentives or employment measures take the form of tax provisions. An example could be the previously illustrated case about tax advantages for newspaper publishers\(^{72}\). In that instance, the national tax measure, favoring only national printing production, restricted the free movement of goods and fell under the provisions of Art. 28. However, usually such measures fall under the scope of Art. 87, prohibiting any State aid, whether direct (in the form of subsidies), or indirect (for example, via tax measures), save for several exceptions listed. Thus, as it is formulated in the legal literature\(^{73}\), “State aid is to be understood in terms of its function as an instrument of national economic and social policy, resulting in a tangible benefit for specific undertakings or individuals”. The EC Court has repeatedly held that the prohibition in Art. 87(1) does not distinguish between measures of State intervention but rather defines them in relation to their effects.\(^{74}\)

So, in order to constitute a State aid, a public support measure should provide “aid” or a benefit that reduces the expenses normally borne in the accounts of the recipient companies. Besides, the aid should be granted “by a Member State or through State resources”; the latter includes companies or undertakings owned or controlled by the State or other agencies of the State. This kind of aid comprises grants by regional or local authorities as well as by central government.

Another condition for a measure or scheme of similar kinds of aid to constitute State aid, which it has to satisfy cumulatively together with the other provisions here listed, is that the recipient is an “undertaking” – that is, a legal or natural entity that engages in economic transactions.

\(^{73}\) European Union Law, Wyatt, Dashwood et al. (Sweet & Maxwell, 2000), p. 681.  
Central to the notion of aid, characteristics of benefactor and beneficiary of State aid, is the requirement that it must “favor” certain undertakings or the production of certain goods. This formulation impliedly requires some comparison to be made between the treatment of the aid beneficiary and the position of other undertakings. The Commission view, supported by European Courts’ case-law, is that hypothetical market investor test helps to determine, whether situation is advantageous or not. The key question in this investigation principle is whether the recipient undertaking receives an economic advantage which it would not have obtained under normal market conditions.75

It should be also noted that Art. 87(1) only covers aid, which is selective “by favoring certain undertakings or the production of certain goods”. From this it can be derived, that a distinction is drawn between general measures of economic policy (such as a specific tax regime for the self-employed, which may improve the position of undertakings in the country vis-à-vis their competitors in the Community), and the measures giving a competitive advantage to particular undertakings or industrial sectors. At this point, one could agree with the conclusion of some commentators76 that a general investment incentive, either through tax relief or otherwise, potentially benefiting all undertakings resident in a Member State, does not fall within the scope of Art. 87.77

The same applies for specific tax relief when cross-border trade between Member States is not affected. The Irish favorable corporation tax regime for IFSC’s (International Finance Service Companies) could be a good example for illustration.78 The reduced corporation tax rate of 10 percent was a clear measure of State aid, falling under provision of Art. 87(3) and needing the approval of the Commission, as it was definitely not a general investment incentive, but a measure favoring certain undertakings in a certain area (Shannon). The measure was nonetheless (temporarily) approved by the Commission under Art. 87(3)(c), since it constituted “aid to facilitate the development of certain economic activities or of economic areas”.

77 See below an example from the case C-70/72 Commission v. Germany [1973] ECR 813.
78 See previously chapter 2, section 2.2. (2).
Coming back to the option of tax incentives as a rule being *general* in their application in the Member States and therefore, falling outside the scope of Art. 87, it must be specified, however, that tax exemptions [even of a general application] granted on a *sectoral* or *regional* basis are not considered to be general measures and therefore are found to constitute “aid”, in case the reduction is confined to products defined by regional, sectoral or other criteria. The case brought by the Commission against Germany\(^79\) concerning the State’s [Germany] assistance in coalmining has established this rule from the early stages of the Community.

In the late 1960s Germany has obtained approval from the Commission to reduce taxes for new investments in the coalmining industry. However, later on, with the purpose to assist regeneration of the coalmining industry, Germany modified the aid scheme, so that tax benefits would be applicable not only to new investments, but to all companies investing in the regions affected by the coalmining crisis. However, these non-sectorally selective but regionally concentrated incentives were considered to constitute State aid anyway.

On the other hand, it is important to note that because the tax systems of the Member States are not completely uniform, already differences in the treatment of companies themselves may be found infringing provisions of the Treaty (for instance, be contrary to the obligations of free movement and free establishment), even if there is no sectoral or territorial differentiation in treatment.

From this it follows that the Commission may find Art. 87(1) applicable *by virtue* of infringement of another Treaty provision.\(^80\) This conclusion confirms once again that, despite the national sovereignty left to the Member States to decide upon their direct tax systems, the Commission rules upon these matters “with a rod of iron” and does not make it an easy way to find justifications for national taxation provisions, which have been found discriminative. If a tax measure is found discriminative against other undertakings (and this already allows calling it “selective”), it is considered to infringe some provision of the Treaty and just by virtue of that – also to be a form of State aid. This conclusion is important, as it deprives that measure from possibility of obtaining any exemption under Art. 87(3), because the exemptions under Art. 87(3) cannot benefit a measure that violates other provisions of the Treaty.\(^81\)

\(^{79}\) C-70/72 Commission v. Germany.

\(^{80}\) Nicolaides (*World Competition* 2001), p. 326.

\(^{81}\) In the case C-156/98 Germany v. Commission [2000] ECR I-6857 the Court found that tax incentives for companies established in Berlin and new Länder were contrary to Art. 43, even though they were applied in a non-discriminative
In connection with this finding, which reveals the relationship between Articles 87-89 and other Treaty provisions, a question arises whether reverse dependence is possible. In other words, if a measure is regarded as a form of State aid, does its compatibility with Community law fall to be determined exclusively on the basis of State aid provisions? The answer, which emerges from the relative case-law, is negative. In *Commission v. Italian Republic* case\(^{82}\), for instance, it was made clear that a measure of discriminatory taxation, which may be considered at the same time as a forming part of an aid within the meaning of Art. 87, remains nonetheless subject to the prohibition in Art. 90: “…It follows that discriminatory tax practices are not exempted from the application of Art. 90 by reason of the fact that they may at the same time be described as a means of financing a State aid.”

So, as it can be seen from examples listed, tax provisions that discriminate in favour of, or treat certain companies in a different manner may be regarded as ‘selective’ and, consequently, constitute a form of State aid in the meaning of Art. 87(1). However, given the fact that tax systems are not uniform throughout the EU, the problem arises, what kind of differentiation is acceptable to use when defining whether the tax provisions contain a State aid and therefore whether they are compatible with the common market.

It is suggested\(^{83}\), that the easiest criterion for establishing whether a tax measure is a form of State aid is to ask whether the government of the taxing authority loses or forgoes revenue. Commission Communication 1/94 concerning tax relief (in the form of reduced rate of corporate tax) granted to mushroom growers in Ireland is an example of such a measure: it involves some loss of tax revenue and has been found to be State aid. However, it must be kept in mind that loss of tax revenue by public authorities does not necessarily imply that a certain measure is a form of State aid.

Distinguishing between general and specific tax measures, on the other hand, could be a helpful tool to define discrimination. For this purpose Nicolaides overviews three “tests”, which have been initiated by advocates-general in their opinions on State aid cases.\(^{84}\)

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\(^{82}\) Case 73/79 *Commission v. Italian Republic* [1974] ECR 177, concerning internal taxation measure “surcharge”, found to be discriminatory.


\(^{84}\) Nicolaides (*World Competition* 2001), p.331.
1) The first test was proposed in *Sloman Neptun* case\(^85\), where A-G argued that “a measure is not general (hence, it is ‘specific’) when it constitutes a derogation from the scheme of the general system”. The ECJ uses this definition to identify ‘specific’ tax measures.

2) The second test derives from *Italy v. Commission* case\(^86\) concerning tax credits to road haulers. Here the A-G concluded that “a measure is general when it follows from or is compatible with the internal logic of the tax system”. The limitation of this test is that an ad hoc element of a tax system (which by no means makes it ‘specific’) can be not at all compatible with the overall logic of that system.

3) The third test appears in *Belgium v. Commission* case\(^87\), where it is concluded that “a measure is general when it aims to achieve equality between businesses and it should apply to all undertakings to which it is capable of being applied”. This formulation is criticized for being not specific enough and ambiguous.

In summary, it is recognized that the fundamental weakness of these tests, which appeared in the case-law, is that they assume that from reviewing a tax system, a benchmark can be established, and the digressions from it help to classify the policy measures applicable.

Because of these limitations of the tests, an alternative two-stage test for identification of fiscal aid has been suggested. The first stage establishes the “revealed potential targets” (i.e. the companies or regions that can potentially benefit from a fiscal aid); while the second stage identifies the “revealed potential scope” of their policy measure in question. As a result of this test, a measure is considered to be general, when both its revealed targets and revealed scope do not pose an obstacle for any potentially eligible firm from any sector or region to enter the market.

The test in essence requires, first, that no company that could potentially benefit is excluded and, second, that public policy measures used to determine eligibility are not defined so narrowly that they may also favor certain undertakings by limiting the extent of their application.\(^88\)

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\(^88\) For more details see Nicolaides.
Conclusions

Some public law impediments to the competition conditions of the common market take a form of a State aid. Articles 87-89 of the EC Treaty are set to define the principles on the basis of which compatibility of State aids with the common market is judged – the Commission normally prohibits any State aid scheme that goes beyond what is necessary for achievement of the objectives defined in Art. 87(3) and thus distort competition to an extent which contradicts Community interests.

Although the objectives and procedures of Community policy on fiscal aid treatment are clear, the criteria for distinguishing general and specific tax measures may be found confusing. For the purpose of identification of specific tax measures in order to define discrimination, a number of tests have been suggested.
3.5. Conclusion of the chapter

Unlike indirect taxes, direct taxes are not explicitly mentioned in the EC Treaty, and no explicit provisions are found that would give the EU the authority to harmonize corporate income taxes. Harmonization of direct taxes (and corporate income taxes as a part of them) has, therefore, a much thinner legal basis than that of indirect taxes. The only possible legal basis found in the Treaty are the general, “catch-all”, harmonization provisions of Arts. 94 and 95; and Art. 293 concerning abolition of double taxation.

Otherwise, the relations between Member States in matters of direct taxation – as well as their relations with third countries – are largely governed by a network of bilateral or multilateral tax treaties. Therefore, it has only been necessary for the States to justify their legislative action in the field of more general objectives: the free movement of workers (Art. 39), the freedom of establishment (Art. 43), the free movement of capital (Art. 56), state aid affecting intracommunity trade (Art. 87) and the functioning of the common market (Art. 94). However, such intergovernmental forms of cooperation in the field of company taxation are limited in their effect: they may only help eliminate some problems at the EU level, but do not guarantee elimination of all the distortions to the internal market caused by lack of coordination of national corporate systems.

Out of a number of Commission proposals aimed at harmonization of corporate income taxes throughout the EU, only five directives were passed by the Council: Mutual Assistance Directive (77/779), Merger Directive (90/434), Parent-Subsidiary Directive (90/435), Directive on interest and royalty payments (2003/49) and Directive on taxation of savings income in the form of interest payments (2003/48), adopted to become applicable from 1 January 2005. The only convention (90/436 on Arbitration and abolition of double taxation) has applied only for the limited period of five years (from 1 January 1995 until it ceased to be effective on 31 December 1999) and until now its extension protocol has not been ratified by all EU Member States yet. 89 However, the case-law on the subject, actively developed by the European Court of Justice, seems to fill in the gaps in determining corporate tax policies of the Member States.

89 Additionally, the legally not binding Code of Conduct for Business taxation has political force – see chapter 4, section 4.5.2.
4. Role of the EU Commission: historic overview of harmonization initiatives in the sphere of corporate income tax

4.1. Intro

The EC Treaty assigns to the European Commission the task, in consultation with the Member States, of eliminating distortions in competition due to differences in the law and administrative practices of those States, in order to establish and maintain a common market. Ever since the Rome Treaty, the Community legislative measures have been successfully introduced to maintain the integration, or harmonization, of market conditions all over Europe. EC Commission’s (and also Member States’) primary attention to indirect taxation originates from the EC Treaty – its set out objectives clearly included elimination of intra-Community tariffs and establishment a common external tariff. Despite clear indications in the EC Treaty of similar measures towards direct taxation, the Commission was also concerned about that as the reason for possible obstacles to the functioning of the common market.

For a number of reasons the Commission has attempted to harmonize/cooperate various differences between the national corporate tax systems and to remove discriminatory tax treatment by national tax systems of international investment activities. Harmonization proposals have concerned several national (withholding tax on dividends and corporate taxation) and international aspects (cross-border mergers, parent-subsidiary relations, elimination of double taxation, mutual assistance in direct taxation). However, despite the long history of initiatives and reports, no particular results have been achieved in this area, unlike indirect taxes. Direct taxation is continuously said to be a core competence of the Member States, and today the EU countries still operate their own national corporate income taxes, with only limited co-ordination between them.

This chapter presents the analysis of the procedural developments, legal documents and initiatives, in its historical perspective, concerning harmonization of corporate income tax, which the European Commission has undertaken. The chronological outline gives the background for tracing the Commission’s aims and reasons for being determined enough in getting closer to achievement of direct tax harmonization in the EU, as well as for considering changes in the tendency to reach its goals. In concluding remarks possible reasons are suggested for Commission’s failure to find the
It must be taken into account that this chapter is mainly of a descriptive character and its task is not to analyze in depth important Commission’s legislative initiatives, but just give a historic overview of what has been done, in order to see the tendency and evaluate ambitions and reveal the reasons for failure. Firstly, the consideration is given to the early stages of the EC’s existence, when the link between the direct taxation and the internal market has been identified. Secondly, examination of the 1970s initiatives will be made, when the Commission’s attempts to implement the ambitious objectives defined in the 1960s were constantly opposed by the Council. This highlights one of the main limits to the progress of company tax harmonization – the unanimity requirement. Thirdly, the evolution of the 1980s and a shift in Commission’s strategy in the 1990s are described, which was a break through period that came up with fruitful results. Forth section of the chapter concentrates specifically on the Code of Conduct and its implications. And finally, the latest developments, starting from 2000, and the tendencies are envisaged. The chapter is finalised by concluding remarks, where possible reasons for Commission proposals’ failure are suggested.

4.2. Early stages of the EC’s existence

As previously mentioned, while performing its task of ensuring the proper functioning of the single market, the European Commission’s attention has firstly been drawn to indirect taxation. However, it also considered direct taxes being possible obstacles. Thus, already in 1959 it was interested in the reform of direct taxes, especially company taxes of the Member States, and set up several working groups to study those issues. The two most important initiatives of this period are set forth below: the “Neumark Report” and the “Van den Tempel Report”.


Generally, the first initiatives in the area of corporate income tax were characterized by being rather drastic – these were proposals for radical reform by establishing uniform rules for the problem of corporate income taxes. However, in 1962 the Neumark Committee has pointed out that the configuration of the Member States’ tax systems was influenced by historical and social

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circumstances, therefore _harmonization_ in the area as opposed to _unification_ “should be the guiding principle of the Commission’s policy in both direct and indirect taxation”, since only the former would allow eliminate distortions to the common market and at the same time preserve national characteristics of the different corporate tax systems of the Member States.\(^{91}\)

Furthermore, the Fiscal and Financial Committee held that it is not the total tax burden that influences conditions of competition within the Community, but rather the differences in tax bases and structures that had this effect.\(^{92}\) Thus, the Committee developed concrete suggestions, aimed at harmonization of the company tax systems among the (then) six Member States in the form of an _imputation system_ with a split rate for retained and distributed profits.\(^{93}\)

According to the Committee, in order to implement these proposed measures and ensure equitable distribution of income between Member States, “supranational structures of financial compensation should be set up”. In addition, according to the report, bilateral tax treaties between the States should be amended in accordance with the OECD Model Tax Convention, and in the final end replaced by one multilateral tax convention between Member States.

### 4.2.2. Programme for the Harmonization of Direct Taxes\(^{94}\) – 1967

As the studies continued on EC level, Commission’s reaction to them and the “Neumark Report” followed in 1967 in the “Programme for the Harmonization of Direct Taxes”. Although the Commission did not accept all the recommendations of the Neumark Committee, from this programme it becomes obvious that it had high ambitions regarding harmonization of company taxation in the EU.

The programme contained a number of policy issues, such as integration of corporate and private income taxation, abolition of withholding taxes on dividends and interest, removing tax

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\(^{93}\) Imputation system and split-rate system are the two types of systems which reduce the extent of double taxation of dividends. The split-rate system allows charging a lower rate of corporate taxes on distributed profits, than on undistributed profits. Under imputation system, corporate tax is charged at the same rate regardless of the destination of profits; however if the profits are distributed, shareholders are given a tax credit, which reduces their personal tax. (_Corporate Tax Harmonization and Economic Efficiency_, M. Devereux, M. Pearson (Institute for Fiscal Studies Report Series No. 35), p. 26.)

impediments to cross-border mergers, a single individual income tax, uniform corporate tax base and approximation of Member States’ corporate tax rates, and the combating of international tax avoidance and evasion.

The importance of the Programme is that it laid down the main objectives to be achieved through harmonization of direct taxes, which have been being pursued also in further Commission legislative proposals. The most important initiatives based on the Programme were the “Proposal for a directive on the common taxation arrangements applicable to mergers, the splitting up of companies and the transfer of assets” and the “Proposal for a directive on the common taxation arrangements applicable to parent companies and subsidiaries”. These proposals came out in 1969, but were finally approved by the Council, with some modifications, as directives only in 1990. Both proposals, together with a Model of a European Double Tax Convention, presented by the Commission in 1968 but never approved by the Council, again witness how ambitious and persistent the Commission was in pursuing harmonization of corporate taxes already in the late 60s. Moreover, from the specifics of the suggested measures one may conclude that the Commission was aiming at full harmonisation of the corporate tax systems of all Member States.

4.2.3. Van den Tempel Report 1970

Van den Tempel Report, in contrast to the Neumark Report concluded that a classical system of taxation of distributed company profits would be the best for the EC because it avoids the main disadvantage of the imputation system – discrimination against foreign shareholders. And although classical system produces double taxation, “its international neutrality and simplicity would justify the adoption of such a system in the EC”, according to the Report.

The Commission, however, did not take these recommendations when submitting the Proposal for a Directive on harmonising corporate tax systems in 1975, because, as suggested by Jiménez, several Member States who were practicing classical system in 1970 or before, had adopted imputation system after the Van den Tempel Report was published. Besides, as it follows from the

97 Classical system is the simplest corporate tax system, in which dividends are subject to income tax without any credit against corporate tax. While being advantageous for its simplicity, classical system discourages saving through purchase of equity because of the double taxation of dividends.
Preamble to the 1975 Proposal of Directive, Commission preferred imputation system, as, in its opinion, “it promotes neutrality regarding corporate finance and the legal form of investment, tax equity”; and is effective when preventing tax evasion “since the classical system discourages distributions of dividends, the imputation system will help in the development of capital markets”\(^9\).

So, both reports, Neumark and Van den Tempel, come up with similar conclusions. They both agree that for achievement of the common market direct taxes should be neutral within the EC, and thus harmonization needed as the most optimal solution. Both reports identify, among other things, the tax treatment of cross-border dividend payments, unless harmonized, as a major problem within common market, but suggest different tactics for dealing with double taxation of dividends. As it can be seen from Commission’s reaction to the suggested measures in the reports, it preferred imputation system for its international neutrality.

4.2.4. Conclusions

It follows from the EC Treaty that a common market requires neutral taxes, which should be harmonized at EC level, such as: customs duties and tariffs, as well as indirect taxation. Indeed, these present obstacles to the effective functioning of the common market by creating distortions and double taxation to the free trade of goods and services. Therefore the Commission’s and also the Member States’ attention was first drawn to indirect taxes and reforms of the indirect tax systems. Thus, it may be concluded that Commission initiatives (in the form of positive integration like, for instance, introduction of common system of VAT\(^{100}\)) were not opposed by the Member States because of their common interest in this problem. Therefore, a unanimity requirement of Arts. 93 and 94 was not an obstacle to reach a common agreement.

Regarding direct taxation, there was obviously no progress with company taxation in particular, in spite of Commission’s high ambitions to harmonize them, for a number of reasons. First, as opposed to the issue of indirect taxation and tariffs, company taxes were not of a vital importance to the Member States. Besides, most of the Commission’s harmonization proposals were not implemented, as they did not meet the Council’s interests. In addition, Member States were determined to keep their power in the sphere of direct taxation, one of the few areas left not harmonized within the Community. Therefore, unanimity requirement in this case, contrary to the

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\(^9\) Preamble to the 1975 Proposal of Directive, paras. 4-12.
situation with indirect taxes or other areas, proved to be the main hurdle for achieving harmonization of company taxes.\textsuperscript{101} Last but not least, there were no direct legislative or judicial provisions from EEC Treaty or ECJ that referred specifically to company taxes – again, unlike in the situation with tariffs and indirect taxation.

4.3. Commission and Council’s confrontation in the 1970s

With appearance on the scene of the Economic and Monetary Union (EMU) resolution in the 1971 and the “Green Paper”\textsuperscript{102} on financing the Community budget, two new characteristics added to the corporate taxation harmonization process.

Firstly, EMU resolution made a connection between economic union and company tax harmonization. The Commission used this link to revive its objectives defined in the 1967 “Programme for the Harmonization of Direct Taxes” and even to use this as a justification of its ambitious policy on corporate taxation.\textsuperscript{103} Jiménez comments this bold conclusion with the following note\textsuperscript{104}: “a centralizing process to achieve economic and monetary union should be completed by a centralized harmonization of company taxation”. This suggests an idea that – in accordance with the principle of subsidiarity – in order to get power to legislate in the sphere of corporate taxation, the Commission had to convince the Council that it is the most apt at achieving the EMU.

The second new characteristic of the 1970s period was Commission’s conviction that national corporate taxes could be used as a source of revenue for the EC, and thus, harmonization was needed in order to avoid unequal contributions to the EC budget.

\textsuperscript{101} Jiménez (1999), p. 114.
\textsuperscript{102} The “Green Paper” on financing the Community budget did not specifically pertain to company taxation, however gave the Commission food for thought that Member States could make an input to the EC budget in the form of national corporate taxes. This idea, however, was later abandoned, as it required harmonization of the base of Member States’ company taxes.
\textsuperscript{103} Jiménez (1999), p. 122.
\textsuperscript{104} From Jiménez’ personal interview at the Commission, April 1994.
4.3.1. Commission’s Action Programme - 1975

In this Commission’s Action Programme for taxation in harmonizing corporation systems was submitted. In short, the Action Programme was Commission’s Communication to the Council in order to “remind it about disappointing results of attempts to harmonize Member States’ tax systems.” Specifically, in the field of corporate taxation it recommended the adoption of the 1969 Proposals of Directives (on taxation of mergers, parent companies and subsidiaries); came up with the “Proposal for Directive on harmonizing corporation systems and arrangements for withholding taxes on dividends”, as well as proposals to fight tax avoidance and evasion.

In the “Proposal for Directive on harmonizing corporation systems and arrangements for withholding taxes on dividends” the Commission, following the majority of the (then) nine member States, followed neither Neumark, nor Van den Tempel conclusions, but suggested a partial imputation system, when the national corporation tax should be between 45 percent and 55 percent for either distributed or retained company income, and an imputation credit provided for both Community and domestic shareholders. Under the suggested regime, a double taxation arising from classical system would be eliminated, while at the same time discriminative feature of the imputation system would be neutralized.

The proposal, however, never came into force, as the European Parliament found that it did not make sense to harmonize corporate income tax without a simultaneous approximation of the corporate tax bases in the EC. In Terra and Wattel’s opinion, it is Parliament’s criticism to the 1975 proposal, leading to a standstill of the discussion of this proposal, that “left the Commission no choice but to initiate a far-reaching tax base harmonization”, which was not in Commission’s original goals and had actually no chance of the Member States’ approval.

Other proposals of the 1970s have been rejected as well. Thus, “the desire of the Member States to retain full control of transfer-pricing policies was, probably, the main reason why the proposal for...”
Directive on elimination of double taxation\textsuperscript{112} in 1976 did not meet the agreement of the Council.\textsuperscript{113} This proposal has never become a directive but nearly 15 years later it was passed in the form of an EC Treaty Art. 293 Convention.\textsuperscript{114}

4.3.2. Mutual Assistance Directive - 1977

The only fruitful result in the field of direct taxation was Mutual Assistance Directive\textsuperscript{115} in the year 1977. It intended to implement the Council Resolution on fighting international fraud and evasion and the 1975 Action Programme for Taxation. The Directive promoted exchange of information between competent authorities of the Member States, which would enable a correct assessment of taxes on income and capital and help prevent tax avoidance and fraud. Interestingly, the adoption of this Directive shows that in spite of the need to obtain unanimous approval from the Member States, the legislative process may only be effective when it is in the interest of all the Member States to cooperate. Even the Member States with favorable tax regimes for tax avoidance or fraud did not use their right to veto this Directive at the Council level, because the Directive actually was not effective and far-reaching enough to deal with the problem of banking secrecy – this basically shows its limitations.\textsuperscript{116}

4.3.3. Conclusions

As mentioned in the introduction to this section, Commission’s ambitions in the 1970s, with the two new characteristics added to the process of corporate tax harmonization in the EC, required a centralist approach for their implementation. Therefore, one may conclude that there appears to be no difference between the harmonization goals of the 1960s and those of the 1970s. Unfortunately, the Commission was not able to make sufficient adjustments to its proposals and thus its initiatives kept on being rejected by the Council and the Member States. It became clear that only in the sphere of fight against tax avoidance and evasion Member States’ interests coincided with those of the Commission’s – otherwise they preferred to oppose legislative proposals aimed at corporate tax harmonization.

\textsuperscript{112} COM (76) 611 final, 24.11.1976, OJ C301 21.12.76, p. 4.
\textsuperscript{113} Jiménez (1999), p. 119.
\textsuperscript{114} See further section 4.4.2. Arbitration Convention.
\textsuperscript{116} Jiménez (1999), p. 120.
Jiménez draws attention to other factors that may also have shaped the Commission’s policy in the 1970s, such as this period being the years of the so-called “crisis of the harmonization process”. With a shred of irony, he however insightfully notes that “the Commission’s tendency to over-propose was matched by the Council’s bent to ‘over-neglect’ those proposals”. Indeed, the 1975 Action Programme for Taxation did not bring much new but repeated (and thus, just reminded to the Council) its goals and principles of the Fiscal and Financial Committee in the 1960s. Moreover, the situation has extended to the areas other than taxation and, as Van Empel notes, “the combination of unanimity requirement and the Commission’s striving for complete harmonization of rules and regulations throughout the EEC led to lack of legislative results”. This note sounds true and important, as it leads to the reasons of legislative stagnation in the 70s-80s.

What has also important happened in this period is that the EC Court’s judgment in the Cassis de Dijon case, from which it followed that having at hand the principle of mutual recognition, harmonization was no longer a necessity. It is the opinion of the analysts that this judgment brought an incentive for the Commission to change its approach towards harmonization of national legislations. However, the Commission “failed to see what implications of the judgment were in the field of corporate taxation and kept on repeating the same old principles regarding company taxation”. Jiménez even considers it the third characteristic of this period. From this it follows that one of the reasons for Commission’s failures to get its proposals approved by the Council was its disregard of the special nature of the EC legislative process, where the unanimity condition presupposed national legislative freedom regarding their tax systems, even if, in its entirety, the national tax system is considered inefficient from an EC perspective.

4.4. The new Commission’s policy

The period of the 1980s was even less productive in the development towards harmonization of corporate taxes. It was only the Commission’s White Paper of 1985 that gave an important stimulus to the harmonization of direct taxes. The company taxation, however, was explicitly referred only later in the 1990 Commission’s Communication to the Council “Guidelines on Company Taxation”, which resulted in two directives and a convention, and reflected Commission’s new policy. The

following proposals of the Commission and finally the work of the Ruding Committee will be presented in this section.

4.4.1. The White Paper on the Single Market\textsuperscript{119} - 1985

The Commission’s White Paper on the Single Market contained little on direct taxation. What was important in it for corporate taxation is that the White Paper on the Single Market indicated that the Commission had the intention of publishing the White Paper on company taxation before the end of 1985.\textsuperscript{120} Moreover, the Commission insisted on the adoption by the Council of the proposals for directives on taxation of cross-border mergers, on taxation of transfers of dividends from the subsidiary to the parent company, on prevention of double taxation, and compensation of losses.\textsuperscript{121}

The White Paper on company taxation, however, was not submitted by the year promised, as the Commission probably preferred to concentrate on the Single Market in those years. (Publication of Single European Act of 1987 is the evidence of it). Generally, the White Paper has not been productive for the company taxation also because “in the 1980s the Commission was still relying on the centralist approach to harmonization of company taxation defined in the 1960s and 1970s”.\textsuperscript{122}

4.4.2. The 1990 “Package of Three” – Commission’s Communication to the Council\textsuperscript{123}

The 1990s, however, brought a break through to the long-awaited efforts of the Commission’s legislative initiatives. The new approach to company taxation, with the principle of subsidiarity as its cornerstone, was taken up by the Commission. This Communication was actually considered to be the White Paper on company taxation announced in 1985 White Paper on the Single Market.\textsuperscript{124}

According to it, the idea of full harmonization of national corporate taxes had to be abandoned, and the unpopular 1975 Proposal on the harmonization of company taxation systems and dividend withholding taxes under the Action Programme was withdrawn\textsuperscript{125}. It was stressed that tax neutrality in company taxation was a guiding principle for further Commission’s policy on direct taxation,

\textsuperscript{119} “Completing the internal Market”, White Paper from the Commission to the Council, 14 June 1985, COM (85) 310 final.
\textsuperscript{120} Ib\textit{id} para. 150.
\textsuperscript{121} Ib\textit{id} para. 151.
\textsuperscript{122} Jiménez (1999), p. 127.
\textsuperscript{123} SEC (90) 601 final, 20.4.1990.
\textsuperscript{125} See above section 4.3.1.
which implied that “Member States should remain free to determine their tax arrangements, except where these would lead to major distortions” to the functioning of the internal market. The Commission promised it would only concentrate on “the measures essential for the completion of the internal market”. And regarding the long-term harmonization objectives, the Communication announced a study to be conducted by a committee of independent experts to study whether or not further action on direct company taxation is necessary at the Community level.126

Mrs. Scrivener, the new Commissioner of taxes, first introduced the new guidelines for the Commission to follow at a presentation in Amsterdam in November 1989 and summarized the new Commission’s approach in three guidelines127:

(1) **Subsidiarity**: Commission’s intervention into Member States’ taxation policies would happen only when it is necessary to attain specific mutually agreed objectives.

“We do not want to harmonize all taxes on companies. It would be useless and impossible. […] Maybe the Commission has been overambitious in some of its old proposals on corporate taxation which were not adopted by Member States.”

(2) **Completion of the internal market**: A fundamental priority for the Community should be the completion of the objectives of the internal market regarding company taxation before the end of 1992.128

(3) **Consultation**: Closer cooperation at the national and Community level when defining the priorities and proposals from the Commission.

“The priorities and the proposals have to be defined in close cooperation with all parties at national and Community level. The Commission cannot work alone.”

The new approach proved to be politically successful, and the Communication resulted in a “package of three” successfully adopted in July 1990 as well as two new proposals dealing with foreign losses and the abolition of withholding taxes on group interest and royalty payments.

126 See further section 4.4.3.
128 This guideline goes in line with the aim of the Single European Act published in 1987.
Merger Directive\textsuperscript{129} and Parent-Subsidiary Directive\textsuperscript{130}

The proposals for both Merger and Parent-Subsidiary directives were first submitted to the Council in 1969\textsuperscript{131}, however were not approved until 1990. Interesting to note and agree with Jiménez, that the reason for these directives were finally passed was not at all in the change of the Commission’s policy in the field of corporate taxation.\textsuperscript{132} He suggests that, apart from the unanimity rule, it is German and Dutch opposition for 20 years because of the specifics of their national tax systems that hindered approval of the directives. However, starting from the mid-80s, in complex with other political and economic developments, Germany and the Netherlands decided to declare their willingness to compromise over both directives, which were finally adopted with derogation clauses in favour of the two countries.\textsuperscript{133}

In short, the Merger Directive ensures the removal of fiscal barriers to cross-border mergers, divisions, transfers of assets and exchanges of shares resulting from the taxation of hidden capital gains which occur in the process of these operations by postponing the realization of capital gains on assets or shares of the merger until they are actually sold by the newly-merged company.

The Parent-Subsidiary Directive exempts from withholding taxes at source the inter-company dividends paid by subsidiaries to parent companies within the EC, by this also eliminating the double taxation of such distributions.

In addition to the two directives passed, the Commission submitted to the Council the proposals for two more directives: one concerning arrangements for taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States\textsuperscript{134}; and the other on a common system of taxation applicable to interest and royalty payments made.

\begin{footnotesize}
\begin{enumerate}
\item[129] 90/434 Directive of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, OJ L225 20.9.90, p. 1.
\item[131] See above section 4.2.2.
\item[132] Jiménez (1999), p. 129. Some other commentators (like J-Ph. Chetcuti, for example, in Corporate Taxation in the EC: The Process of Corporate Tax Harmonization in the EC, 2001) also acknowledge Germany and the Netherlands as the main cause for the delay in adoption of the directives.
\item[133] For instance, the derogation clause of the Parent-Subsidiary Directive Art. 5 para. 3 allowed Germany to levy the compensatory withholding tax as long as it charges corporation tax on distributed profits at a rate at least 11 points lower than the rate applicable to retained profits, and at least until mid-1996. The same applied to Merger Directive, where Art. 11 para. 1 (b) is specially designed to preserve German legislation on the representation of workers.
\item[134] COM (90) 595, 28.11.1990.
\end{enumerate}
\end{footnotesize}
between the parent companies and subsidiaries in different Member States\textsuperscript{135}. Neither of the proposals, however, has been approved by the Council – with, again, unanimity being the main obstacle for that. The proposal for interest and royalties directive has been withdrawn in 1994, however, as will be seen, it would resurface again in 1997 when the Commissioner M. Monti develops his approach to tax harmonization.\textsuperscript{136}

\textit{Arbitration Convention}\textsuperscript{137}

The Arbitration Convention - a multilateral convention between Member States based on the EC Treaty Art. 293 – introduced a revolutionary innovation in international tax law: it required a compulsory arbitral procedure which requires tax administrations to eliminate international double taxation. The situation in question arises when tax authorities of the Member States fail to come to a mutual agreement on the applicable transfer price and on adequate double taxation elimination.

Originally submitted to the Council in November 1976 the Transfer Price Arbitration Directive was approved in 1990 in the form of a less binding multilateral Convention, and came into force only in January 1995, after its ratification by the national parliaments of all the Member States.

\textbf{4.4.3. The Ruding Committee 1990-1992}

As it was mentioned before, the Committee of Independent Experts on Company Taxation under the chairmanship of Mr. Onno Ruding (the Ruding Committee) was set up following the 1990 Commission’s Communication on corporate taxation. Its mandate was to “evaluate the importance of taxation for business decisions with respect to investment and international allocation of profits between enterprises”. The committee had to answer three questions, on the basis of which the Commission would decide on further measures regarding corporate tax harmonization:

“(1) Do differences in Member States’ taxation cause major distortions in the functioning of the internal market, particularly with regard to investment decisions and competition?

\textsuperscript{135} COM (90) 571, 24.1.1991.
\textsuperscript{136} See further section 4.5.1.
\textsuperscript{137} Decision 90/436, Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, OJ 225 20.8.90.
(2) Insofar as such distortions arise, are they likely to be eliminated simply through the 
interplay of market forces and tax competition between Member States, or is action at 
the Community level required?

(3) What specific measures are required at the Community level to remove or mitigate 
these distortions?"

The Ruding Committee produced its report in March 1992\textsuperscript{138}. Its main findings were that tax 
differences among Member States distort foreign location decisions of multinational companies, 
and cause distortions in competition, especially in the financial sector. Despite the observed 
convergence that had happened in the past, the differences in tax regimes which distort the 
functioning of the internal market still remain and are unlikely to be reduced solely through market 
forces or through independent action of Member States – consequently, action on the Community 
level is needed.

However, the Ruding Committee follows the new - tax neutrality - approach of the Commission and 
bases its recommendations on the principle of subsidiarity where Community harmonization should 
be reduced to minimum necessary to remove discrimination and main distortions. Therefore, it was 
proposed not to impose uniform rules, but the basic standards which have to be followed by the 
Member States when designing their tax systems.

Committee’s recommendations fell into two essential categories: on elimination of double taxation 
of cross-border income flows; and on corporation taxes. And the priorities, on which action should 
be concentrated, were suggested as follows:

“(1) removing those discriminatory and distortionary features of countries’ tax arrangements 
that impede cross-border business investment and shareholding;

(2) setting a minimum level for statutory corporation tax rates and also common rules for a 
minimum tax base, so that to limit excessive tax competition between Member States 
to attract mobile investment of taxable profits of multinational companies […]]; and

(3) encouraging maximum transparency of any tax incentives granted by Member States to 
promote investment with a preference for incentives, if any, of a non-fiscal character.”

Beside the abovementioned basic standards for the tax base, Committee’s recommendations specifically included, for example, introduction of a minimum and maximum statutory tax rates, regardless whether profits are retained or distributed; a uniform withholding tax on dividend distributions by an EC resident company. Moreover, Ruding recommendations were favourable about the three measures agreed in 1990 and recommended the further extension of the two directives; the proposals for two new directives were welcomed as well.

Follow up of the Ruding Report

Subsequent to the conclusions of the Ruding report, the Commission issued a Communication to the Council and to Parliament in June 1992 “indicating guidelines on company taxation linked to the further development of the internal market”\(^{139}\). The Commission agreed with the Ruding Committee on a number of issues, like, for instance, that priority should be given to the elimination of double taxation on cross-border income flows, and that the scope of the two proposed in 1990 but not approved directives should be extended. In addition, the Commission proposed several measures to eliminate double taxation in the single market, but on the other hand critically assessed some of the Committee’s most far-reaching proposals regarding company taxation. Specifically, it opined Ruding recommendations on the convergence of corporation tax rates, bases and systems, as they seemed to go beyond what was strictly necessary at Community level (for instance, the 30 percent minimum corporation tax rate proposed by the Committee was considered too high).

Jiménez, basing on his personal interview at the EC Commission in April 1994, comes to a number of conclusions, which deserve attention. He suggests the reasons, why Commission’s reaction to the Ruding Committee recommendations regarding corporate tax rates, bases and systems was so conservative – namely, because “the Commission did not consider it politically opportune to adhere to the most far-reaching proposals regarding company taxation”. In his opinion, the content of the Communication subsequent to the Ruding report was conditioned by the acceptance of those recommendations of the Member States (especially the UK, a traditional opponent of corporate tax harmonization, which shortly after the 1992 Communication was taking over the presidency of the EC). Besides, the impending expiration date of the Commission’s mandate expedited the drafting of the 1992 Communication, and it is customary that in such cases the outgoing Commission would not establish clear-cut policy guidelines so that not to impose limitations on the new Commission’s

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Policy in this field. Moreover, the Commission was interested in submitting its reaction to the Ruding report before the Council could do so, so that to prevent the shelving of the report together with the other abovementioned reports and proposals. The Commission found it easier to comment on the legislative exercise proposed by the Committee, as it was not coherent with the 1990 Commission’s new approach to company taxation; while regarding far-reaching harmonization proposed, the Commission had apprehension that the Council would not welcome it.

The Commission’s reaction to the Ruding recommendations, amongst other things, continued in July 1993 with two proposals to amend the two directives of 1990140 and to extend their scope to include more legal forms of enterprises. The proposals have been withdrawn by the Council in August 2004 as being “no longer of topical interest”.141

Although the Council in its conclusions on company taxation of November 1992142 agreed that elimination of double taxation of cross-border flows of income should be the priority, it still has not implemented the pending directives to achieve this, however it introduced a number of criteria that should be taken into account in deciding whether action was appropriate at Community level.

The European Parliament’s reaction to the guidelines on company taxation announced by the Commission came in the “Cox Report”.143 It merely agreed with the Commission’s expressed opinions following the recommendations of the Ruding report.

The analysts, however, criticise the Ruding report144 for concentrating too much on the positive integration - legislative process to implement the goals indicated, but does not devote enough attention to the question whether and to what extent harmonization is necessary at all. Moreover, as it is concluded by Jiménez, the conclusions of the Ruding report were in essence in line with the reports and tax programmes of the 1960s and 1970s:

140 Proposal for a Council directive of 26 July 1993 (COM (93) 293).
142 Guidelines on company taxation linked to the further development of the internal market – Council conclusions, press release (10088/92 – Presse 216) after the Ecofin Council meeting of 23 November 1992.
143 Report of the European Parliament Committee on Economic and Monetary Affairs and Industrial Policy on the Commission Communication to the Council and the Parliament subsequent to the conclusions of the Ruding Committee indicating the guidelines on company taxation linked to further development of the internal market. SEC (92) 1118, 11.3.1994.
144 Jiménez confirms his conclusions with comments by McLure and Vogel.
“The Ruding Committee proposed a great number of harmonizing measures to be elaborated at EC level that in the long term would lead to a centralist approach similar to the one proposed in the 1970s. In other words, the Ruding Report was again merely dressing the same old stories on company taxation in a new guise.”145

Following this, it may be also concluded that “in spite of the high principles of the 1990 Communication, there has been little evolution regarding corporate tax policy at the Commission level” since 1960s.

4.5. Code of Conduct and OECD position

In April 1996 Mr. Monti, the new Commissioner responsible for common market issues, submitted a Memorandum to the informal EU Council of Economy and Finance Ministers (ECOFIN) meeting held in Verona,146 which did not focus on a single policy (e.g. corporate taxation), but presented a global comprehensive view of taxation policy. According to Mr. Monti, “direct tax coordination suffers from two main obstacles: the unanimity rule for decision-making and the lack of an overall perspective with Member States showing them the economic and social downside of not reaching decisions”. In essence, the Memorandum did not bring anything new but mainly repeated conclusions of previous documents (1990 Communication, Ruding report and ECOFIN’s reaction to the Ruding recommendations), therefore it may be concluded that this first Memorandum intended to convince the Member States once again that action in the field of taxation at the Community level is needed in order to implement previous initiatives.


The first Monti Memorandum was followed by the formation of a High Level Group, composed of personal representatives of ECOFIN Ministers, to study the Commission’s proposals. In its report, presented by the Commission in October 1996, the High Level Group was unsupportive of the minimum corporate tax bases or rates, but stressed the need to fight tax avoidance and evasion,

restrain or eliminate unfair tax competition; and invited the Commission to revise the draft directive on intra-group interest and royalty payments, which was withdrawn in 1994.\textsuperscript{148}

After the second Monti Memorandum, the Commission released the Communication “Towards tax coordination in the European Union: Package to tackle harmful tax competition”;\textsuperscript{149} (hereinafter: Tax Package) where the Commission came up with a package of measures necessary to adopt at the EC level to fight harmful tax competition:

\begin{enumerate}
\item a Code of Conduct for Business Taxation (hereinafter: Code of Conduct) in the form of a non-binding legal act to eliminate harmful business tax regimes;
\item a measure to ensure an effective minimum level of taxation of savings income;
\item a measure to eliminate source taxes on cross-border payments of interest and royalties between associated companies;
\item a set of guidelines containing specific conditions for the area of state aid in direct taxation matters.
\end{enumerate}

The general goal aimed at by these initiatives is “the need to tackle harmful tax competition within the EU in order to reduce and ultimately eliminate the economic distortions, the fiscal degradation and the increase of growth of the already high unemployment rate”.\textsuperscript{150} The main document of the Tax Package is the Code of Conduct for Business Taxation, which targets all tax measures implemented by the Member States that harm tax competition within the Community.

\textbf{4.5.2. Code of Conduct - 1997}\textsuperscript{151}

The Code of Conduct for Business Taxation, aimed at eliminating certain preferential tax regimes which currently exist in the EU, is not a legally binding instrument but it clearly does have political force. Therefore, much of its impact will depend on the extent to which this initiative is transformed into changes to legislation of individual countries.

\textsuperscript{148} See above section 4.4.2.
\textsuperscript{149} COM (97) 564, 1.10.1997.
\textsuperscript{150} See the Council Conclusions on Taxation Policy contained in the Package and the preamble of the Code of Conduct.
\textsuperscript{151} On 1 December 1997 the ECOFIN Council approved the Tax Package submitted by the Commission, and approved the Code of Conduct in its Resolution (OJ C 002, 6.1.1998 pp. 2-5).
By adopting this Code, the Member States have undertaken to re-examine their existing laws and established practices and to amend or eliminate if necessary the existing tax measures that constitute harmful tax competition (to "rollback"); as well as to refrain from introducing any such measures in the future (that is, to "standstill"). In addition, in accordance with the principle of transparency and openness, the Member States have committed to exchange information about existing or proposed measures, which may fall within the scope of the Code (Art. E).

The Code does not concern corporate income tax rates or general aspects of corporate income tax bases, but is specifically designed to detect only such measures which are considered to be harmful to tax competition. In order to identify such harmful measures the Code sets out the criteria against which any potentially harmful measures are to be tested.

According to the Code, taxation deemed ‘harmful’ when it concerns “those measures which affect, or may affect in a significant way the location of business activity in the Community” (Art. A). Also defined as harmful are “tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the member states in question” (Art. B).

Specifically, ‘harmful’ are considered to be the following measures:

- tax preferences accorded to only non-residents;
- tax advantages that are ring-fenced from the domestic market, so they do not affect national base;
- tax advantages granted to firms with no real economic activity in the country;
- rules for profit determination that depart from internationally accepted principles;
- non-transparent administrative practices in enforcing tax measures.152

In March 1998 there was set up a High Level Working Group, consisting of representatives of the Member States and the Commission and chaired by Mrs. Primarolo, with the task to evaluate and exchange information on tax measures, which are likely to fall within the scope of the Code of Conduct. The Group’s findings were submitted to the ECOFIN Council on 29 November 1999.

152 Code of Conduct, para. B.
1998 OECD, Harmful Tax Competition: An Emerging Global Issue

Of course, in viewing ECOFIN’s standpoint against harmful tax competition the background of the globally increasing intolerance of preferential tax regimes must be considered. In its 1998 report “Harmful Tax Competition: An Emerging Global Issue”, the Organization for Economic Cooperation and Development (OECD) also deals with the issues of harmful tax competition, attempting to identify the characteristics of “tax havens and preferential tax regimes” as well as measures to deal with them.

Generally, the OECD has recognised that liberalization and globalization of the marketplace is leading to a situation where location and financing decisions for the companies are becoming tax-driven, by this “distorting capital and financial flows, impeding fair competition for real economic activities and hindering the collection of the revenue”. In response, the OECD Member States (other than Luxemburg and Switzerland) have subsequently adopted guidelines under which harmful practices are to be identified and, within five years, removed.

The key factors of ‘harmful’ tax competition identified by the OECD are the low or zero rate of effective tax on relevant income, the existence of ring-fenced regimes, the lack of transparency, and the lack of information exchange.

Comparing this with what constitutes ‘harmful’ measures in the EU Code of Conduct, one may conclude that the Code is effective within a wider scope of measures which could have a bearing upon location decisions of the companies. In addition to the key factors mentioned by the OECD, factors such as the lack of real economic activity, the availability of relief only to non-residents and deviation from internationally accepted accounting principles must also be considered when identifying a potential harmful tax measure.153 The harmful tax measures, which fall under the Code, are naturally more oriented to the single, as of the EU, market functioning; and this guides the EU initiative on harmful tax competition more towards harmonization of the tax base than is necessarily sought at the OECD level. In any case, from the analysis of the both Code of Conduct

and the OECD Report it is clear that there exists no general and universally accepted definition of ‘harmful’ tax competition, partly also because it is a relatively new issue. 154

Generally, there is obviously a close link between the two initiatives, however they would hardly interact with each other due to the different political framework and legal nature of the EU and the OECD, as well as different number of the Member States involved. In terms of being successful in combating the pointed out harmful tax competition, in the view of Pinto, for instance, “the Code of Conduct seems to have greater chances to succeed due to its more comprehensive scope, to the very high degree of integration amongst the Member States of the EU, and to the legal (and political) remedies available under EU law”. 155

In any case, bearing in mind a long series of unsuccessful initiatives aimed at corporate tax harmonization, it is remarkable that the Member States have unanimously recognized existence of harmful to the single market tax regimes and agreed to comply the legally non-binding Code of Conduct in order to eliminate and prevent economic distortions. The success of the Code was probably in its right timing: different to negative reaction to the Ruding Report in 1992, there seems now to be a “political willingness of the Member States to cooperate with each other”. This also reflects in a successful outcome of the two proposed directives of the package.

4.5.3. Proposed Directives of the “Tax Package”

*Proposed Directive on the taxation of interest from savings* 156

This proposal of the Commission was aimed at “guaranteeing a minimum of effective taxation of savings income in the form of interest payments within the Community”. The Member States, in which the income was earned, had to follow the so-called ‘dual approach’, where they had to either provide information to the other Member States about the savings interest paid to their resident individuals, or apply a withholding tax at a minimum rate to such income arising to individuals resident in other Member States. 157

154 A more profound comparative analysis of the differences and similarities of the scope of the Code of Conduct and the OECD Report is given by C. Pinto in the article *EU and OECD to Fight Harmful Tax Competition: Has the Right Path Been Undertaken?* Intertax, Vol. 26, Iss. 12 [Kluwer Law International 1998]
155 Ibid., p. 409.
156 Proposal for a Council directive to ensure a minimum of effective taxation of savings income in the form of interest payments within the Community, COM (98) 295, 20 May 1998.
157 European Commission internet page information.
Later on in 2001 the Commission will come up with a new proposal for the Directive\textsuperscript{158}, and in June 2003 the “Directive on taxation of savings income in the form of interest payments” was adopted by the Council\textsuperscript{159} to become applicable from 1 January 2005. The final outcome, however, was quite different from the original political agreement in 1997: the ultimate (not the immediate) goal would be the taxation of interest paid to non-resident taxpayers in the country of residence and eventually the effective taxation of such interest; and the only instrument would be that of the exchange of information.\textsuperscript{160}

\textit{Proposed Directive on intercompany payments of interest and royalties}\textsuperscript{161}

On interest and royalty payments between companies, withholding taxes create difficulties for companies engaged in cross-border business. They can involve time-consuming formalities, result in cash flow losses, and sometimes lead to double taxation. As part of the Tax Package, the Commission proposed the directive that aims at ensuring that interest and royalty payments between associated companies of different Member States are subject to tax only in one Member State. Together with the other proposal, this initiative was passed by the Council as a Directive 2003/49/EC in June 2003\textsuperscript{162} to enter into force on 1 January 2004.

\textbf{4.5.4. Conclusions}

“Harmful tax competition” has been chosen a successful political instrument for bringing back the attention to the previously neglected policy area. Before the Tax Package of the 1997 the attention of the Commission, the economists and the EU Member States was driven towards the problem of distortionary domestic taxes on intra-community operations which hinder the development of a genuine single market.

\textsuperscript{158} COM (01) 400, 18.7.2001.
\textsuperscript{160} \textit{The Interest-Savings Directive: European Hide and Seek}, Prof. F. Vanistendael [Faculty of Law, KULeuven (Belgium)], 30 April 30 2004.
\textsuperscript{161} Proposal for a Council directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, COM (98) 67, 4.3.1998.
The “Tax Package” introduced an important innovation in that it suggested that the main problems are the functioning of the single market, the degradation of the fiscal systems and unemployment. The European Commission based its new policy on a presumption that ‘harmful’ tax competition results in a shift in taxation away from taxes on mobile capital and towards taxes on comparatively immobile labour, which is a detriment to employment. However, as noted by commentators, this argument is open to debate.163

Although the Code of Conduct is silent on competition in the form of uniformly low corporate income tax, it is obvious that in the final end Commission’s interest remains to be corporate tax harmonization. Despite that, the Member States have unanimously acknowledged the threat of the tax measures that cause harmful competition and agreed to commit themselves at a political level to comply with the Code of Conduct. The reason for this will of cooperation is probably the right timing of this initiative, both within the EU and worldwide, as well as possibly the legally non-binding form of the agreement, which seemed to put less pressure on the States and still left them with the right to denounce it at any time.


4.6.1. COM (2001) 260 “Tax policy in the EU – priorities for the years ahead”

In October 2001 the European Commission has presented a Communication to the Council COM (2001) 260, containing a comprehensive strategy for the EU’s future taxation policy. The document in fact does not contain any legislative proposals about tax policy but describes a number of recent agreements on tax instead and urges the Member States to take progress on a number of issues.

The Commission considers that the Community must ensure that tax policy is developed in accordance with broader EU policy objectives - such as the goal established by the Lisbon European Council of March 2000 for the EU to become the most competitive economy in the world by 2010. As it is highlighted in the Communication, increased tax coordination would help Member States to meet these objectives.164

What concerns company taxation in particular, the Commission intends to prepare a study with related tax policy implications for coordinated actions to tackle the remaining tax obstacles and

164 COM (2001) 260, para. 2.3.
inefficiencies in the company tax field, “taking into account that cooperation in the tax policy area is not aiming at uniform tax rates and is not inconsistent with fair tax competition”. One of the important questions that the study will raise will be whether Commission’s solutions to tax obstacles should continue being achieved on an individual basis, “leaving the different corporate tax systems in the EU continue to coexist”; or whether a more comprehensive, politically ambitious solution should be attempted such as “providing companies with the option of a single set of corporate tax base rules” which would be applicable on an EU-wide basis. Whatever solution is followed, it is clear that the removal of tax obstacles would be a “substantial contribution towards improving the competitiveness of EU business”.

4.6.2. COM (2001) 582 “Towards the Internal Market without Tax Obstacles”

If the first Communication of October 2001 identified both general objectives and a number of specific priorities in direct and indirect taxation, then this Communication on a European strategy for company taxation takes the issue a step further and specifically addresses the issue of direct company taxation in the EU. The document itself does not contain any legislative proposals, but proposes a strategy by which companies with cross-border activities within the EU could be taxed on a consolidated corporate taxation basis according to one set of rules. In Commission’s opinion, consolidated corporate tax base will improve company tax systems in the EU and help to overcome tax obstacles to the internal market.

Following this, the Commission considers four technical possibilities for achieving a consolidated corporate tax base:

1. **Home State Taxation (HST):** where the tax base can be computed in accordance with the tax code of the company’s home State;

2. **Common (Consolidated) Base Taxation (CCBT):** where the tax base is computed according to completely new harmonized EU rules that Member States agree upon;

3. **European Corporate Income Tax:** where the tax base is computed according to EU rules, with some or all of the revenue going directly to the EU;

4. **Harmonized Single Tax Base in the EU:** where national system is replaced and the tax base is computed according to a harmonized EU approach.

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165 *Ibid.*, para. 3.2.2.
The Communication proposes a number of measures, including, *inter alia*, amendment with broadening the scope of the existing proposals of the Mergers and Parent-Subsidiary Directives; drafting a Communication on double taxation conventions; making sure that tax law is applicable to companies formed under the European Company Statute as from 2004; as well as organization of a European Company taxation conference.

4.6.3. European Company Statute (ECS, Societas Europaea) – October 2001

Statute for a European company, adopted as the Council Regulation of 8 October 2001\(^{166}\), aims at creating a European Company on a supra-national European level (lat. "Societas Europaea" or SE) with its own legislative framework. This will make it possible for the companies incorporated in different Member States to merge or form a holding company or joint subsidiary without legal or practical difficulties emerging from differences of fifteen (and as of May 1, 2004 – twenty five) legal systems. The new legislation will enter into force on 8 October 2004.

As concerns tax matters, the SE is subject to the tax regime of the national legislation applicable to the company and its subsidiaries – that is, treated as a multinational company. SEs are subject to taxes and charges in all Member States where their administrative centers are situated; thus their tax status is not perfect as there is still no adequate harmonization at European level.\(^{167}\)

The European Company State, although not very effective, is still of a value as much as it provides a unique opportunity to develop a more coordinated European corporate tax system.

4.6.4. European Conference on Company Taxation (Brussels) – April 2002

The conference is specifically aimed at the question of how to remove tax obstacles to business activity in the Internal Market. This conference is actually a follow-up of the Commission Communication COM (2001) 582, therefore one of the central topics for debates was the achievement of a single tax base for EU companies to use when calculating their EU-wide taxable profits.


\(^{167}\) European Union internet pages.
The conference gave considerable support to the Commission’s suggestion of the optional ‘Consolidated Corporate Tax Base’ out of four suggested possibilities; the other three (HST, a ‘European corporate income tax’ and ‘compulsory harmonization of existing tax bases’) were either generally not favored by the participants to the conference or deemed unfeasible at that time.

Generally, as noted by commentators,\(^{168}\) the Commission is being “clever and dangerous” in this conference and its study report, putting the focus not on harmonizing tax rates but rather on harmonization of computational rules in the Member States, which sounds sensible. The solution in fact is the existence of the single EU-wide rules for computing the corporate tax base, which can be done in one country but would be valid in any other country as well; however with a “tiny detail” behind – a corporate tax rate, applicable in each separate country. In McGowan words, if all else but the tax rates is harmonized, the pressure for tax rates harmonization “could become irresistible”, and “the issue would then be isolated and focused on”. Thus, it may be correct to say that the true interest of the Commission concerning the issue of corporate tax harmonization remains the same as in the years behind.


The Communication has affirmed the previously identified tax-related inefficiencies and obstacles to the Single Market, as well as the effectiveness of the 2001 ‘two-track’ strategy to deal with these obstacles:

- via targeted immediate solutions, and
- taking steps towards the longer-term goal of providing companies with a common consolidated tax base for their EU-wide activities\(^{169}\).

\(^{168}\) *Harmony Once Again*, P. McGowan, KPMG Tax Monitor, April 2002

\(^{169}\) The *Financial Times* of 11 November 11 2003 rated the likelihood of the second goal being achieved “as equal to that of pigs flying”. However, at the Rome Conference F. Bolkestein, commissioner in charge of Internal Market, commented that similar remarks had been made by opportunists of the euro. (*EU Corporate Tax Reform: Progress and New Challenges*, Frits Bolkestein SPEECH/03/596)
The second track involves the following steps:

- Developing HST pilot scheme for small and medium-sized enterprises (SME);
- Developing common EU tax base for companies operating in the EU, with reference to “accounting dependency”;
- Commission proposals to progress mechanism to allocate taxing rights between Member States;
- Depending on overall progress in other areas, possible scheme for SE to have common consolidated EU tax base (this decision is postponed until 2005).  

As noted and classified by the commentators, three themes are highlighted in the Communication, which describe the current position of the Commission. First, it considers that in order to progress with the reform of company tax systems, cooperation of the Member States is indispensable. Second, the Commission acknowledges that many Member States are skeptical about the Commission’s strategy, both for political and technical reasons. And finally, the Commission draws attention to the recent and forthcoming developments of the ECJ case-law, which “will contribute to an increasing acceptance of the need for action in this area”.

The Commission even suggests that the ECJ could become the key driving force in this area; however it acknowledges that the Court’s approach to tax obstacles is rather piecemeal, therefore Member States are encouraged for closer cooperation and a more constructive approach to building an Internal Market, rather than “compromising by tax obstacles and inefficiencies”.

4.6.6. Conclusions

As the Nice Treaty was signed on 26 February 2001, it became clear that more far-reaching reforms, also concerning the issue of corporate income taxation, would be inevitable in order to ensure the efficiency of the European institutions in an enlarged union. It is believed that increased tax coordination would also help to reach broader EU policy objectives, like for instance Lisbon targets to become the most competitive economy in the world by 2010.

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171 Ibid.
172 Frits Bolkestein SPEECH/03/596.
Two Commission Communications issued in 2001 identified general objectives and specific priorities concerning coordination of Member States’ company tax systems for the years ahead, coming up with a strategy divided into targeted immediate solutions and a longer-term objective of agreeing upon common consolidated corporate tax base.

Some commentators note, that the Commission is being “clever and dangerous”, putting the emphasis this time not on harmonizing tax rates but rather on harmonization of computational rules in the Member States, which actually sounds achievable. The Commission acknowledges the skepticism of many Member States about its corporate tax harmonization strategy, both for political and technical reasons. However, especially with the increasing ECJ case-law on the issue during the last decade, the Commission calls for the need for action in this area and Member States’ will to cooperate.

It is therefore might be concluded that the true interest of the Commission concerning the issue of corporate tax harmonization remains the same as in the years behind.

4.7. Concluding remarks: Reasons of Commission Proposals’ Failure

As it can be seen, indeed, in spite of a long history of Commission initiatives in the field of harmonization of corporate tax systems of the Member States, little progress has been achieved. Commission’s proposals over the decades have been continuously opposed by the Council and the Member States.

The Commission’s focus on tax neutrality, which calls for legislative action (positive integration measure) at the EU level, has determined the evolution of company tax harmonization in the EU. There are indeed examples, when the legislative process does work (the four directives, the Arbitration Convention, the Code of Conduct). However, if analyzed, this happened either because of the right timing of the proposals, both in the sense of internal institutional EU process and shifts in the global tendencies; change in the specifics of the national tax systems (like, German and Dutch opposition to approval of Merger and Parent-Subsidiary directives in 1990); setting the right focus of the proposed initiatives which could be attractive to the Member States as well; or a less
legally-binding form of the commitment (‘soft-law’), which would leave room for national initiative (the Code of Conduct).

The major reasons of Commission’s failure are, first, its general approach of the legislative initiatives based on the assumption that positive integration is the only feasible means to eliminate company tax distortions to the establishment and functioning of the common market.

Second, still effective the precondition of unanimity rule for decision-making for the adoption of tax harmonization measures, which with a gradual erosion of Member States’ sovereignty in other areas, especially indirect taxation, stays the main defence mechanism for guarding their autonomy that the States are obviously reluctant to relinquish.

In addition, with the legislative process clearly representing the interests of the Member States, the Commission’s strategy is condemned for, in the words of M. Monti, “lack of an overall perspective with Member States showing them the economic and social downside of not reaching decisions”.

Third, the Commission is being criticized for neglecting to consider the “special nature of the EU legislative process, where the unanimity condition presupposed some room left for national legislative freedom regarding their tax systems, even if as a whole this national tax system is considered inefficient from an EC perspective”. Besides, as it can be seen from the analysis of the initiatives, the Commission’s final goal and its centralist approach to harmonization or coordination of corporate tax systems throughout the EU did not change much, but may be just acquired another form of it. And, as correctly noted, “the Commission’s tendency to over-propose is matched by the Council’s bent to over-neglect those proposals”.

Thus, it follows that there is a deep-set structural conflict in the European Union integration process.173 On the one hand, on the EU level the goal of integration for different areas has been laid in all major EU treaties and accepted unanimously by the Member States. On the other hand, in contrast, some of the Member States (“welfare states” like UK, Ireland) have predominantly been safeguarding their national tax systems. So the solution is that the European Commission should probably re-consider its policy and tame its enthusiasm, if it wants its proposals to become law.

173 Is Harmonization of Tax Policies between EU Countries a Good Idea? K. Wickman
Otherwise, as wisely proposed by Dr. Onno Ruding\textsuperscript{174} in October 2001\textsuperscript{175}, an alternative way for making at least some progress towards reducing the existing cross-border tax obstacles could be “the use of instruments of competition policy”. Making the most of the situations when the behavior of national authorities results in tax obstacles to cross-border activities, which are also in conflict with the competition policy of the EU, the Commission “can perform its responsibilities [which may go hand in hand with its goals in the area of company taxation] under the competition policy of the Treaty, which is not hampered by the requirement of unanimity of Council decisions”. Although welcomed by Ruding, this approach would “address only part of the relevant tax obstacles”.

Another solution envisaged by Ruding is “enhanced cooperation approach”, when, under the circumstances of “differentiated integration”, as he names it, a common and consolidated tax base for company taxation could be reached among the majority of the Member States. Although sounding positive, the measure however would be impossible to use when dealing with other Member States.

Then again “a shift from the traditional harmonization to coordinated voluntary measures” by Member States wishing to correct certain tax inefficiencies between themselves. This practice, notes Ruding, is the one initiated by Commissioner Monti and being practiced by the Commission since 1997. However, in Ruding’s opinion, this procedure is time-consuming and is not certain in its desired outcome.

Finally, and already being probably the most efficient measure, is finding another “actor” whose powers and authority would be different from those of the Commission, but supreme, and who would associate or even take over it in its striving for the corporate tax harmonization. Could it be the European Court of Justice with negative integration through far-reaching judgments of the emerging number of cases in the area? The possibility and arguments are presented in the following chapter.

\textsuperscript{174} Vice-Chairman of Citybank and former Minister of Finance of the Netherlands.  
\textsuperscript{175} Article The Long Way to Removing Obstacles in Company Taxation in Europe, European Taxation, January 2002, which reproduces the speech given by Dr Ruding at the congress held on the opening of the IBFD’s new headquarters in Amsterdam on 26 October 2001.
5. Role of the ECJ and its case-law in the area of direct taxation

5.1. Intro

The lack of progress on the legislative front in direct tax harmonization, coupled with the requirement of unanimity, has resulted in the European Court of Justice becoming the driving force behind European direct tax harmonization. Being not a traditional player in similar instances, the EC Court anyway plays a role in the direct tax harmonization issues of the European Union. Armed with the principle of non-discrimination and non-restriction of the four freedoms, the Court has been the most effective of all EC institutions at removing direct tax obstacles to cross-border economic activities within the EU. 176

Despite the principle of subsidiarity, which means that Member States’ competences in determining their corporate tax policies are to be respected, the ECJ keeps on increasing the number of cases, “that are becoming increasingly fundamental” (as notes Peter Cussons, a tax partner at PricewaterhouseCoopers, London),177 “there are a lot of areas where, notwithstanding the retention of the national veto, the treaty of Amsterdam calls the shots”. Also, the Financial Times wrote on 4 December 2003 about the “enormous implications” of ECJ decisions in the tax arena; the Economist’s “Charlemagne” column on 17 January 2004 emphasized the ECJ’s position at the cutting edge of defining EU powers – expanding them into areas, including tax, traditionally regarded as belonging to Member States. 178 Indeed, today the jurisprudence of the ECJ strongly influences almost all aspects of company tax law, its decisions have an effect of putting pressure on the Member States to may be adjust some of the aspects of their company law systems; and there is good reason to believe that this influence will continue to increase. Because the ECJ has unquestionably already made a significant contribution to the removal of tax obstacles for companies, it is unlikely that today the interpretation of the Treaty is sufficient to address all tax obstacles to cross-border activity.

These recent developments suggest the following issues for analysis. First, any possible solution to the existing tax obstacles must take account of the existing judgements of the ECJ. Second, the question arises, to what extent the Court of Justice jurisprudence calls for further coordination between Member States.¹⁷⁹

Moreover, these developments are taking place at the time when negotiations for a new EU constitutional treaty are to start with regards to accession of 10 countries to the EU as from 1 May 2004. Inevitably, as 15 member states become 25, achieving consensus will become more difficult and it would seem obvious that legislative measures need to be adopted before EU enlargement is achieved.

The structure of this chapter is as follows. First, a short overview of the general principles of Community law will be given, on the basis of which the jurisprudence of the EC Court is being developed. Next, specific examples from the Court’s case-law will be selected and analysed in accordance with the three questions open for discussion. First, the Court’s position on the free movement of companies and freedom of establishment within the EU will be given. Second group of selected cases concerns the question whether secondary establishment of a company in the form of a Permanent Establishment is treated discriminatively in comparison to the local companies. Third and last, a possibility will be considered for the Member States to “safeguard” their local companies from moving to other States with more favored tax regimes.

5.2. General Principles of Community Law

General principles of Community law are frequently used by the ECJ to determine the validity of EC or national measures, including tax rules. The recognition and application of them by the Court has made a crucial contribution to the structure and coherence of Community law by filling the gaps of the latter and making it more coherent. General principles are particularly important in an area such as direct taxes since legislative action on this subject by the Council is still rare and the general principles enable the Court to measure the interests protected by Community law against actual concerns of national laws.

The principles of Community law regarded as being particularly important are, for instance:

a) the principle of supremacy or precedence of Community law over any provision of national law;

b) the direct effect principle;

c) the previously mentioned principle of non-discrimination (which, according to well-established case law, is one of the fundamental principles of Community);

d) the principle of proportionality, which requires that the means employed by the Community should be suited to the purpose of achieving the desired objective and should not go beyond what is necessary to achieve it;

e) the principle of loyal co-operation which is binding on the Member States ad the EU institutions (e.g. Case 44/84 Hurd v. Jones [1986] ECR 29, paras. 38-39 and Case 94/87 Commission v. Germany [1989] ECR 175, para. 9);

f) the principle of effective judicial control, sometimes referred to as the principle of judicial supervision of administrative acts in a Community, based on the rule of law; and others.

Application of the principle of supremacy together with the doctrine of direct effect used by the EC Court shows the crucial distinction of the ECJ between negative and positive integration. That is, by turning the negative obligations of the EC Treaty into directly applicable rules in the Member States’ legal systems, and conferring on them a supreme character over national laws, the EC Court of Justice achieved two effects: it rendered some legislative norms superfluous and on the other hand it stimulated positive integration.

Apart from these general principles of EU law, certain specific principles of tax law which are common to the Member States are becoming recognized in ECJ case-law as well. For example, Schumacker case establishes the principle of a distinction between residents and non-residents for income tax purposes. Moreover, in Futura Participations case the Court explicitly recognized the “fiscal principle of territoriality”, when upholding the requirement of Luxemburg corporate tax law to be an economic link between losses carried forward and income earned in the State where tax is levied. Tax law principles may also be recognized in a more implicit or indirect way.

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181 Case 6/64 Costa v. ENEL [1964] ECR 1141.
Therefore, even though the Court has not yet recognized the ability-to-pay rule as such, this principle would nevertheless seem to be an important factor in deciding whether or not income tax rules differentiating between residents and non-residents are actually discriminatory.185

5.3. Examples from Jurisprudence

It is clear that as EC Treaty encompasses the principle of non-discrimination – and therefore of equal treatment – as its cornerstone, the jurisprudence of ECJ is therefore based on how the Court ensures this principle.

The light on some cases solved by the EC Court in the field of company and corporate income taxation has been already given in chapter 3, with a breakdown to the principle of non-discrimination, the fundamental EC freedoms, and state aids. In this section out of a big number of relevant cases only several will be selected and for the sake of clarity discussed in accordance with the following three questions:

1) How does the EC Court ensure that a European company has the right to free movement? (supported with examples from Centros, Daily Mail and Überseering cases)

2) How is a secondary establishment of a company (in the form of Permanent Establishment) discriminated to the local company of the Member State? (Commerzbank, Saint Gobain, Avoir Fiscal, Futura and X-Y cases)

3) To what extent Member States can “safeguard” their companies, i.e. prevent them from moving out to other Member States to exploit better tax regimes? (giving examples from the cases: ICI, Eurowings, Lankhorst-Hohorst and de Lasteyrie du Saillant which concerns exit taxes)

5.3.1. Free movement of companies in the EU

Freedom of establishment ensures the free movement of companies within the EU. As it has previously been discussed in chapter 3, there are two conflicting criteria connecting a company to a Member State, which define the conditions for company relocation, if it wants to make a cross-border movement for any purposes. These are incorporation method and real seat (siège réel)

185 See Schumacker, paras. 36-41.
method. However, the barriers of different company laws (as well as different tax laws) of the Member States affect the use of these methods and consequently the freedom of movement for a company.

For instance, the situation when the company registered in a Member State that applies real seat principle wants to transfer its real seat to another Member State that practices incorporation theory, forms a conflict of recognition: this company on its transfer of the real seat abroad stays no longer subject to the law of the state of origin, however the host country is supposed to treat the company by the rules of the place of its incorporation. In addition, the lack of recognition of the company may also lead to loss of its legal personality, including tax law as well.

As the incorporation principle does not require the transfer of the company’s central administration or production but just the transfer of its registered office from one Member State to another, it is clear that the incorporation principle favors the mobility of companies. As for the real seat principle, it is considered to be more protective and it would even appear that it may entail obstacles to the free movement of companies. So, the question arises, whether these obstacles fall under the provision of Art. 43 – that is, infringe the freedom of establishment; and if affirmative, are there any justifications possible. In Überseering case the EC Court had to deal with this kind of questions. And it had to do so against the background of its rulings in Centros and Daily Mail.

**Centros**

*Centros* concerned a refusal by the Danish authorities to register a branch of the company Centros which was incorporated in the UK. The reasons underlying this refusal were as follows: the company Centros was formed in the UK by Danish citizens, residing in Denmark, so that to avoid the application of Danish rules on minimum capital; in fact the company had never conducted any business in the UK. Asked by the Danish Supreme Court whether this refusal was in conformity with the Community law, the EC Court ruled that the situation fell within the application of the Treaty provisions on the freedom of establishment. The formation of a company in one Member State in order to avoid the application of the rules governing the formation of a company in another Member State did not amount to an abuse of the freedom of establishment. Therefore, the EC Court

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186 Case C-208/00 Überseering v Nordic Construction Company Baumanagement, judgment of November 5, 2002, not yet reported.
has found the refusal of the Danish authorities to register Centros’ branch in Denmark – a restriction of that freedom.

As to the question when such restriction could be justified, it followed from the Court’s ruling that it is only the requirements in the general interest such as aims of protecting public and private creditors and preventing fraud that may be serve as justification grounds.

After the ECJ decision in Centros the contrasting effects of the two approaches (seat and incorporation) became more controversial. On the one hand, the Centros decision can be understood as allowing an entrepreneur to freely choose a corporate form within the European Community.188 On the other hand, academic debate flourished as to the extent to which Centros undermined the real seat doctrine.

Indeed, in Centros ruling the EC Court concluded that the freedom of establishment is not abused in the situation when a company pursues no activities in the state of incorporation – which does not agree with the real seat theory that requires the real seat of the company to be situated in the state of incorporation.

So, as a consequence of the ruling, Centros case gives ground for a discussion of at least two questions. The first concerned the seat principle and its compatibility with the Community law. The second question concerned the EC Court’s judgment in Daily Mail case: whether that judgment had been overruled by Centros or it still stood.

Daily Mail

The Daily Mail case189 concerned a company incorporated in the UK, with its registered office there, which wanted to transfer its central management and control to the Netherlands, essentially for tax reasons. The UK tax authorities refused to give consent to Daily Mail required under UK law for the transfer of its seat. Preliminary questions were referred to the EC Court as to whether the company could rely on the freedom of establishment to overcome such refusal of the UK tax

THE ROLE OF E. COMMISSION AND ECJ IN DEVELOPMENT TOWARDS HARMONIZATION OF CORPORATE INCOME TAX IN THE EU

authorities. The EC Court gave a clear cut final answer, that although Art. 43 of the EC Treaty prohibits the state of origin from imposing obstacles to the right of establishment, in the then state of Community law, the provisions on freedom of establishment conferred no right on a company incorporated in one Member State and having its registered office there to transfer its central management and control to another Member State while retaining its status as a company incorporated under the legislation of the first Member State.

However, the reasoning underlying this result was less straightforward. First, while developing its arguments towards the conclusive decision, the Court took account of the wide variations in the national laws of the Member States concerning the connecting factor between companies and the national territory for the application of company and tax law. Nevertheless, the EC Court has decided that in the then state of Community law, companies, unlike natural persons, are creatures of the national law, and it is national legislation which determines their incorporation and functioning. Secondly, the Court also stressed that nothing prevented Daily Mail from setting up a secondary establishment in the Netherlands (in the form of an agency, branch or a subsidiary), which did not require any consent from the UK tax authorities and was ensured by the Treaty provision of the freedom of establishment. Finally, the Court concluded that these problems were not to be resolved by negative integration under the right of establishment, but to be dealt with by positive integration through appropriate Community legislation or multilateral conventions between the Member States, and referred to the clause of Art. 293 which suggested the conclusion of agreements between the Member States in order to ensure the retention of legal personality in the event of cross-border seat transfer. Nevertheless, no such legislation or convention is existent yet.

However, one may observe that in Daily Mail case there was indeed no conflict of national corporate laws (as the EC Court has defined in para. 23 of the judgment), since both the UK and the Netherlands apply incorporation company principle. The real question in the case actually concerned whether the tax authorities of the home Member State were allowed under the EC Treaty Art. 43 to require settlement of a company’s tax position wishing to leave its tax jurisdiction in order to establish itself in another Member State. It seems that the Court consciously avoided this

190 Together with the EC Court, one may note that although the UK is the country that follows incorporation principle in company law, it attached importance to the seat in tax matters. (See Daily Mail paras. 3-4)
191 Daily Mail, para. 19.
192 For instance, as it has been recently recommended, the Commission should consider adopting a proposal for a coordination directive on the transfer of the registered office, which under Art. 44 (1) and (2) of the EC Treaty may help to resolve the problems and hence promote freedom of establishment. (Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels, 4 November 2002)
question, which also gives an idea that it in fact intentionally circumvented the tax issue and defined the problem at issue as a problem of international company law rather than as a tax law problem.\textsuperscript{193}

As an alternative solution, some commentators\textsuperscript{194} submit that the Court could instead have pointed to the lack of harmonization in the area and to the existence of public interest reasons (like prevention of tax avoidance or fraud) for the Member States justifying a requirement of prior tax settlement for cross-border seat transfers.

Generally, \textit{Daily Mail} has been interpreted as a case where the Court wanted to remain self-restraint in order to leave more room for Community legislature. Indeed, recognition of the right to transfer the primary establishment to other Member States could have important consequences for the Member States, as it would encourage companies migrate to countries with lower level of taxation and more advantageous tax systems.

\textit{Comments: 1) Daily Mail vs. Centros}

So, the decision in \textit{Daily Mail}, which claimed that a company exists only by virtue of the domestic law, was seen as acceptance of the seat principle: although the case concerns obstacle imposed by the home state, the judgment was generally interpreted as allowing application of real seat theory in relation to both emigrant and immigrant companies.\textsuperscript{195} However, \textit{Centros} decision caused disagreement with these widely held assumptions about the implications of the \textit{Daily Mail}.

As for the question whether \textit{Daily Mail} was overruled by \textit{Centros}, it is disputable as well. In spite of the conflicting conclusions which can be made from both cases, they dealt with different issues, and it does not seem from the \textit{Centros} judgment that the EC Court intended to overrule \textit{Daily Mail’s} decision. In fact, neither Advocate General nor the Court mentioned \textit{Daily Mail} in the \textit{Centros} case.

Another interpretation may reconcile the results of the \textit{Centros} case with the \textit{Daily Mail} case.\textsuperscript{196}

The two cases actually deal with different situations: \textit{Daily Mail} concerns the obstacles for

\textsuperscript{193} As Terra and Wattel hold, “Daily Mail might be trying to circumvent taxation, but the Court did its best to circumvent the tax issue”. (Terra and Wattel [1993])

\textsuperscript{194} \textit{Current issues of Cross-Border Establishment of Companies in the EU}, J.Wouters, H.Schneider, p. 128.

\textsuperscript{195} \textit{The Internationalisation of Companies and Company Laws}, M. Neville, K.E. Sørensen (Djøf, 2001), p. 222.

\textsuperscript{196} M. Neville, K.E. Sørensen (2001), p. 223.
company cross-border movement imposed by the country of origin, and Centros deals with those imposed by the host Member State. Based on the Court’s statement that companies are creatures of the national law and that they exist only by virtue of the law of their Member States, it may be acceptable to apply real seat principle to the companies incorporated in a Member State, but not in relation to those formed under the company law of another Member State.

2) Exit taxes on the transfer of seat

As Daily Mail case proves, the obstacles to the company’s freedom of movement can be of a fiscal character – that is, EU Member States may levy exit taxes on a company’s transfer of seat to another Member State. The question is whether these national tax law requirements result in the restriction on the freedom of establishment and thus, conflict with EU law. On the basis of Daily Mail judgment this exit taxation policy can be interpreted as being acceptable. However, it is reasonable to conclude that similar actions are permitted in accordance with the principle of proportionality – to the extent it is necessary to protect the objective interests of the home country.

Interesting enough that some commentators see EC Court accepting the levy of exit taxes in Daily Mail because the Court assumes those [exit taxes] as a condition for the transfer of the company’s seat without loss of legal personality (which is generally not the case). The commentators point at an incorrect Court’s assumption that there is a link between the retention of legal personality and exit taxes under the incorporation principle; and see it purposeful for the EC Court to revise its decision in Daily Mail.

Finally, as there are still doubts regarding the issue of the real seat theory compatibility with the EC Treaty, requests for clarifications have been made in the form of references to the EC Court for preliminary ruling, and one of which was the reference in Überseering.

Überseering

Überseering was a company incorporated and having its registered office in the Netherlands. It then acquired a real estate in Germany and entered into contract with a company concerning works to be

197 See footnote 191 above.
done at the property. Considering the works were defective, Überseering brought an action against that company before the German courts. This action was dismissed by the German authorities, since after the company’s incorporation in the Netherlands, all its shares in Überseering had been acquired by two German nationals, residing in Germany. As a consequence, the Dutch company has transferred its central place of management and thus its seat to Germany. As Germany is the country where seat principle applies, the courts ruled that Überseering had not complied with German law governing the formation of companies and thus had no capacity of a legal personality to bring court action in Germany, unless it reincorporated in Germany.

The EC court held such denial an infringement on the freedom of establishment, as Arts. 43 and 48 of EC Treaty implied that the freedom of establishment of a company like Überseering precludes its legal capacity and capacity to be a party to legal proceedings. In the words of the Court, the requirement of reincorporating the company in Germany was “tantamount to an outright negation of the freedom of establishment”. In addition, limitations like that could not be justified by the goals a Member State sought to accomplish in applying the company seat principle of, for example, securing the applicability of creditor, minority shareholder and employee protection rules (requirements relating to the general interest).

**Comments: 1) End of the real seat theory?**

So, the EC Court reaffirmed its principle established in *Centros*, that companies incorporated in EU Member States and having their actual centres of administration within the European Union are entitled to exercise the freedom of establishment in any Member State. A necessary precondition for such exercises of freedom of establishment is that those companies be recognised by any Member State in which they wished to establish themselves.

Does this ruling imply a dismissal of the seat principle? As is often the case, interpreting the ECJ judgement will not be straightforward. The implication of *Überseering* ruling is that Member States are now clearly required to fully recognise the legal capacity a company enjoys under the laws of state of incorporation. This, moreover, will require the real seat countries like Germany to recognise the foreign incorporated corporation as legal entity with limited liability. Thus, the real seat principle may be considered dismissed, at least to the extent it applies to the recognition of the legal
capacity of companies incorporated in other EU states.\textsuperscript{199} However, Member States may obviously still apply the principle in relations not governed by the Community law – for instance, in relation to companies from third countries.

Following the ECJ decision in Überseering, impediments to a company's ability to move its seat, at least as regards to legal capacity and standing, are inconsistent with the freedom establishment. The interesting question is whether this principle also extends to impediments to the mode of moving, that is, whether the company is free to opt for a legal merger as opposed to moving its company seat. The confirmation by the ECJ that companies incorporated in the EU are entitled to freely establish themselves in other Member States will pressure them to consider widening their company law in order to receive a transferring company. A broad interpretation of the ECJ judgement may already lead to such a result.

2) Connection with Daily Mail case

Next, to the question of the connection between Überseering and Daily Mail cases. The Court dismissed the claimant’s arguments based on Daily Mail that a company exists only by virtue of the domestic law. The EC Court emphasised that it was not possible to assimilate the Daily Mail case with Überseering, as its judgment dealt with a ‘moving out’ situation while Überseering concerns a ‘moving in’ situation, i.e. the relation between the company and the host Member State.

Anyway, one may observe that the most significant considerations of the Court’s Daily Mail decision are repeated literally in Überseering.\textsuperscript{200} It should be borne in mind that when the Court establishes that a company of a Member State “exists only by virtue of the national legislation”, it also follows that the company's legal capacity and functioning are to be determined by national legislation as well. This means that the EC Court accepts that under the company seat principle a company’s legal existence ends when it transfers its central administration and management to the Member State, other than the one of incorporation. In this case the company would not be able to invoke the freedom of establishment towards its initial Member State since it no longer existed in that state. In the absence of European harmonization, national law can also determine the conditions


\textsuperscript{200} See, for instance, Überseering para. 67 and Daily Mail para. 19 where ECJ states that companies are creatures of national law.
under which a company may transfer its central management and control *without losing* its status as a legal personality – as is the case under the incorporation principle. From this it appears that the EC Court did not give preference to one of the connecting factors set out in Art. 48, since both principles – seat and incorporation - are put on the same level for the purposes of the freedom of establishment.201

As concerning the question whether *Daily Mail* has been overruled by *Überseering*, P. Dyrberg insightfully comments, that for those who held the assumption that the judgment implied that any transfer of seat (i.e. both transfers into and out of a Member State) fell outside the scope of the Treaty provisions on freedom of establishment, *Überseering* entails an overruling. For the others the opposite is equally clear. In relation to the *Daily Mail* the EC Court found sufficient to rule that *Daily Mail* concerned a situation different to the one at hand; and it was not necessary to decide whether *Daily Mail* was still valid as to the situation it concerns. So, the wording of the ruling in *Überseering* may not help much in assessing the question whether *Daily Mail* still stands.

**Conclusions**

In summary, in the question of eliminating obstacles of the companies’ cross-border movement within the EU, the EC Court considered in its case law situations of two kinds: when obstacles to the free movement are imposed by the home state, the country of origin, (*Daily Mail*), and when obstacles are imposed by the host state (*Centros*).

As a result, the EC Court judged in favour of the incorporation principle, at least in cases where a Member State should determine the legal capacity of a company incorporated and with its seat in another Member State. In connection with this, the increased freedom of movement of companies - as the obstacles formed by the real seat principle have been smoothed - may also affect tax law. With incorporation principle being preferred, it is reasonable to expect that companies will exploit the possibility to take advantage of favourable tax regimes in another Member States, and this may result in a more intensified already existing tax competition.

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201 See also A-G Darmon in point 13 of his Opinion in *Daily Mail*. 
Concerning the exit taxes on a company’s transfer of seat to another Member State, the EC Court considered them acceptable, however in accordance with the principle of proportionality.

Still, the seat principle has not been ruled out - at least not explicitly - in as far as it implies for companies locating their actual seat outside the Member State of incorporation, that Member State considers its legal personality to be lost.

5.3.2. Secondary establishment of a company

As pointed repeatedly above, violations of the equal treatment principle generate tax obstacles to cross-border economic activity in the internal market. The EC Court has enforced the principle of non-discrimination very strictly both in general principles developed outside of the tax field and in specifically tax connected matters, as the case-law proves.

For instance, an archetypal form of discrimination that the Court has found unlawful arises in the situations, where the tax treatment of nationals of a Member State are treated in a more favourable way than the non-nationals of that Member State. As the following cases show, it may for example concern a permanent establishment of a company established in another Member State, where their less favourable tax treatment is found by the Court to be discriminatory and incompatible with the Treaty freedoms.

Art. 43 of the EC Treaty prohibits a Member State from imposing discriminatory restrictions on the freedom of companies from another Member States to establish themselves within the territory of the first Member State through a branch or subsidiary.

In this section I will refer to branches and agencies as to “permanent establishments”, which is by definition a permanent place or a permanent facility for the performance of activities, by means of which taxpayers with a limited tax liability perform their activity, either fully or partially, and the place or the facility is deemed as the permanent place or facility if it is used to perform these activities either continuously or repeatedly.
Avoir Fiscal

Although this case\(^{202}\) has been a benchmark for tax lawyers,\(^{203}\) in terms of EC law it is a logical continuation of the EC Court’s line of jurisprudence on the four freedoms. In this case the Court has held that national tax law which refused a dividend imputation tax credit to branches and subsidiaries of foreign companies, whilst granting it to resident companies, was discriminating and contrary to Community law – Art. 43. Unsurprisingly, this decision caused confusion among practitioners of international tax law at the time (year 1986), as for them it was practically unheard that non-residents and residents could not be subjected to different treatment.

Apart from its clarification on the Art. 43 of the EC Treaty in case of companies, the importance of the *Avoir Fiscal* judgment lies most of all in the Court’s extensive review (and rejection) of the several grounds for justification, brought up by the French government.\(^{204}\) For instance, in its arguments French government justified its tax credit (*avoir fiscal*) given only to resident companies by the lack of harmonization in the field of tax law, which can only be resolved by positive integration, and which a Court can do nothing about. To this the Court has replied that the exercise of Treaty freedoms, such as the freedom of establishment, cannot be made conditional upon harmonization.\(^{205}\) As for bilateral agreements and their conditions for granting tax credit reciprocally, the Court has reminded that the scope of Community freedoms cannot be restricted by reciprocity clauses either.

Moreover, answering justifications of the French government to the exclusion of permanent establishments of foreign companies from the benefit of the tax credit, the EC Court was inflexible, saying that the risk of tax avoidance may not be used as an argument to escape the application of Treaty provisions of Art. 43\(^{206}\).

When the French authorities emphasised that subsidiaries of the foreign companies, in contrast to their permanent establishments, are treated as residents, the Court pointed out that as France follows the principle of territoriality regarding its corporate tax, there is no justification for treating


\(^{203}\) Jiménez (1999), p. 221

\(^{204}\) *Current issues of Cross-Border Establishment of Companies in the EU*, J.Wouters, H.Schneider, p. 121.

\(^{205}\) Specifically, in *Avoir Fiscal*, para. 24, the Court has stated: “The fact that the laws of the Member States on corporation tax have not been harmonized cannot justify the difference of treatment in this case.” It is significant that the EC Court specified its rejection of the argument to the case involved (“in this case”), which gives an idea that the Court does not consider this rejection absolute, but in the absence of tax harmonization measures at the time.

\(^{206}\) *Avoir Fiscal*, para. 25
residents and non-residents in a different manner, because they are put on the same footing for the purposes of taxing their profits.\textsuperscript{207} In addition, answering to the French authorities’ justification that disadvantages of establishing though a permanent establishment could be avoided by setting up a subsidiary instead, the EC Court has found that the possibility for foreign companies to enjoy more benefits with one way of establishment but not the other could not justify a different treatment either. As has been rightly observed, this should not mean that permanent establishments and subsidiaries are to be subject to identical taxation rules, but rather that discriminatory restrictions on the choice of a secondary establishment are not allowed.\textsuperscript{208}

Finally, the Court has held that the breach or the principle of non-discrimination cannot be justified by the potential advantages enjoyed by foreign companies.\textsuperscript{209} If to look at the types of advantages listed by the French government (the non-levying of taxes payable upon constitution, transformation, merger, division, or dissolution), one could agree with Advocate General Mancini that “it is not possible to draw parallels between burdens which recur every year, such as corporation tax, and sums levied at most only when the company is established”\textsuperscript{210}. And actually, the tax advantages named by the French government are levied not on permanent establishments of a foreign company, but on a company itself.

As an outcome of Avoir Fiscal case, it is correctly concluded\textsuperscript{211} that it does not imply that France is obliged to grant tax credit to all foreign shareholders in French companies, but on the contrary: normally, a direct portfolio investment in French shares would be made by a foreign individual or a company, which would generally not constitute a permanent establishment for the income taxation in France. Consequently, unlike the non-resident shareholder in Avoir Fiscal case, such non-resident portfolio shareholder is not subject to French income tax and therefore is not in the same position with the French resident holding a portfolio and entitled to a tax credit. Thus, it is within the logic of imputation system, that the tax credit would not be given to the non-residents not paying domestic income tax on the dividends received.

\textsuperscript{207} Not in the case of an imputation system, the Court however has recognized later in Schumacker (Case 279/93) and Wielockx (Case 80/94) judgments that residents and non-residents are not as a rule in an equal position for direct tax purposes (“In relation to direct taxes, the situations of residents and of non-residents are not as a rule comparable”), but also made it clear that differences in tax treatment must be proportionate to real differences in situation.


\textsuperscript{209} Avoir Fiscal, para. 21


\textsuperscript{211} Terra and Wattel (1997), pp. 44-45.
Commerzbank

Commerzbank case continued to erode the distinction between residents and non-residents. The case concerned the UK branch (permanent establishment) of the German Commerzbank AG which granted loans to US companies. The English branch of Commerzbank was subject to UK tax as a non-resident taxpayer in respect of the interest received from these loans. Subsequently, Commerzbank claimed a refund of the tax paid on the grounds that the Double Income Tax Convention between the UK and the US exempts from UK tax any interest paid by a US company to the non-residents in the UK. Moreover, Commerzbank claimed compensation by way of interest (“repayment supplement”) for the period that UK Inland Revenue held the unduly paid tax, which was denied on the grounds that this provision of compensation applied only to companies residing in the UK. Consequently, Commerzbank appealed to the court claiming that this deny was contrary to EC Treaty Arts. 43 and 48. And the UK government argued that:

- far from being discriminated against, Commerzbank on the contrary received a preferential treatment, enjoying refunds not available to resident banks; and
- Commerzbank cannot enjoy both the advantages granted to non-residents under double tax treaties and those granted to residents under UK legislation.

In his analysis of the reasoning of the Court for this case, Jiménez first brings attention to the opinion of the Advocate General Darmon, who also covers the second of the abovementioned UK authorities’ reasoning, omitted by the EC Court. The Advocate General rejected the arguments of the UK government and concluded that the application of EC law cannot depend on the application of a double tax convention. Consequently, the exemption from taxation recognised in the double tax convention is inappropriate when determining whether a provision of the national tax system of a Member State is discriminatory. Therefore, as it also was concluded in Avoir Fiscal, application of EC Treaty Arts. 43 and 48 cannot depend on the granting of an exemption by a tax treaty; and therefore these articles prevent a Member State from not repaying undue taxes to companies which are resident for tax purposes in that state whilst refusing it to companies resident for tax purposes in another Member State.

The Court reached the same conclusion but jumped directly to the discriminatory character of the provision on repayment of the undue taxes. According to Jiménez, the EC Court did not refer to the considerations of the Advocate General concerning the relationship between EC Treaty Arts. 43 and 48 with double tax treaties, probably, so that to avoid entering into the delicate question of supremacy of EC law over double tax conventions concluded with non-EU countries.

In its judgment, the EC Court has also referred to the previous case law in Avoir Fiscal and establishes the case of discrimination in Commerzbank. The question of whether it is an overt or covert form of discrimination is not an easy one. On the one hand, the Court makes analogy of the “seat” concept of a company and the “nationality” of a natural person, where in the last case nationality is the criterion for overt discrimination. On the other hand, in the area of corporate tax, fiscal residence of a company in most of the States is determined on the basis of its place of effective management (that is, following the real seat principle). This brings up the main novelty of Commerzbank case, as Wouters specifies it\(^\text{214}\), - that the use of the criterion of fiscal residence can amount to a covert form of discrimination. The case also raises the question as to when precisely in the area of corporate tax residence-based distinctions are incompatible with EC law. In fact, this is a matter of case-to-case analysis.

The UK argued to this indictment that the refusal of compensation did not constitute discrimination but was a different treatment of situations which were not comparable. Since Commerzbank was taxed differently from resident companies, the UK government considered that Avoir Fiscal judgment, concerning the two categories of taxpayers (residents and non-residents) to be treated in the same way for the purpose of taxing profits, did not apply in this case.

The Court rejected this argument, following Advocate’s General opinion that the relevant criterion to reveal discrimination should not be an overall comparison of the tax position of a non-resident company vis-à-vis a resident company, but a comparison between the position of a non-resident and a resident company which has found itself in the situation identical to that of Commerzbank.\(^\text{215}\)

Finally, as followed from the Avoir Fiscal judgment, the compensating advantages argument of the UK government to Commerzbank was also not accepted as a justification for discriminatory treatment in other fields. The compensation, in the Court’s opinion, should be paid to both resident

\(^{214}\) Wouters, p. 130.
and non-resident companies carrying on an undertaking in the UK, whatever the reason for the tax refund to which the supplement is incidental. Therefore in this situation Commerzbank should not be compared with a resident company not having overpaid, but with the one overpaid.\footnote{216 Terra and Wattel (1997), p. 53.} In fact, the Court was actually not concerned about the reasons for the tax refunds that Commerzbank was entitled to.

**Futura Participations**

*Futura Participations* case\footnote{217 Case C-250/95 Futura Participations SA, Singer v. Administration des Contributions [1997] ECR I-2471.} continues a series of cases dealing with the compatibility of national direct tax provisions with EC Treaty Art. 43. In this case Singer, the Luxemburg branch (permanent establishment) of the French company Futura challenged Luxemburg legislation which allowed non-resident taxpayers to carry forward previous losses on the condition that these are related to the income received locally, but refused in that to Singer on the basis that the company did not have the required accounts kept in Luxemburg.

In its judgment, the EC Court found the condition requiring that proper accounts must be kept in Luxemburg in order to offset previous losses against taxable being incompatible with Art. 43 and therefore restricting the freedom of establishment. The Court has reasoned that, although not being discriminatory, this condition placed burden on the non-resident taxpayers since it requires to keep a double set of accounts in both Luxemburg and the home country, which adds a supplementary cost. It can therefore be concluded that *Futura Participations* case is important as it acknowledges that non-discriminatory restrictions to the freedom of establishment can also be judged contrary to EC Treaty provisions.

However, citing its *Cassis de Dijon*\footnote{218 Case C-120/78 Rewe (“Cassis de Dijon”) [1979] ECR 649.} jurisprudence, the Court acknowledged that the need to keep accounts in Luxemburg to carry forward previous losses may be justified if this is necessary in order to satisfy mandatory requirements in order to protect the effectiveness of fiscal supervision. On the other hand, the Court also reasoned that the fact that Luxemburg legislation is addressed at the mentioned outcome of the mandatory requirement does not mean that the provisions at issue are not contrary to the EC Treaty, as they still have to remain proportionate to the goals they intend to achieve. Therefore the EC Court ruled that the need to keep accounts in Luxemburg as a condition...
to carry forward previous losses violates the proportionality principle, and the measure is therefore contrary to Art. 43 EC Treaty. Since the requirement of Luxemburg legislation served only to verify what losses have been realised by the taxpayer, there could be found another way to demonstrate that, other than keeping accounts in Luxemburg.

One may note that in Futura Participations case the EC Court appears to follow the Avoir Fiscal doctrine that resident and non-resident taxpayers are generally considered to be in the same situation.219 The Court, actually, started the Futura Participations judgment with the question of compatibility of the Luxemburg legislation with EC Treaty without assessing the comparability of the situation of resident and non-resident taxpayers (as in previously mentioned cases). Some commentators220 suggest another possible reading of the case: that the Court might be less willing to consider the interest of the Member States in the field of company taxation than in the field of personal income taxation, where the distinction between residents and non-residents is clearer due to progressive tax rate of the personal income taxes. Generally, whether the Court intended to overrule the judgments of the recent cases and “returned” to Avoir Fiscal, or just wanted to distinguish between the application of EC law to personal income taxes and corporate income taxes, remains unclear.

Compagnie de Saint-Gobain221

In the judgment of this case the EC Court ruled that a German branch of the company could not be granted less favourable tax treatment than a German-incorporated subsidiary of the company.

The case arose as a result of a dispute concerning Saint-Gobain ZN, the German branch of the French-based Compagnie de Saint-Gobain SA and the German Tax Office. The latter refused to allow Saint-Gobain SA certain tax concessions relating to its German branch on the basis that these concessions were only granted to companies resident in Germany (and as Germany applies real seat theory, this means that it is the companies whose seat or business management were located in Germany). According to German law, Saint-Gobain ZN was treated as effectively part of its parent company and was therefore not considered to be resident in Germany for tax purposes. So, Saint-Gobain SA challenged the German law being contrary to EC Treaty freedom of establishment.

219 Which is, as previously mentioned in footnote 185, is contrary to the conclusions in the more recent cases: Schumacker (Case 279/93) and Wielockx (Case 80/94).
220 Jiménez (1999), p. 240
221 Case C-307/97 [1999] ECR I-6161
In its judgment, the EC Court rejected the arguments of German authorities that the conclusion of bilateral tax treaties with non-member countries, particularly concerning the taxation of income and profits, does not fall within the Community’s competence and that, in the absence of EU harmonization in this area, Member States are free to decide on the question of tax concessions. Specifically, the Court indicated that “although direct taxation is a matter for the Member States, they must nevertheless exercise their taxation powers consistently with Community law”. This meant that in double treaties with third countries, Member States are required to grant the permanent establishments of non-resident companies the advantages applied to resident companies.

However, generally an issue concerning bilateral and multilateral double taxation treaties between independent tax jurisdictions is one of the unresolved issues in the EU tax area. And although the case of *Compagnie de Saint-Gobain* comes close to answering this question, it still stands undecided, to what extent the Treaty limits the Member States’ external competence to conclude these kind of treaties with other Member States or third countries.

**X and Y v. Riksskatteverket (National Tax Board)**

In this case[^222] X and Y were owned in equal parts by individuals A and B, and an unrelated Maltese company. As part of reorganisation, the owners of X were to sell their shares in X to a Swedish subsidiary of Y, where the latter is a Belgian company. The sale was to be made at cost basis, which was considerably below the market value.[^223] At the time of application (1999), the provision on sale to Swedish companies in which foreign companies held an interest[^224] was not yet in force. Nevertheless, the Council on Advance Tax Rulings (Sweden) concluded that the sale had to be made at market value, hat there was no establishment under the EC Treaty and, concerning the free movement of capital, that the exception in Art. 58.1a EC applied.

The tax payers appealed this judgment, with the main argument being that a seller of shares to a Swedish company was treated less favourably when the seller holds an interest in the acquiring

[^222]: Case C-436/00 [2002] ECR I-10829

[^223]: According to the rules of the Swedish Income Tax Act Ch. 53, when the acquiring company is Swedish, the sale at cost basis is accepted even if the market value is higher. In case with sales to a foreign company, or to a Swedish company in which foreign company directly or indirectly holds shares, the sale is deemed to have taken place at market value, even if the price is below that level. This difference in tax treatment is based on the fear of a loss of tax revenue in Sweden. This would especially be the case where an individual transfers his shares to a foreign company before leaving Sweden and selling his new holding.

[^224]: Effective 1 January 2000 the principle that sales of shares to Swedish companies held through a foreign company came under the market value, was introduced. Before that, effective 1 January 1999 only sales of shares to foreign companies had to be made at market value, or else the sales would be deemed to have taken place at market value.
through a foreign company, compared with the situation where the interest was held through a Swedish company. So, the only reason for this different treatment was the nationality of the intermediary company. Therefore they argued infringement of Arts. 43 and 56 EC, and did not consider the exception under Art. 58.1 EC applicable.

The opinion of the Advocate General was that the difference in the sales situations described, results in the timing difference\textsuperscript{225} with respect to the obligation to pay the taxes, which constitutes an infringement of the right to establishment.\textsuperscript{226} As for the threshold (a considerable shareholding) requirement of the Swedish taxation rules, that must be exceeded by a shareholding in order to invoke the right to establishment, it could, according to the opinion, deter Swedish businessmen from exercising their right to establishment in other Member States by acquiring a considerable portion of the shares in companies established there; but also may deter foreign companies to establish themselves in Sweden because it cannot acquire companies in the same way as a Swedish company that does not have a foreign company among its shareholders. So, one might say that the Swedish corporate taxation rules prevent both inbound and outbound establishments in the country.

As the provisions have been determined to infringe the freedom of establishment, National Tax Board tried to justify this measure as being necessary to protect the tax base and to safeguard tax control. Referring to \textit{Bachmann} case\textsuperscript{227}, they consider that the difference in treatment can be justified, \textit{inter alia} by the need to ensure the cohesion of the tax system and effective fiscal control. The Advocate General has pointed out that a desire to prevent reduction of the tax base cannot justify a measure that is contrary to a fundamental freedom; he also has not found this measure proportionate or coherent.\textsuperscript{228} The arguments have been that:

- The coherence of the tax system cohesion is not secured at one individual level by a strict correlation between the tax deferral and the final taxation of the gain. Coherence is ensured by the reciprocity of rules between states as set forth by double tax treaties; besides

- Measures which are less restrictive or less prejudicial to EU legislation could be implemented.

\textsuperscript{225} B. Witman in \textit{Pending Cases Filed by Swedish Courts from Direct Taxation: Recent ECJ Development}, M. Lang (ed.), together with an extensive overview of the Swedish corporate taxation rules, gives an example (p. 196) which explains how the timing difference occurs in a situation like the one in the \textit{X and Y} case.

\textsuperscript{226} Opinion of A-G Mischo [2002], points 4 and 24-26.

\textsuperscript{227} Case C-204/90 [1992] ECR I-249.

\textsuperscript{228} Opinion of A-G Mischo [2002], points 45, 56.
Conclusions

All the judgments of the cases quote the EC Court’s finding that although direct taxation falls within the competence of each Member State, they must nonetheless exercise that competence consistently with Community law and avoid any discrimination on grounds of nationality.

Potential or compensating advantages enjoyed by foreign companies, prevention of tax avoidance or evasion, and the desire to establish tax coherence are not accepted as justifications of the blanket rules discriminating between resident and non-resident entities. Only carefully targeted antiavoidance rules can be justified. Generally, as Commerzbank judgment proves, it is not enough to make an overall comparison of the tax position of a non-resident company vis-à-vis a resident company that should be done in order to reveal discrimination. Furthermore, as it is acknowledged in Futura Participations, non-discriminatory restrictions to the freedom of establishment can also be judged contrary to EC Treaty provisions.

As for bilateral and multilateral agreements between the Member States and third countries, the scope of Community freedoms cannot be restricted by reciprocity clauses and generally application of EC law cannot depend on the application of a double tax convention. However, it still stands undecided, to what extent the Treaty limits the Member States’ external competence to conclude these kind of treaties with other Member States or third countries.

5.3.3. Member States safeguarding national tax interests

As it has been mentioned before, the principle of subsidiarity ensures the right for the EU Member States to determine their corporate tax policies themselves. Direct taxation is one of the few fields left not harmonized among the States, so it is clear that the Member States are eager to use their corporate taxation regimes in a competitive way as a tool to attract investment from abroad as well as to safeguard their own national tax interests in order to make sure that local companies would not have fiscal-driven incentives to move out abroad to exploit more favoring corporate tax rules or try to escape national taxation through, for instance, transfer pricing or loss offsetting. Therefore, one may conclude that Member States impose restrictions on conducting business on their territory, based on the fear that companies would escape national taxation. Thus, there is a risk that the EC Court may find those restrictions discriminative, either in an overt or in a covert way, and restricting the freedom of establishment for companies, and would not accept justifications for such taxation
measures as, for instance, prevention of tax avoidance, double taxation, or creation of artificial arrangements with the only taxation-driven incentive.

**Imperial Chemical Industries plc (ICI)**

*Inter alia* this case\(^{229}\) illustrates the extent to which the principle of freedom of establishment within the European Union can affect national direct taxation rules. ICI and Wellcome Foundation Ltd., both UK resident companies, formed a consortium through which they beneficially owned 49 percent and 51 percent, respectively, of Coopers Animal Health (Holdings) Ltd. It was the sole business of Holdings was to hold shares in some 23 trading companies that operated in many countries. Out of those 23 subsidiaries, 4 were resident in the United Kingdom (including Coopers Animal Health LTD (CAH)), 6 in other Member States, and 13 in non-member countries. When CAH incurred losses on its UK operations, ICI decided to use to the consortium tax relief rules and set off 49 percent of CAH’s losses for those periods, in proportion corresponding to its shareholding in Holdings, against its chargeable profits for the related periods.

The UK tax authorities (Inland Revenue) refused ICI’s application for tax relief on the ground that Holdings did not constitute a “holding company” in that respect because the majority of its subsidiaries (19 out of 23) were not resident in the United Kingdom, as required by UK tax law. ICI argued that the requirement for a holding company’s business to consist wholly or mainly of holding shares or securities of companies resident only in UK was a form of a discriminatory tax regime, which restricted the freedom of company establishment.

ICI made an interesting argument against the discriminatory regime.\(^ {230}\) It claimed that the discrimination arose because tax relief for losses incurred by a resident company, which was a subsidiary of a resident holding company, was granted to a member of a consortium where all, or most of, the subsidiaries controlled by the holding company were resident. Whereas, other things being equal, it was refused if the holding company – because it had exercised its right to freedom of establishment conferred by the EC Treaty – controlled mainly subsidiaries resident in other Member States.

\(^{229}\) Case C-264/96 [1998] ECR I-4695

\(^{230}\) *ICI*, para. 11.
The EC Court has reminded (as in other cases\textsuperscript{231}), that “although direct taxation is a matter for the Member States, they must nevertheless exercise their direct taxation powers consistently with Community law”. The Court found that the legislation in question (denial of tax relief on losses) had discriminatory character and was contrary to the Art. 43 EC Treaty requirements, as it allowed tax consortium relieves only for companies controlling, wholly or mainly, subsidiaries whose seats were in the national territory.

Justification of the Inland Revenue was based on two aspects. First, it was based on the risk of tax avoidance. They argued that the purpose of the legislation at issue was to prevent the creation of foreign subsidiaries from being used as a means of depriving the UK Treasury of taxable revenues. As regards that, the EC Court found it sufficient to note that the legislation at issue did not have the specific purpose of preventing \textit{wholly artificial arrangements}, set up to circumvent UK tax legislation from attracting tax benefits, but applied generally to all situations in which the majority of a group’s subsidiaries were established outside the country. However, the establishment of a company outside the UK does not, of itself, necessarily entail tax avoidance.\textsuperscript{232}

A further UK justification was an objective to prevent a reduction in revenue caused by the mere existence of non-resident subsidiaries – that is, to escape the risk of and prevent the charges that might be transferred from foreign subsidiaries. In this case, the Court insightfully notes that there need not to be the majority of subsidiaries resident outside the UK – the existence of only one non-resident subsidiary is enough to create the risk invoked by the UK Government.

\begin{quote}
“diminution of tax revenue occurring . . . cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify unequal treatment that is, in principle, incompatible with Article 43 of the Treaty.”
\end{quote}

The question of fiscal cohesion is of importance in the judgment of this case as well. In a number of previous cases the Court has consistently accepted the principle that the need to safeguard the cohesion of a national tax system can justify a restriction to one of the fundamental freedoms guaranteed by the EC Treaty.\textsuperscript{233} However, the Court restrictively interprets the principle of fiscal cohesion.


\textsuperscript{232} \textit{ICI}, para. 26.

cohesion: it requires a strict correlation between a tax advantage granted to a taxpayer, and the taxation of that same person.

ICI case, as well as previously analyzed Compagnie de Saint-Gobain, appear to represent a new approach by the EC Court which is much less sympathetic to this concept. For example, in the ICI case, the ECJ found that there was “no such direct link between the consortium relief granted for losses incurred by a resident subsidiary and the taxation of profits made by non-resident subsidiaries.” And in Saint-Gobain it was held that there is no derogation from EU obligations for the prevention of evasion of a Member State's national tax base. Generally, in all cases reviewed by the EC Court, except Bachman and Commission v. Belgium cases, it held that the national direct taxation rules in question could not be justified by the principle of fiscal cohesion.

But to look objectively at the situation, in any event, cohesion technically cannot be used as an argument for a relief or exemption from tax, designed to secure a social objective, because the relief or exemption are already intended to make the tax system inconsistent – less cohesive – in order to promote that objective.

Eurowings Luftverkehr 234

In a decision to the Eurowings case, the EC Court found central provisions of German trade tax law discriminating against foreign lessors of movable goods, and violating the guarantee of freedom to provide services under Art. 49 of the EC Treaty. The Court found that it is not permitted to impose higher taxation on the leasing of equipment from another Member State, compensating for the lower tax rates imposed on the lessor in that State.

Eurowings AG, a German lessee of airplanes from an Irish lessor, challenged German trade tax law, which provisions it found encourage German lessees to lease from German but not foreign lessors; by this disadvantaging foreign EU lessors and therefore being impermissibly discriminating (amounting to covert discrimination).

The Court adopted the following line of reasoning. While these German taxation rules aimed at avoiding double taxation on the one hand, they also tended to increase the overall trade tax burden than taxation of 100 percent of the lease payments, instead of simply shifting it from the lessor to

the lessee. As a result, a foreign lessor would have had to offer prices significantly below those of a domestic lessor in order to compensate the lessee for the added trade tax lease cost.

In this case the EC Court had also rejected for justifications the cohesion argument. It was concluded that “a Member State cannot justify discrimination on the ground that its removal would entail a loss of tax revenue”. In addition, as also ruled in the previous case-law, “unfavorable tax treatment cannot be compensated for by other tax advantages in order to justify discrimination”.

Finally, neither the difficulties in obtaining information nor the absence of reciprocity on the part of other Member States constituted valid defenses. In particular, the EC Court has held that:

“Any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favorable treatment in tax matters given to recipients of services established in the latter State (...). As the Commission rightly observed, such compensatory tax arrangements prejudice the very foundations of the single market.”

So, this is again the case where national tax provisions are found being discriminating and unjustifiable.

**Lankhorst-Hohorst**

The EC Court issued its much-anticipated decision in the *Lankhorst-Hohorst* case on 12 December 2002, concluding that Germany’s thin capitalization rules cannot be applied to cross-border interest payments made by German companies to related parties in other EU Member States, as they violate the freedom of establishment.

In 1994, Germany introduced thin capitalization rules to the effect that interest paid to foreign related parties, among others, on debt exceeding certain debt-to-equity ratios is deemed a hidden dividend distribution. These debt-to-equity ratios do not apply if the interest is paid to taxpayers resident in Germany. Such difference in treatment between resident subsidiary companies according

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235 *Eurowings*, paras. 20-21.
237 *Eurowings*, para. 44 et seq.
238 Case C-324/00 [2002] ECR I-11779
to the seat of their parent company constitutes an obstacle to the freedom of establishment, which is prohibited by Art. 43 EC Treaty. The German rules make it less attractive for companies established in other Member States to exercise freedom of establishment.

The German company, Lankhorst-Hohorst GmbH, is a wholly owned subsidiary of a Dutch parent (the Dutch parent is wholly owned by another Dutch BV (grandparent)). Lankhorst’s balance sheet showed a negative net equity for the years 1996, 1997 and 1998 because of losses. To reduce its debt and interest burden, the grandparent granted a loan to Lankhorst at the end of 1996, on which Lankhorst paid an arm’s-length rate\(^{239}\) of interest.

The German tax authorities concluded that the safe havens did not apply and, therefore, reclassified the entire amount of interest paid on the loan as a deemed dividend distribution pursuant to thin capitalization rules and denied a deduction. Consequently, 30 percent German corporate income tax was assessed on all the interest payments for the years 1997 and 1998.

The Advocate General concluded that the German thin capitalization rules are incompatible with the freedom of establishment principle. He concluded that the rules are discriminatory because they do not apply to shareholder loans granted by a comparable German resident parent. And the desire of the German fiscal system to protect its tax base is not a valid justification for discriminating against subsidiaries with shareholders from other EU Member States.

The EC Court agreed that the difference in treatment between local and resident subsidiary companies according to the seat of their parent company constituted an obstacle to the freedom of establishment which was, in principle, prohibited by Article 43 EC. In any case the Court found that the Dutch parent companies of Lankhorst-Hohorst GmbH suffered from discrimination because their situation was not comparable to that of German tax-exempt parent entities, and the thin capitalization restriction applied to the foreign parent entities independently of other conditions that might have led to a similar reclassification in a domestic context. Such discrimination can only be justified if the national measure pursues a legitimate aim compatible with the EC Treaty, is required by pressing reasons of public interest, is able to achieve the aim in question and does not exceed what is necessary for that purpose.

\(^{239}\) “Arms-length” principle in this case applies in conformity with Art. 9(1) of the OECD Model.
The EC Court found that none of these criteria were met in the present case. Specifically, the Court noted that “reduction in tax revenue did not constitute an overriding reason in the public interest which might justify a measure that was in principle contrary to a fundamental freedom”. Besides, thin capitalization rules cannot be accepted as general anti-abuse rules when their application depends on the location of the seat of the parent company, which is, itself, subject to the tax legislation of its home country. Second, the Court rejected the argument that thin capitalization restrictions are justified by the need to ensure the coherence of the tax system. No direct link between the tax disadvantage suffered by the German subsidiary and a tax advantage at the same level could be established. Finally, the Court did not see how the thin capitalization rules in question could possibly enable the tax authorities to supervise the amount of taxable income. Therefore, the German thin capitalization rules were found to be prohibited by Art. 43 of the EC Treaty.

As a possible implication of the *Lankhorst-Hohorst* judgment, similar rules in other EU Member States that are based on a distinction between domestic and cross-border situations may also be challenged.\(^{240}\) *Lankhorst-Hohorst* could encourage groups to set up companies in, say, Ireland, which had the lowest corporate tax rate in the EU at 12.5 percent before May 1, 2004; Cyprus, which has a 10 percent corporate tax rate; or Estonia, with 0 percent. Profits from thinly capitalised companies in other Member States could effectively be shifted to Ireland or other low corporate tax countries.

In addition, the implications may go beyond the EU taking into account that the EEA Treaty and agreements with Central and Eastern European countries, the new EU members, contain non-discrimination clauses similar to the provisions in the EC Treaty. Association agreements with other countries (e.g. the agreement with Turkey) might also be relevant in this context. Therefore, any of the tax rules mentioned above are affected if they result in discrimination in these other countries, or in the EU Member States with respect to transactions with these particular countries.

**Hughes de Lasteyrie du Saillant**

The case deals with exit taxes. In principle, they are not discriminatory, since they apply to all residents who want to emigrate, irrespective of their nationality or law of incorporation, but they

\(^{240}\) Belgium, Denmark, France, Portugal and Spain also have thin capitalization rules.
might restrict workers, self-employed persons and companies in their freedom to leave the country in order to take up a job or establish themselves in another Member State. Terra and Wattel draw our attention to the necessity to make a distinction between ‘restriction’ and ‘discrimination’. The concept of discrimination, according to them, only envisages overt distinctions between residents and non-residents; and the free movement of goods, services and capital beside overt discriminative measures also prohibit “unjustified restrictive measures without distinction”. Therefore a national measure even indiscriminately applicable to both domestic and foreign goods may still be considered restrictive if it hinders intra-Community trade and be prohibited.

As for the freedom of establishment, however, Arts. 39 and 43 (free movement of workers and freedom of establishment) require “national treatment of workers and undertakings” of other Member States, thus Terra and Wattel point out that these articles do not seem to forbid restrictive measures without distinction, which is important with the case of exit taxes. As pointed out before, being non-discriminative, they might still be restrictive. At this point EC Court seems to play its role filling up this gap by laying down prohibitions not only on discriminative, but also restrictive measures, under which fall exit taxes. Consequently, Terra and Wattel suggest a conclusion that in the latest EU case-law there seem to be signs “pointing to a gradual shift from prohibition of discrimination to prohibition of all restrictive measures”. This affirmation sounds truthful as it proves the tendency of the EC Court to put more and more pressure on the Member States’ national taxation systems.

And the Hughes de Lasteyrie du Saillant case, which has been being commented a lot these days, is exactly an example when the EC Court continues to exert its powerful influence on the domestic tax policies of the Member States. The case has awaited many comments from different States, since many of them apply similar national taxation rules, which were challenged in this case, and the judgment of the Court would definitely have an impact on them as well. Besides, the case is important in terms of showing once again that Member States have not found it easy to defend their domestic tax laws that have cross-border implications within the EU.

French legislation, in order to avert the risk of tax avoidance, established a mechanism for taxing increases in value where tax residence was transferred abroad. Taking the view that those
provisions both created “inequality of treatment” because they penalized only taxpayers wishing to leave France, and were disproportionate to their declared aim of preventing tax avoidance, Mr. de Lasteyrie challenged these French legislation for being incompatible with the principle of freedom of establishment under the EC Treaty.

The Advocate General agreed that the residential exit tax breached the freedom of establishment provisions of the Treaty and ruled they could not be justified. In his opinion, the case could also apply to free movement of persons within the European Union. It was held that “freedom of establishment could not be enacted simply because people may decide to become residents of another Member State in order to avoid tax in their former state of residence”. And it is disproportionate to have a law penalizing everyone who transfers his tax residence, as people would want to change their residence for reasons other than (only) tax avoidance. In A-G’s opinion, if Member States want to stop tax evasion and tax avoidance, they need to introduce less restrictive laws.

It follows from the judgment of the case that there is a disagreement between different Governments on the subject. About the possible infringement of the freedom of establishment the Danish and German Governments argue that the French provisions in question are not discriminatory and do not constitute an obstacle to the freedom of establishment. In their opinion, there is no evidence that French tax legislation directly or indirectly prevents French nationals from establishing themselves in another Member State.\(^\text{244}\)

Portuguese Government and Commission on the other hand consider French tax provisions restrictive to the freedom of establishment, because “such system penalizes taxpayers who leave France in comparison with those who remain there and thereby introduces a discriminatory difference in treatment”.

The EC Court began by underlining that freedom of establishment is one of the fundamental provisions of Community law and it precludes a Member State of origin from hindering the establishment of one of its nationals in another Member State, including by tax measures. In this case, the Court took the view that the provision in question was likely to “restrict the exercise of that right, having at the very least a dissuasive effect on taxpayers wishing to establish themselves

\(^{244}\) Hughes de Lasteyrie du Saillant, para. 21.
in another Member State”245, because just by the fact that they are transferring their tax residence outside France, they were subjected to tax on the income that has not yet been realized, and thus to disadvantageous treatment by comparison with a person remaining in France.

The French Government for its justification argued that the measure pursued an objective to prevent tax avoidance. It also recalled *ICI* judgment, which mentioned that “legislation specifically aimed at excluding from a tax advantage purely artificial arrangements that are designed to circumvent tax law may constitute an imperative reason in the public interest”. Moreover, the Government argues that applications of its tax measures in question is proportionate to the aim pursues, since the constraints imposed on the taxpayer are limited in time.

The EC Court did not accept these justifications, judging that the tax measure in question “is not specifically designed to exclude from a tax advantage purely artificial arrangements aimed at circumventing French law, but is aimed generally at any situation in which a taxpayer with substantial holdings in a company subject to corporations tax transfers his tax residence outside France for any reason whatever”. 246 Moreover, the Court considered that the objective envisaged – to prevent a taxpayer escaping payment of the tax on increased value due in France – “may be attained by measures that are less coercive or less restrictive of the freedom of establishment”, and which relate specifically to the risk of such a temporary transfer, for example by taxing a taxpayer who, after a short stay abroad, returns to France once his increased values have been realized.

The implications for Member States of the judgment of this case could be significant. Commentators are of opinion, that this Court’s ruling in favor of an individual French taxpayer could have wider implications for the Member States that impose company exit taxes.247 It is believed that the ruling in particular will force the French tax authorities to make changes to exit laws.248 Also, as it is insightfully noted,249 if exit taxes, combined with guarantees, wholly or partly are considered conform to EC law, an increase in number of exit taxes in various fields could be foreseen. However, this may turn out to be an unfortunate development, especially as it will weaken the mobility within Europe.

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246 *Hughes de Lasteyrie du Saillant*, para. 50. Here the Court refers to cases *ICI*, para. 26 and *X and Y*, para. 61.
248 This is the opinion of Pierre-Yves Bourtourault, head of the tax group at Baker & McKenzie in Paris. (*Ibid*)
Conclusions

One may note from the case-law that, basically, it is a rear case when the measures used by Member States to safeguard their national taxation interests and local companies from moving out from the country to exploit better tax regimes are accepted by the EC Court. Specifically, Member States find it not easy to define whether their protective measure has a purpose to preventing wholly artificial arrangements or whether the Court finds it of a general character. Preventions of revenue reductions or double taxation, tax avoidance, compensations by other tax advantages in either host or home Member States, as well as principle of fiscal cohesion were not accepted as justifications.

Generally, with the recent developments in the case-law it might be observed that EC Court more often rules in advantage of the taxpayers. Ad in spite the States having their right to control their own direct tax systems, the Court’s decisions seems to put a pressure on the Member States to review their domestic corporate taxation rules.

5.4. Conclusions of the chapter

5.4.1. Unresolved issues

The aim of this chapter has been to shed some light on the EC Court’s judgments concerning tax barriers to companies’ right of establishment in a perspective of the case-law on free movement. Throughout the established case-law, the Court has clarified a number of questions, which the Member States have faced while interpreting the Treaty provisions regarding direct taxation. However, still many issues necessitate further explanation, such as: the precise definition of the notion of ‘seat’ used by the Court to determine the existence of overt discrimination of companies; the difficulties in distinguishing seat (overt discrimination) and fiscal residence (possibly covert discrimination) as criteria for justification in national tax laws; the question about under which circumstances the situation between a resident and non-resident company can be considered “comparable” for tax purposes under Art. 43; the possible justifications for the national tax rules provisions which, albeit of a non-discriminatory nature, are anyway found to discourage or hinder companies in exercising their freedom of establishment; and, last but not least, to what extent the
Treaty limits the Member States’ external competences to conclude double taxation treaties with other Member States or third countries.\(^{250}\)

Effectiveness of the ECJ’s case-law, which pursues the aim to ensure accurate application of the EC Treaty provisions, also depends on the ability of the Member States to interpret and implement the EC Court’s rulings in a correct way; or rather draw more general consequences following from separate case judgments. Analyzing the case-law, one may conclude that the area of direct taxation has not yet reached its maturity and some decisions of the ECJ are not systemised, coherent, and lack its guidance to the Member States. As a solution, it is therefore believed that positive legislation in the sphere of direct taxation could promote uniform application of the important rulings in a form of communications or recommendations.\(^{251}\)

5.4.2. ECJ rules in favor of European integration

Speaking in general terms, direct taxation case-law shows that the impact of European tax law on the Member States continues to widen. There is a growing concern that recent decisions of the ECJ threaten Member States’ control of their own direct tax systems. The judgments of the Court keep putting more and more pressure upon the States and have implications not only on their national corporate taxation rules, but even affect intra-Community agreements.

Naturally, the EC Court acts on the basis of the EC Treaty, however one may note that it tends to allow itself interpretations of the established Treaty provisions, sometimes shaping them or presenting them in the light that may have not necessarily been originally foreseen. It is true that with no agreement on EU direct tax measures the EC Court does fill in the vacuum, however I would agree with some commentators who state that such court-based approach to resolving disputes is fragmented, i.e. limited to case-to-case issues. “The rulings are given on the basis of legal challenges, rather than reflecting any attempt to develop a coherent legal structure within the EU. (…) The ECJ does not focus on a domestic system as being a standalone environment, but rather treats the EU as a single economic entity in which tax rules should not hinder cross-border investment.”\(^{252}\) In addition, it may be concluded that generally the Court, while being mindful of the consequences of its decisions on to international tax law, interprets Community law in favor of EU

\(^{250}\) Current issues of Cross-Border Establishment of Companies in the EU, J.Wouters, H.Schneider, p. 141.


integration. This implies that the ECJ rulings can be interpreted in favor of harmonizing direct taxation among Member States; which is in line with the EU Commission’s strategy.

5.4.3. Pressure on the Member States

Despite Court’s judgments may sometimes interfere with the national interests, the States nevertheless are willing to cooperate and even reshape their national corporate taxation policies in compliance with the EC Court decisions. However, the resulting pressure from the latest case-law seems to become overwhelming indeed, which leaves Member States in frustration, witnessing the Court armed with its proportionality principle being able to criticize any national policy which aims at keeping the corporate tax base inside the country and protecting national taxation interests. Justifications of various grounds keep on being rejected by the Court. Preventions of revenue reductions or double taxation, tax avoidance, compensations by other tax advantages in either host or home Member States, desire to protect own tax base or the cohesion of the Member States’ tax systems – would not satisfy the Court as sufficient justifications for national tax policies. Thus, it may be concluded that in this sense the EC Court’s policy bears a destructive character; and it leaves the national tax authorities with the question – how then to combat tax avoidance?

A possible consequence of such a policy may be that the ECJ will finally force Member States to cooperate much more closely in order to protect the integrity of their own tax systems. Perhaps the reality is that Member States are under growing pressure to give up their autonomy in the direct tax field and go for the solution of (minimum) tax harmonization. The other scenario could unfortunately be Member States’ decision to be better off without the common Union, if its requirements are as much as destructive for their own national interests.

There are opinions that the Court should restrict itself in its direct tax judgments, accept that it cannot solve by way of negative integration the problems arising from the lack of harmonization of national direct tax systems, and that positive integration is the only true solution. On the other hand, some commentators observe that the Court is simply applying settled Community law in the field of integration. This implies that the ECJ rulings can be interpreted in favor of harmonizing direct taxation among Member States; which is in line with the EU Commission’s strategy.

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254 For instance, German and French initiative to establish in the EU a minimum rate of corporate income tax.
direct taxation, and the Member States should not complain but better “make serious progress in positive direct tax harmonization”.  

To conclude, a figurative comparison of the Irish consultants from Deloitte & Touche seems to reflect the atmosphere among the Member States towards the EC Court’s policy. The consultants name the way that the EC Court treats the EU residents in direct tax matters the “Procrustean”-like, comparing the ECJ with the Greek innkeeper Procrustes, an ancient champion of enforced conformity, who used to “adjust” his guests to the size of a special bed he had made – by either stretching them on the rack if they were too short for it or chopping off their legs if they were too long. From this point of view, Irish observers bring to attention “the bloody consequences” of the attempts to make individuals (or Member States in case of the EU) fit a pre-existing framework: that is “billions of euros in damages and/or reduced tax from many Member States”.  

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6. Conclusion

The achievement of a common market within the EU involves elimination of barriers to the free movement of goods, services, persons and capital as well as the prohibition of distortions to fair competition. The use of corporate taxes by the Member States may cause those distortions and thus should be forbidden in order to achieve common market. For this purpose corporate tax harmonization is believed to be an effective tool of European integration process.

The foregoing has been an attempt to designate the problem and structural conflict of the interests with EU Commission and ECJ on one side and some of the Member States with their national interests on the other side in attempt of achieving an agreement. Analysis of Commission’s initiatives and strategy, as well as EC Court’s case-law and tendencies of its judgments attempt to reveal the failures and malfunctions of work of both institutions and the possible reasons for them; as well as discovering whether any institution (legal or judicial) in the EU is in a position to undertake the task of harmonizing corporate taxation.

Given the EC Treaty requirement that the decisions regarding direct tax are to be agreed unanimously among the Member States, the agreement concerning corporate tax harmonization proves to be hard to achieve. By now, the only effective legal obligations are posed on the Member States in the form of directives (Mutual Assistance Directive 77/779, Merger Directive 90/434, Parent-Subsidiary Directive 90/435, Directive on interest and royalty payments 2003/49 and Directive on taxation of savings income in the form of interest payments 2003/48), convention (90/436 on Arbitration and abolition of double taxation, which is waiting for its extension ratification). In addition, the legally not binding Code of Conduct, aimed at eliminating certain preferential tax regimes in the EU, is to some extent an effective measure as well.

Other Commission initiatives throughout the years have been being opposed by the Member States and the Council for a number of reasons. Analysis of the tendencies in Commission’s striving towards achieving EU corporate tax harmonization shows that malfunctions at the institutional level, combined with Member States’ reluctance to relinquish their sovereignty in direct tax matters, make achievement of compromise an arduous task.

The major reasons of Commission’s failure are its prioritizing of positive integration measures only, forgetting that negative integration in the form of strict rules that the Member States must abide is especially important in direct tax matters; Commission’s neglect to consider the specifics of the EU
legislative process in the field of corporate taxation, where the unanimity condition presupposes some room left for national legislative freedom. Finally, Commission’s hunger for harmonization regarding corporate taxes (even where it is not needed) as a mixture of its intention to control the Member States’ company tax legislations resulted in its tendency to over-propose, and thus was matched by the Council’s bent to over-neglect Commission’s proposals.

On the other hand, lack of legislative progress in the field of direct tax harmonization has resulted in the European Court of Justice becoming the driving force behind European direct tax harmonization. Emerging number of cases on company taxation are characterized for being ‘fundamental’ and prove the Court’s inclination towards corporate tax harmonization. However, malfunctions of the Court’s approach do not allow concluding that it is the institution that should be taking care of achieving approximation of corporate tax systems of the Member States. Practice proves that the area of direct taxation has not yet reached its maturity and some decisions of the ECJ present a piecemeal approach, are not systemized, coherent, and lack its guidance to the Member States. Thus, EC Court’s judgments, which with their direct applicability effect are harmonization measures of a negative character, are believed to be better complemented with positive legislation in a form of communications or recommendations, which would help in promoting uniform application of the important rulings.

At the same time, the EC Court is criticized for its burdensome activism in the field of corporate taxation, which it may be concluded bears a destructive character, and in the end may lead the Member States to neglect the Court’s decisions. Thus, the Court is suggested to take into account Member States’ interest when deciding company tax cases, otherwise “its prestige at the apex of the judicial pyramid in the EC runs the risk of being neglected”\(^\text{257}\).

Thus, as an ultimate conclusion, it may be asserted that neither European Commission (legislative institution), nor the European Court of Justice (judicial institution) are capable in achieving harmonizing corporate taxation on their own. As both institutions present limitations in their role in the process of harmonization, it is the question of balance between the powers of two institutions, which can complement each other and compensate own malfunctions. In addition, positive and negative integration measures are not alternatives, but complementary means of achieving some degree of corporate tax harmonization.

List of Appendixes

Appendix 1. Table of equivalences of the EC Treaty articles referred to in the text
Appendix 3. Chronology.
Appendix 1.

Table of equivalences of the EC Treaty articles referred to in the text

<table>
<thead>
<tr>
<th>Present numbering</th>
<th>Previous numbering</th>
</tr>
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<tbody>
<tr>
<td>Art. 2</td>
<td>Art. 2</td>
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<tr>
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<td>Art. 3</td>
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<tr>
<td>Art. 14</td>
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<td>Art. 308</td>
<td>Art. 235</td>
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Appendix 2.

**Highest Statutory Corporate Income Tax Rates in OECD Countries, 2003**

[Central government]

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<thead>
<tr>
<th>Country</th>
<th>Rate</th>
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<tbody>
<tr>
<td>Austria</td>
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<tr>
<td>Belgium</td>
<td>40.2</td>
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<tr>
<td>Cyprus (1)</td>
<td>10.0</td>
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<tr>
<td>Czech Republic</td>
<td>31.0</td>
</tr>
<tr>
<td>Denmark</td>
<td>30.0</td>
</tr>
<tr>
<td>Estonia (2)</td>
<td>0.0</td>
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<tr>
<td>Finland</td>
<td>29.0</td>
</tr>
<tr>
<td>France</td>
<td>36.3</td>
</tr>
<tr>
<td>Germany</td>
<td>26.5</td>
</tr>
<tr>
<td>Greece</td>
<td>35.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>18.0</td>
</tr>
<tr>
<td>Ireland (3)</td>
<td>12.5/25.0</td>
</tr>
<tr>
<td>Italy</td>
<td>34.0</td>
</tr>
<tr>
<td>Latvia</td>
<td>19.0</td>
</tr>
<tr>
<td>Lithuania</td>
<td>15.0</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>22.9</td>
</tr>
<tr>
<td>Malta</td>
<td>35.0</td>
</tr>
<tr>
<td>Netherlands</td>
<td>34.5</td>
</tr>
<tr>
<td>Poland</td>
<td>27.0</td>
</tr>
<tr>
<td>Portugal</td>
<td>33.0</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>25.0</td>
</tr>
<tr>
<td>Slovenia</td>
<td>25.0</td>
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<tr>
<td>Spain</td>
<td>35.0</td>
</tr>
<tr>
<td>Sweden</td>
<td>28.0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>30.0</td>
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**Unweighted Averages: (4)**

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<th>Region</th>
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<tr>
<td>EU 15</td>
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<tr>
<td>EU 25</td>
<td>26.6</td>
</tr>
<tr>
<td>OECD</td>
<td>29.3</td>
</tr>
</tbody>
</table>

(1) For tax years 2003 and 2004 only an additional 5% is imposed on taxable profits over C£1,000,000.

(2) For distributed profits (and certain non-business expenses) the rate is approximately 35%.

(3) The standard rate (on trading income) is 12.5%. The rate on passive income is 25%.

(4) Midpoint tax rate used for countries with multiple tax rates.

Appendix 3.

Chronology

1967 - Programme for the Harmonization of Direct Taxes
1968 - Model of a European Double Tax Convention (not approved)
1969 - “Proposal for a directive on the common taxation arrangements applicable to mergers, the splitting up of companies and the transfer of assets” (passed in 1990)
1969 - “Proposal for a directive on the common taxation arrangements applicable to parent companies and subsidiaries” (passed in 1990)
1970 - Van den Tempel Report
1971 - Economic and Monetary Union (EMU) resolution
1975 July 23 - Commission’s Action Programme for taxation COM (75) 391
1975 July 23 - Proposal for Directive on harmonizing corporation systems and arrangements for withholding taxes on dividends
1976 November 24 – proposal for Directive on elimination of double taxation COM (76) 611 (passed in 1990 as Arbitration Convention)
1979 – ECJ judgment on Cassis de Dijon Case 120/78
1987 - Single European Act
1990 “Package of Three” – Commission’s Communication to the Council
1990 July 23 – Merger directive Dir 90/434
1990 July 23 – Parent-Subsidiary directive Dir 90/435
1990 August – Arbitration Convention - Decision 90/436 (approved on 1 January 1995 but ceased to be effective on 31 December 1999. Now still not applicable)
1991 January 24 – proposal for interest and royalties directive COM (90) 571 (withdrawn in 1994)
1992 March - Ruding Committee Report
1992 June – Commission’s Communication to the Council and to Parliament
1992 November – ECOFIN Council meeting – Council’s reaction
1993 May 6 – Commission’s legislative programme, which included European Company
1993 July – Commission’s proposal to amend two 1990 directives - COM(93) 293 (withdrawn in 2004)
1996 April – First Monti Memorandum
1997 October 1 – Communication “Towards tax coordination in the European Union: Package to tackle harmful tax competition” COM (97) 495
1997 December 1- ECOFIN Council meeting – “Tax Package”:
1997 – Code of Conduct – COM (98) 595 (not legally binding)
1998 October 12 – Commission Notice on the application of the State aid rules to measures relating to direct business taxation
COM (2001) 260 “Tax policy in the EU – priorities for the years ahead”
COM (2001) 582 “Towards the Internal Market without Tax Obstacles”
2002 April 30 – European Conference on Company Taxation (Brussels)
2003 December 6 – Conference in Rome
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