A SUMMARY OF THE *ACQUIS COMMUNAUTAIRE* ON DIRECT TAXATION[1]

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Introduction

This article seeks to provide a basic summary of the *acquis communautaire* on direct taxation in the European Union[3] as at the end of January 2001. It discusses both the legislative measures that have been adopted so far, the jurisprudence of the European Court of Justice ("ECJ") on direct taxation, and further measures currently under consideration. It does not seek to analyse in any detail the existing tax measures, or the jurisprudence of the ECJ, or discuss the desirability of the measures currently under consideration.

One point of terminology may be made at the outset. There has been

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1 This article was originally prepared as part of advice to the Ministry of Finance of the Republic of Latvia during a consultancy under the Phare programme. An earlier version of the article appeared in *The TAXline Tax Review 1999-00* (eds. Tim Good and Anita Monteith) (Oxford: Professional Training Partnership, 1999), ch. 22.

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3 There is a technical difference between the European Union and the European Community which is quite difficult to express. In broad terms, the European Union represents the interests and policies of the Member States with respect to the rest of the world, while the European Community represents the network of rules which have been adopted within the Member State to achieve the objectives established by the various treaties. In principle, therefore, matters concerning direct

much discussion in recent years of direct tax *harmonisation*, but the term that it coming into more popular usage is that of "co-ordination of tax policy"[4]. In general, the term "co-ordination" is intended to imply the guidance of Member States towards the acceptance of a mutually beneficial policy rather than any element of imposition of tax measures from the Commission. Certain of the direct tax measures adopted so far have been issued under Art. 94 of the Treaty of Rome[5] which provides for the issue of directives for the approximation of laws.

The Legal Bases for Co-ordination of Direct Taxes in the EU

There is no specific reference to the co-ordination or harmonisation of direct taxes in any of the treaties establishing the European Union or the European Community. The only specific reference to direct taxation in the Treaty of Rome is Article 293 (formerly Article 220) which provides:

> "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:
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> …

taxation ought to come under the heading of European Community Tax Law. However, there is some simplification if one refers to the territories of the Member States as the European Union.

4 See, for example, the evidence of Commissioner Mario Monti to the Select Committee on the European Communities (Sub-Committee A) of the House of Lords on the 13 May 1999 (15 Report of the Select Committee, Session 1998/99 entitled "Taxes in the EU: Can Co-ordination and Competition Co-exist?" HL Paper 92, pages 81 to 90).

5 Formerly Art. 100. In general this article will use references to the Treaties as amended by the Treaty of Amsterdam, but with the former Article number given in brackets or in a footnote.

- the abolition of double taxation within the Community;

…"

The Arbitration Convention[6] was adopted on the basis of this Article. The ECJ has held that Article 293 is not intended to lay down a directly-applicable legal rule, but merely defines topics on which the Member States are to enter into negotiations with each other "so far as is necessary"[7].

The position with regard to direct taxation may be contrasted with that of turnover taxes, excise duties and other forms of indirect taxation where Article 93 (formerly Article 99) requires the Council to adopt provisions for the harmonisation of legislation concerning these taxes.

The absence of a specific provision in the Treaty of Rome relating to the harmonisation of direct taxes is undoubtedly one of the reasons why so little has been achieved on the legislative front with regard to direct taxation.

In the absence of a specific warrant for harmonisation, measures relating to direct taxes have generally been adopted under Article 94 (formerly Article 100) on the approximation of laws. This Article provides that the Council, acting unanimously on a proposal from the Commission (and after consulting

6 Discussed further below.

7 *Gilly*, paragraph 15.

the Parliament and the Economic and Social Committee) may issue directives for the approximation of laws. Article 94 requires the unanimous agreement of the Council. This may be contrasted with Article 95 (formerly Article 100a) which provides for measures on the approximation of laws to be adopted by qualified majority voting. Article 95(2) states that qualified majority voting "shall not apply to fiscal provisions". This is the basis for the requirement of unanimity on fiscal matters.

Turning from the provisions in the treaties regarding direct taxation to the role of the ECJ, the Court has now repeated on several occasions the following mantra:

> "Although direct taxation is a matter for the Member States, they must nevertheless exercise their direct taxation powers consistently with Community Law"[8].

The principles of Community Law that are most generally relevant in the field of direct taxation are, first, the freedoms set out in Title III of the Treaty of Rome - free movement of workers (Article 39, formerly 48), freedom of establishment (Article 43, formerly 52), freedom to provide services (Article 49, formerly 59) and free movement of capital (Article 56, formerly 73b). Also relevant - though displaced where there is a more specific provision of

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8 See, for example, *Colmer*, paragraph 19 (referring to *Schumacker*, paragraph 21), *Wielockx*, paragraph 16, *Asscher*, paragraph 36, *Futura Participations*, paragraph 19, *Gschwind*, paragraph 20, *Baars*, paragraph 17, *Verkooijen*, paragraph 32 and *AMID*, paragraph 19.

applicable Community law - is the general prohibition of discrimination on grounds of nationality in Article 12 (formerly Article 6).

Within the general principles of Community Law, it is interesting to note that Article 6 (formerly Article F) of the Treaty on European Union provides that the Union shall respect fundamental rights as guaranteed by the European Convention on Human Rights as general principles of Community Law. The ECJ has at times had regard to provisions of the European Convention on Human Rights when determining the scope of Community Law[9].

There is a further group of provisions of the Treaty of Rome under which direct tax measures may come up for consideration before the Commission (and, on an appeal or a reference, the Court). These are the state aid provisions of Articles 87 and 88 (formerly Articles 92 and 93). Article 87(1) prohibits any aid granted by a Member State or through State resources which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods. The state aid provisions impose an obligation of prior notification of any potential state aid. The Commission may also take any state which does not abolish or alter a state aid direct to the ECJ. Direct tax

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9 There is a well-established jurisprudence of the Court that fundamental human rights are part of the general principles of Community Law protected by the Court: see *Stauder v. City of Ulm* (Case 29/69) [1969] ECR 419 at page 425, paragraph 7; *Internationale Handelsgesellschaft* (Case 11/70) [1970] ECR 1125 at page 1134, paragraphs 3 and 4; *Nold* (Case 4/73) [1974] ECR 491 at page 507, paragraphs 12 and 13; *Prais* (Case 130/75) [1976] ECR 1589 at page 1597, paragraph 8; *ERT* (Case C-260/89) [1991] ECR I-2925 at pages 2963-2964, at paragraphs 41 to 44; and *P v. S and*

measures may fall within the scope of the state aid provisions[10].

Legislative Provisions Adopted So Far

Largely for the reasons explained above, there have been few legislative measures adopted in the field of direct taxation.

The earliest measure was the Mutual Assistance Directive[11] which contains extensive provisions for the exchange of information between Member States for the purposes of making correct assessments of taxes on income and capital. This Directive makes provision for a broader exchange of information than is generally provided for under the exchange of information Article of a bilateral double taxation convention[12].

The Mutual Assistance Directive was preceded by a Council Resolution on international tax evasion and avoidance[13]. That resolution emphasised the

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Cornwall County Council (Case C-13/94) [1996] ECR I-2143 at pages 2164-2165, paragraphs 16 to 19.

10 See, in particular, the Commission Notice on the application of the state aid rules to measures related to direct business taxation discussed further below, and see the judgments in *Banco Exterior de España* (Case C-387/92) [1994] ECR I-877 at page 908, paragraph 14 and in *Germany v. Commission* (Case C-156/98) [2000] ECR I- XXX at page XXX, paragraphs 22-28.

11 Council Directive 77/799/EEC of 19 December 1997 concerning mutual assistance by the competent authorities of the Member States in the fields of direct and indirect taxation, OJ L336, 27.12.1977, page 15 as amended by Council Directive 92/12/EEC of 25 February 1992, OJ L76, 23.3.1992, page 1.

12 There has been one case on the Mutual Assistance Directive – *WN*.

13 Council Resolution of 10 February 1975 on the measures to be taken by the Community in order to combat international tax evasion and avoidance, OJ C35, 14.02.75, pages 1 to 2.

exchange of information as a means of combating international tax avoidance and evasion.

Two legislative measures contain matters which have a relevance to direct taxation. The first is the EEIG Regulation[14] which provides in Article 40 that the profit or losses from the activities of an economic interest grouping are taxable only in the hands of the members. The second is the Capital Movements Directive[15] which provides a classification for capital movements which are subject to the freedom of movement of capital now found in Article 56 of the Treaty.

The July 1990 Package

The main legislative achievements of the Community in the field of direct taxation came together as a package in July of 1990. This package contained two Directives and a Convention: the Mergers Directive, Parent-Subsidiary Directive, and the Arbitration Convention.

The Mergers Directive[16] applies to four types of corporate reorganisations

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14 Council Regulation 2137/85/EEC of 25 July 1985 on the European economic interest grouping, OJ L199, 31.7.85, page 1.

15 Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, OJ L 185, 8.7.88, page5.

16 Council Directive 90/434/EEC 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 L 225, 23.7.90, page 1.

- mergers, divisions, transfers of assets and exchanges of shares - (not all of which are possible under the existing corporate laws of all Member States). Where the reorganisation, as defined in the Directive, is possible, the Directive contains rules designed primarily to defer the realisation of chargeable gains on the reorganisation.

The Parent-Subsidiary Directive[17] requires that no withholding tax should be imposed on payments of dividends from a subsidiary to its parent where the two companies are resident in different Member States.

Both the Mergers Directive and the Parent-Subsidiary Directive were adopted under the provisions of Article 94 (formerly Article 100) of the Treaty.

The Arbitration Convention[18] was adopted under the authority of Article 293 (formerly Article 220) and provides a procedure for the resolution of transfer pricing disputes through a system of ultimately binding arbitration. The Convention contains, in Article 4, a basic, arm's length, transfer pricing rule modelled on Article 9 of the OECD Model.

The Arbitration Convention was originally concluded for a period of five

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17 Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L225, 20.8.90, page 10.

18 EC Convention 90/436/EEC of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, OJ C 225, 23.7.90, page 10.

years. However, by a Protocol adopted on 25 May 1999 the Convention was amended to provide for automatic renewal for periods of five years at a time unless any Member State informs the Council of its objection to the continuation of the Convention[19].

The two Directives and the Convention of July 1990 represent - along with the Mutual Assistance Directive - the only significant legislative contributions of the EU to direct tax harmonisation to date.

There have been two Commission Recommendations in the field of direct taxation prior to the current round of proposals for new directives (which is discussed below). These are the Commission Recommendation on the income of non-residents[20] (which was the first measure adopted dealing specifically with the direct taxation of individuals), and the Recommendation on small and medium-sized enterprises (SMEs)[21] which provides a justification for special tax provisions relating to SMEs.

The conclusions of the recent meetings of the ECOFIN Council and the proposals for further directives are discussed under the heading of "Current

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19 Protocol amending the Convention of 23 July 1990, OJ C202, 16.7.99, page 1.

20 Commission Recommendation 94/79/EC 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, 10.2.94, page 22.

21 Commission Recommendation 94/390/EC of 25 May 1994 concerning the taxation of small and medium-sized enterprises, OJ L177, 9.7.94, page 1.

Proposals" below.

The Jurisprudence of the European Court of Justice on Direct Taxation

While legislative interventions in the field of direct taxation have been few, there is a growing jurisprudence of the ECJ on direct taxation. Some of the cases having a potentially wide impact[22].

Most direct tax cases have come to the ECJ under Article 234 (formerly Article 177) through the route of a reference for a preliminary ruling from a court in a Member State faced with resolving a tax dispute. A small number of cases have come to the ECJ in the form of infringement proceedings brought by the Commission under Article 226 (formerly Article 169). The challenge has generally been based upon one of the fundamental freedoms of the Treaty.

The case law is analysed below under the following sub-headings: cases relevant to the taxation of individuals; and, cases relevant to the taxation of enterprises. This is followed by a brief discussion of taxation and state aid. By way of introduction to this case law, however, it may be helpful to summarise the current state of the ECJ jurisprudence in direct tax matters.

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[22] The Appendix contain a list of the principal decisions of the ECJ in the field of direct taxation, with the full citation of the cases. The abbreviated name for each case is employed in the text of this article.

Summary of the jurisprudence of the ECJ[23]

At present, the competence in direct taxation rests with the Member States, but they must exercise that competence consistently with the treaties and the general principles of EC law.

The freedom of establishment, in particular, includes the right of enterprises to pursue their activities in Member States through a branch or subsidiary: different tax treatment accorded to local enterprises and to branches of enterprises established in another Member State infringes this principle. The state of origin is also prohibited from applying tax rules which hinder the establishment in another Member State of its nationals or companies incorporated under its legislation.

The treaties and principles contain a prohibition on grounds of nationality; this applies not only to direct discrimination but also to indirect discrimination on grounds other than nationality through national measures which make the exercise of Community law rights by non-nationals more difficult. In general, non-residents are more likely to be non-nationals, so discrimination on grounds of residence may constitute indirect discrimination on grounds of nationality.

[23] The authorities for the propositions in this summary are given in the more detailed text which follows.

The ECJ has defined discrimination as the application of different rules to the same situation, or the application of the same rules to different situations. The Court has shown, particularly in some recent cases, the necessity of analysing carefully the situations of residents and non-residents to see if they are in fact taxed in the same fashion.

Discrimination may sometimes be justifiable, but on narrow grounds. Many of the tax cases have turned on whether or not a discriminatory provision might be justified. The grounds of justification vary. If there is direct discrimination contrary to the freedom of establishment in Article 43, recent cases have indicated that this may only be justified within the narrow grounds contained in Article 46 (public policy, public security or public health). On the other hand, if the legislation on its face is indistinctly applicable, discrimination may be justified provided that the legislation pursues a legitimate aim, that the restriction is reasonable, and that the restriction is no greater than that necessary to achieve a legitimate objective (the test of proportionality).

In tax matters, some grounds of justification have been accepted by the ECJ while others have been rejected. The concept of "cohesion" of the tax system was originally accepted by the ECJ, but recent cases suggest that cohesion will seldom be accepted unless there is a direct link between the discrimination and another tax measure which justifies the discrimination. Safeguarding of a state's tax revenue is never accepted as a justification. The

difficulty of finding out information about non-residents is not accepted: the Court has frequently referred to the Mutual Assistance Directive as a basis for finding out information about residents of other Member States.

The prevention of tax avoidance may be a valid justification, though recent cases have indicated that this only applies where highly artificial schemes are involved.

The fact that there is no EU harmonisation of an aspect of direct taxation is not a justification for discriminatory measures. Nor is it justification generally to refer to the fact that a matter is regulated by a double taxation convention, though a double taxation convention may be relevant, for example, in defeating an argument based on cohesion.

Finally, it is not a justification for the Member State to show that the discriminatory treatment is counterbalanced by a countervailing advantage otherwise available to the person who is discriminated against.

As examination of the case law will show, attempts by revenue authorities to justify discriminatory tax provisions have generally failed.

The Principal Cases Relevant to the Taxation of Individuals

No legislative provisions have been adopted so far that relate specifically to the taxation of individuals. Perhaps because of this lack of legislative development, a significant number of cases have been brought to the ECJ concerning the taxation of individuals. Most of these cases have been brought under Article 39 (formerly 48) on the free movement of workers or under Article 43 (formerly 52) on the freedom of establishment in the case of self-employed individuals. Recently, cases have also arisen under the freedom to provide services in Article 49 (formerly 59) and the freedom of movement of capital in Article 56 (formerly 73b).

The earliest case respecting individuals was *Biehl* which was brought under Article 39 (free movement of workers). Biehl was a German national resident and working in Luxembourg from 1973 to 1983. In 1983 he returned to Germany midway through the tax year. At the end of the year he discovered that his employer had deducted too much tax, and he claimed a repayment from the Luxembourg authorities. Under Luxembourg law, no repayment could be made to a non-resident. Biehl challenged the refusal of the repayment through the Luxembourg Courts, and the Conseil d'Etat referred the matter to the ECJ for a preliminary ruling under Article 234. The ECJ ruled that Community Law forbids not only overt discrimination on grounds of nationality but also covert discrimination, and that discrimination on grounds of residence is more likely

to work against nationals of other Member States[24]. The Luxembourg authorities sought to justify the covert discrimination on grounds of protecting the system of progressive taxation: an individual who moved residence during the course of a tax year might be entitled to personal allowances in both states. The ECJ rejected this ground of justification by showing that an individual is not necessarily better off merely because he has moved during the year and had the possibility of two personal allowances[25].

In *Bachmann*, a German national moved to work in Belgium in 1972. Before leaving Germany he took out a policy for sickness, invalidity and life insurance and for a pension with a German company. When in Belgium he wished to deduct his contributions under this policy, but this was disallowed because contributions were only deductible if payable to a Belgian insurance company. The taxpayer challenged the disallowance of the deduction on grounds of infringement of Article 39 and also infringement of the freedom to supply services in Article 49. The Belgian Cour de Cassation referred a preliminary question to the ECJ which first determined that the restriction was discriminatory as it was more likely to affect non-nationals. However, the provision could be justified on grounds of cohesion of the tax system: Belgium only permitted a deduction for contributions paid to local insurance companies

[24] See paragraphs 13 and 14 of the judgment.

since it would not otherwise be able to tax payments under the policies to individuals who had once again become non-resident. The ECJ accepted this argument on the grounds of cohesion, as well as accepting that the same result could not have been achieved by less restrictive measures. This case is the high watermark of the justification of cohesion: it is an open question whether *Bachmann* would be similarly decided today.

One of the most important cases on the taxation of individuals is *Schumacker* which was also brought under Article 39. A Belgian national lived in Belgium but worked in Germany and derived more than 90% of his income from that country. Germany applied the possibility of a "splitting tariff" to German residents but not to non-residents. The German Government argued that residents and non-residents were not in comparable circumstances so there could be no discrimination. The ECJ replied that, in relation to direct taxation, the situations of residents and non-residents are not, as a rule, comparable[26]; however, the situation is different where the non-resident obtains the major part of his taxable income from the state of employment (in this case Germany) since his situation is then comparable with that of a German resident[27]. There was, therefore, no objective difference between the situation of Schumacker

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25 In a subsequent case, *Commission v. Luxembourg*, the Commission brought infringement proceedings under Article 226 (formerly 169) against Luxembourg which had not changed the rule which was found to be discriminatory in *Biehl.*

26 See paragraph 31 of the judgment.

27 See paragraph 36 of the judgment.

and a German resident. The question that followed was whether there was any justification for this discrimination. An argument based on cohesion of the tax system was rejected as was an argument on the grounds of difficulty in obtaining information about non-residents[28].

The *Schumacker* case implies that a Member State must treat a non-resident who earns the majority of his income in that state in the same way as a resident[29]. Part of the response of the Commission to situations such as this was the Commission Recommendation on the taxation of non-residents[30].

The decision in *Gschwind* tested whether the German measures adopted to implement the decision of the Court in *Schumacker* were adequate. The Court concluded that the German measures were consistent with Community law. The underlying principle was that a non-resident who derived effectively the entirety of his income from a Member State to which he travelled for work was in the same position as an individual resident in the state of employment and should not be taxed in a different fashion from such an individual.

The principle in the *Schumacker* case was applied by the Court in the case of *Asscher* which concerned a Dutch national who moved to live in Belgium

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28 See paragraphs 42 and 45 of the judgment, in particular the reference to the Mutual Assistance Directive in paragraph 45.

29 There was a similar decision reached in the case of *Wielockx*.

30 Commission Recommendation of 21 December 1993 mentioned above.

but continued to work in the Netherlands and earned the majority of his income from the Netherlands. He was treated as a non-resident in the Netherlands and therefore subject to a higher rate of income tax, though without the obligation to pay social security contributions which fell upon residents. The discrimination was by the Netherlands against one of its own nationals but who was resident abroad. Nevertheless, the ECJ held that a Member State cannot set up barriers to its own nationals exercising the freedoms under the Treaty. The Court went on to hold that the discrimination could not be justified on the grounds that there was a countervailing advantage to a non-resident in not having to pay social security contributions, and that the cohesion of the tax system could not be a justification since there was no direct link between payment of the tax and the obtaining of any benefit.

In *Gilly*, a couple lived in France where the husband, who was a French national, was a teacher. The wife had dual French and German nationality and taught in Germany. By operation of the France-Germany double taxation convention, her salary was taxable in Germany where it was subject to the rate of tax applicable to a single person without children. Her salary was also included in the total income of the family subject to tax in France, but subject to a foreign tax credit for the German income: this was an ordinary credit and was less than the total tax payable in Germany. As a result, the income of Mr. and Mrs. Gilly was subject to a higher total tax bill than if they had been subject to

tax in France alone. The ECJ concluded that the higher tax burden arose from the operation of the double taxation convention and that such a convention - based on provisions of the OECD Model - was not incompatible with provisions of the Treaty. Though the challenge in *Gilly* was unsuccessful, the case leaves open the possibility that certain provisions of double taxation conventions might be challenged on the grounds of incompatibility with Community Law.

A further case concerning the taxation of husbands and wives arose in *Zurstrassen*. In that case the husband – who earned the entire income of the family – was resident in Luxembourg, while the wife remained resident in Belgium. Luxembourg did not allow the husband and wife to be taxed as a couple (with the benefit of averaging of income) since the wife was resident abroad. Complaint was made of an infringement of the freedom of movement of workers. The ECJ held that the rule (which required both spouses to be resident) restricted the freedom of movement of workers from other Member States. The rule could not be justified on grounds that it simplified the collection of tax.

In *Vestergaard* the issue concerned the freedom to provide services in Article 49 (formerly 59) and a Danish rule that the expenses of attending training courses in a foreign tourist resort were not *prima facie* deductible (whereas the expenses of attending a similar course in Denmark were

deductible). Though the freedom concerned was that of the service-provider, complaint could also be made by the victim of a restriction on the freedom of others to provide services. The Danish rule – which discriminated between service-providers established in Denmark and in other Member States – could not be justified on grounds of cohesion or of fiscal supervision: the ECJ pointed particularly to the role of the Mutual Assistance Directive in providing information for the purposes of fiscal supervision[31].

Baars concerned the freedom of establishment in Article 43 (formerly Article 52). The Dutch exemption from wealth tax for substantial holdings in companies established in the Netherlands was not granted to the taxpayer who owned all the shares in a company established in Ireland. The rule (which limited this exemption to companies established in the Netherlands) hindered Dutch nationals who wished to exercise their freedom to establish themselves in another Member State. The difference in treatment for companies established in another Member State could not be justified on grounds of cohesion[32] since there was no direct link between the taxation of the company and the exemption from wealth tax.

Perhaps one of the most far-reaching recent cases on the taxation of

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31 See paragraphs 25 – 28 of the judgment.

32 See paragraphs 33 – 40 of the judgment.

individuals is *Verkooijen* which concerned the Dutch exemption for the first 2,000 guilders of dividend income received by a Dutch taxpayer, but only from companies in the Netherlands. The taxpayer was refused the exemption for a dividend he received from a Belgian company. The ECJ held that this was contrary to the Capital Movements Directive since it had the effect of dissuading nationals of the Netherlands resident in the Netherlands from investing their capital in companies having their seat in other Member States. Attempts to justify the rule on grounds of economic interest, cohesion and possible loss of revenue were all rejected.

Most recently, in *Belgium (Bonds)* the ECJ held that a condition which prohibited a Belgian resident from subscribing for bonds issued by the Belgian government infringed the freedom of movement of capital in Article 56 (formerly Article 73b). Justificatory arguments based on cohesion and the need to prevent fiscal evasion were rejected. With respect to cohesion, there was no direct link between the fiscal advantage and the corresponding disadvantage which had to be preserved to ensure coherence[33]; the argument based on prevention of tax evasion failed on the grounds that the measure adopted was disproportionate[34].

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[33] See paragraphs 34 – 36 of the judgment.

[34] Judgment, paragraphs 37 – 47.

The Principal Cases Relevant to the Taxation of Enterprises

Most cases on the taxation of enterprises have arisen under the freedom of establishment (Articles 43 and 48 especially) or under the freedom to provide services (Article 46) and, recently, under the free movement of capital (Article 56).

The earliest case here - and the earliest direct tax case before the ECJ - was the *Avoir Fiscal* case. The avoir fiscal - the dividend tax credit - was granted by French law to French enterprises or French subsidiaries of foreign enterprises, but not to French branches of foreign enterprises. Foreign insurance companies complained of this treatment and the Commission brought infringement proceedings against France. The ECJ held that the freedom of establishment means that an enterprise may establish itself in another Member State in whatever form it chooses: to discriminate against an enterprise that establishes itself in the form of a branch would be contrary to Article 43. France sought to justify this difference in treatment on the grounds of the different circumstances of residents and non-residents: this was rejected on the grounds that France computes the taxation of branches in the same way as French enterprises. Finally, an attempt to justify the provision on the grounds of preventing tax evasion was also rejected.

In a number of subsequent cases, the ECJ has rejected purported

justifications of discrimination against non-residents operating through branches. These include *Commerzbank* (the UK refusal to make repayment supplement available to non-residents), *Futura Participations* (losses could only be carried forward in a branch if separate accounts were maintained in Luxembourg: the requirement of maintaining separate accounts was covert discrimination and went beyond what was necessary to check the amount of the losses), *Royal Bank of Scotland* case (Greek banks were taxed at 35%, while branches of foreign banks were taxed at 40% - the ECJ held that there was no objective difference and there were no grounds for justification under the limited provisions of Article 46) and *St-Gobain*.

St-Gobain is perhaps one of the most important cases on the taxation of enterprises. It concerned a French company with a German branch. The German branch showed that if it had been a German subsidiary, it would have been subject to more advantageous tax treatment in three ways, including access to Germany's double taxation conventions. The Court agreed that this was contrary to Article 48 and that it could not be justified. It seems to follow that, as a result of the judgment, there will have to be a reassessment of the application of double taxation conventions to overseas branches of companies resident in other Member States.

The ECJ has had to decide a small number of cases concerning reliefs for transactions within a group of companies. The first such case was *Halliburton*

which concerned a German company transferring a Dutch permanent establishment to a Dutch, sister company. Dutch law provided for an exemption from transfer tax but only where all members of the group were Dutch companies. The ECJ considered that this was covert discrimination and an attempt to justify the rule on the grounds of the difficulty of obtaining information about non-residents was rejected by reference to the Mutual Assistance Directive[35].

Colmer concerned UK consortium relief. Though on the facts the final outcome was not to provide for consortium relief, the ECJ considered that a provision limited to companies resident in the United Kingdom infringed the freedom of establishment and could not be justified on grounds of cohesion or the prevention of tax avoidance - the prevention of tax avoidance only related to artificial tax avoidance schemes - or on grounds of protecting tax revenue[36].

X AB and Y AB concerned the Swedish rules that apply group treatment only to groups involving non-resident companies established in a state with which Sweden has concluded a double taxation convention. The ECJ determined that these rules hindered the establishment of subsidiaries in other Member States. The Swedish Government did not seek to justify the rules.

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35 See paragraph 22 of the judgment.

36 See paragraphs 26 and 29 of the judgment.

Turning to cases on other aspects of the taxation of enterprises, *Eurowings* concerned the denial of a deduction for rental payments made by a German company to a company established in the low-tax, Shannon Airport Zone in Ireland. The German rules required the payments to be added back, except where they were paid to an enterprise subject to German trade tax (in practice, enterprises established in Germany). Like *Vestergaard*, this interfered with the freedom of a service-provider to establish itself wherever it wished within the Community. A victim could complain of this infringement of the freedom of establishment of another. The German rule could not be justified on grounds of cohesion nor on the grounds that the rule was a countervailing measure to the low tax regime in Ireland.

The most recent case on the taxation of enterprises has potentially significant implications. In *AMID* the issue concerned a specific Belgian rule which required losses to be set off first against the profits of a permanent establishment outside Belgium (with the result that the losses were deductible nowhere). The ECJ drew a contrast with the situation where the Belgium company had located its permanent establishment in Belgium. In that situation, the losses would have been deductible. The Belgian rule might therefore deter a Belgian company from locating an establishment elsewhere in the Community. This infringed the freedom of establishment and could not be justified on grounds that a Belgian company with an establishment abroad was

not in the same position as one with an establishment at home. The case implies that any rule which treats an enterprise with a foreign branch – established in another Member State – differently from an enterprise with a branch at home would be taken to infringe the freedom of establishment.

Taxation and State Aid[37]

Direct tax provisions are subject to the general prohibition on unauthorised state aids in Articles 87 to 89 (formerly Articles 92 to 94) of the Treaty. The ECJ has noted that a tax exemption entails a renunciation of tax revenue and hence a transfer of state resources[38].

The current position on the application of the state aid rules to taxation is summarised in the Commission Notice on the application of the state aid rules to measures relating to direct taxation which was adopted by the Commission on 11 November 1998[39].

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37 For a full discussion of this issue, see C. Pinto; "EC State aid Rules and Tax Incentives: A U-Turn in Commission Policy?" (1999) *European Taxation* 295-309 and 343-352.

38 See *Germany v. Commission*, paragraphs 22 – 28.

39 SEC (1998) 1800 Final, OJ C384, 10.12.98, pages 3 to 9.

Broader Proposals for Direct Tax Harmonisation

There has been no lack of reports and Commission documents considering broader proposals for direct tax harmonisation. The history starts with the Neumark Committee in 1962[40] through the van den Tempel Report of 1970[41] to the last major report on this issue - the Ruding Committee Report of 1992[42]. The Commission responded to the Ruding Report in 1992[43] and no further steps have been taken to implement the recommendations of the Committee. A further Commission communication on tax strategy is anticipated in March 2001, to be followed by a study on company taxation in April or May.

The current round of proposals for direct tax harmonisation owe their origin to the Commission Reflection Document "Taxation in the European Union" of 20 March 1996.

In April 1996 the ECOFIN Council established a High Level Group on tax policy. This led to the Commission Report "Taxation in the European Union: Report of the Development of Tax Systems" of 22 October 1996[44] which in

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40 See H Thrust, *The EEC Reports on Tax Harmonisation* (IBFD, Amsterdam, 1963).

41 *Corporation Tax and Individual Income Tax in the European Communities* (European Commission, Brussels, 1970).

42 *Report of the Committee of Independent Experts on Company Taxation* (European Commission, Brussels, 1992).

43 Commission Communication of 26 June 1992, SEC (92) 118.

44 COM (96) 546 Final.

turn led to the establishment of a permanent group to co-ordinate tax policies within the European Union - the Taxation Policy Group (TPG).

On 1 October 1997 the Commission published a communication "Towards Tax Co-ordination in the European Union"[45] which was discussed by ECOFIN and finally led to the communication from the Commission "A Package to Tackle Harmful Tax Competition in the European Union"[46] of 5 November 1997. This package was discussed at the ECOFIN Council meeting in December 1997, at which the conclusions concerning taxation policy were adopted.

Proposals Under Current Consideration for Tax Harmonisation (or Co-ordination)

The proposals currently under discussion for direct tax harmonisation start with the conclusions of the ECOFIN Council of 1 December 1997 concerning taxation policy[47]. There are three principal measures outlined in those conclusions.

First, the preparation of a draft Directive on the taxation of savings income on the basis of the principles set out in Annex 2 to the conclusions.

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45 COM (97) 495.

46 COM (97) 564 Final.

47 OJ C98/2, 6.1.98, pages 1 to 6.

Second, the preparation of a draft Directive on interest and royalty payments between associated companies.

Third, the adoption of a Code of Conduct for Business Taxation set out in Annex 1 to the conclusions.

Each of these proposals is discussed in turn below.

Though the original conclusions seemed to indicate that only certain Member States required the adoption of certain of the measures to be tied together, as matters have developed it has become clear that the three measures are a package which stands or falls as a whole. Thus, implementation of the recommendations on the Code of Conduct depend, in principle, upon adoption of the two draft Directives.

The Savings Income Draft Directive

The original proposal for the Directive on the taxation of savings income adopted a "co-existence model". Under that model, Member States would have a choice of either imposing a minimum withholding tax (possibly of 20%) on interest income paid to individuals resident in another Member State or, alternatively, to impose no withholding tax but to supply information about the beneficial owner of the interest to that individual's state of residence. The

Commission presented proposals for a draft Directive on the taxation of savings income on 20 May 1998[48]. The proposal proved to be highly controversial, particularly with regard to its application to Eurobonds and the involvement of non-Member States. Following discussion, the co-existence model was abandoned in favour of an approach based, after a transition period, on exchange of information.

The parallel meetings of the ECOFIN Council and of the Heads of States or Governments in Santa Maria de Feira in June 2000 reached agreement on the principles and guidelines for this draft Directive and on a timetable with a view to achieving implementation by the end of December 2002. The ECOFIN Council in July 2000 referred the issue of drafting the Directive to the Working Party on Tax Questions. The essential contents of the Directive were agreed at the ECOFIN Council in November 2000.

One key aspect of this proposal is the involvement of third states in the approach to be adopted by the draft Directive. In January 2001, letters were sent to the governments of third states with a view to securing their adoption of equivalent measures to those in the draft Directive. The success of the proposal for a Savings Income Directive – and hence of the entire tax package - may depend on the response from these third states.

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[48] 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 Final - 98/0193 (CNS).

The Interest and Royalties Draft Directive

The tax package also required the Commission to prepare a draft Directive on interest and royalty payments between associated companies, which it submitted on 6 March 1998[49]. This draft Directive provides for payments to be made of interest and royalties between associated companies without withholding tax. The proposal is generally uncontroversial, however several Member States have indicated that they will not support the adoption of this Directive unless the Savings Income Directive is also adopted at the same time.

Before turning to the Code of Conduct on Business Taxation, it might be noted that one provision of the Code of Conduct required the Commission to prepare a Notice on the application of state aid rules to measures relating to direct business taxation. This was adopted in November 1998[50].

The Code of Conduct for Business Taxation

The Code of Conduct for Business Taxation has as its goal the elimination of harmful tax competition within the Community. Its targets are measures which affect or may affect in a significant way the location of business activity

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49 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 Final - 98/0087 (CNS), OJ C123, 22.4.98, pages 9 to 13.

50 See the discussion above.

in the Community and which provide for a significantly lower effective level of taxation than the level which generally applies in the Member State in question. Any such measures are regarded as potentially harmful: the measure then has to be assessed to determine whether it is actually harmful or not.

With respect to measures that are determined to be actually harmful, by adopting the Code Member States have undertaken a political (though not legally binding) commitment to "roll back" those measures within a period which should normally be completed within five years from 1 January 1998. In addition, Member States commit themselves to the policy of "standstill" under which they are not to introduce any new harmful tax measures within the context of the Code.

The Code of Conduct made provision for a review process under which potentially harmful tax measures were to be assessed to determine whether or not they were harmful. To implement that process, a Code of Conduct Group was established by the Council on 9 March 1998[51] under the chairmanship of the then Economic Secretary to the Treasury, Dawn Primarolo.

The first annual report of the Code of Conduct Group was presented to the

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51 Council Conclusions of the 9 March 1998 concerning the establishment of the Code of Conduct Group (Business Taxation), OJ C.99, 1.4.98, pages 1 to 2.

Council in November 1998[52] but said relatively little about the work of the Group. A second interim report was presented to the ECOFIN Council on 25 May 1999. The conclusions of the Group were contained in a report presented to the ECOFIN Council on 29 November 1999 and made public in February 2000.

A certain amount is known about the way that the Code of Conduct Group went about its business. An initial list of potentially harmful tax measures falling within the scope of the Code was prepared. This list contained 85 potentially harmful tax practices grouped under five headings: intra-group services and holding company regimes, financial services and offshore companies, other sector-specific measures, regional incentives, and other measures.

The initial list of 85 measures for consideration by the Code of Conduct Group was prepared by self-assessment by each of the Member States identifying which of its own tax provisions might fall within the scope of the Code. In addition, the Dutch Ministry of Finance commissioned two independent reports to identify potentially harmful tax practices[53]. Other countries also requested further measures to be examined. As a result of these

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52 COM (98) 595 Final of 25 November 1998.

53 These reports - from PricewaterhouseCoopers and from Baker & McKenzie - are available on the Internet at: http:\\www.minfin.nl\uk\taxation\TaxCompetition\taxcomp.htm and the documents attached.

reports and requests, over a hundred further measures were added to the list for consideration by the Code of Conduct Group.

The report of the Code of Conduct Group to the November 1999 ECOFIN Council identified 66 measures which were potentially harmful. The Group's mandate has subsequently been continued to oversee the process of dismantling those provisions found to be potentially harmful.

Draft Directive on the Enforcement of Tax Debts

There is one other proposal for a Directive relating to direct taxation which is currently on the table in the European Union. This is a proposal to extend the existing Directive on mutual assistance in the recovery of tax debts to cover most direct taxes[54].

There has been a Directive in force since 1976 for mutual administrative assistance in the enforcement of tax claims[55]. Initially, this Directive applied only to matters such as agricultural levies and Customs duties but was extended to VAT in 1979. If adopted, the proposed amendment will extend this system

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54 Proposal for a European Parliament and Council Directive amending Council Directive 76/308/EEC on mutual assistance for the recovery of claims …, COM (98) 364 Final - 98/0206 (COD) of 25 June 1998, and amended proposal for a European Parliament and Council Directive, COM (99) 183 Final - 98/0206 (COD) of 7 May 1999.

55 Council Directive 76/308/EEC of 15 March 1976 or mutual assistance in the recovery of claims ... OJ L73/1976.

to taxes on income and capital (defined as those to which the Mutual Assistance Directive applies).

The proposal to amend the Directive on assistance in the recovery of tax claims has been endorsed by the Economic and Social Committee and by the European Parliament (which suggested certain amendments). The proposal is independent of the other proposals under discussion which arise out of the conclusions on taxation policy of December 1997. The only controversial issues that have arisen are whether the adoption of the amending Directive would require unanimity as a fiscal measure and whether the Directive has been given an inaccurate and inappropriate title.

In January 2001 the ECOFIN Council reached political agreement on this draft Directive, subject to an opinion from the European Parliament on the change of legal basis for the adoption of the measure. The intention is that the Directive will come into force on 30 June 2002.

Concluding Remarks

More attention has been paid to issues of harmonisation and direct taxation in the EU during the last three years than perhaps at any time in the previous twenty. This has opened debate on whether or not harmonisation of direct taxes is desirable, and, if it is, what approaches should be adopted and

what procedures should be followed to adopt those measures.

Though the Feira meetings cleared the way for the adoption of the measures contained in the tax package, it remains unclear whether there will be eventual agreement to adopt the measures. Meanwhile, judgments of the ECJ continue to appear on various matters relating to direct taxation. There can be no real doubt of the increasing impact of EC law on direct taxation in the Member States.

APPENDIX

The Principal Direct Tax Cases of the ECJ

Avoir Fiscal:

EC Commission v. France (Case 270/83), 28 January 1986 [1986] ECR 273

Daily Mail:

R v HM Treasury and IRC, ex p Daily Mail and General Trust plc (Case 81/87), 27 September 1988 [1988] ECR 5505

Biehl:

Klaus Biehl v Administration des Contributions du Grand-duché de Luxembourg (Case C-175/88), 8 May 1990 [1990] ECR I - 1779

Commerzbank:

R v IRC, ex p Commerzbank AG (Case C-330/91), 13 July 1993 [1993] ECR I - 4017

Halliburton:

Halliburton Services BV v Staatssecretaris van Financiën (Case C-1/93), 12 April 1994 [1994] ECR I - 1137

Bachmann:

Hanns-Martin Bachmann v Belgium (Case C-204/90), 28 January 1992 [1992] ECR I - 249

Werner:

Hans Werner v. Finanzamt Aachen-Innenstadt (Case C -112/91), 26 January 1993 [1993] ECR I - 429

Schumacker

Finanzamt Köln-Altstadt v Roland Schumacker (Case C-279/93), 14 February 1995 [1995] ECR I - 225

Wielockx:

GHEJ Wielockx v Inspecteur der Directe Belastingen (Case C-80/94), 11 August 1995 [1995] ECR I - 2493

Asscher:

PH Asscher v Staatssecretaris van Financiën (Case C-107/94), 27 June 1996 [1996] ECR I - 3089

Futura Participations:

Futura Participations SA v Adminstrations des Contributions (case C-250/95), 15 May 1997 [1997] ECR I -

Safir:

Jessica Safir v. Skattemyndighten i Dalarnas Län (Case C-118/96), 28 April 1998 [1998] ECR I - 1897

Colmer:

Imperial Chemical Industries plc v. Kenneth Hall Colmer (HM Inspector of Taxes) (Case C-264/96), 16 July 1998 [1998] ECR I - 4695

Gilly:

Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas-Rhin (Case C-336/96), 12 May 1998 [1998] ECR I - 2793

Royal Bank of Scotland:

Royal Bank of Scotland plc v Elliniko Dimosio (Greek State) (Case C-311/97), 29 April 1999 [1999] ECR I – 2651

Gschwind:

Gschwind v. Finanzamt Aachen-Aussenstadt (Case C-391/97), 14 September 1999 [1999] ECR I-

St Gobain:

Compagnie de Saint-Gobain, Zweigniederlassung v Finanzamt, Aachen-Innenstadt (Case C-307/97), 21 September 1999 [1999] ECR I -

Eurowings:

Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unman (Case C-294/97), 26 October 1999 [1999] ECR I –

Vestergaard:

Skatteministeriet v. Bent Vestergaard (Case C-88/98), 28 October 1999 [1999] ECR I -

X AB and Y AB:

X AB and Y AB v Sweden (Case C-200/98), 18 November 1999 [1999] ECR I –

Baars:

C. Baars v. Inspecteur der Belastingdienst Particulieren (Case C-251/98), 13 April 2000 [2000] ECR I –

WN:

W.N. v. Staatssecretaris van Financiën (Case C-420/98), 13 April 2000 [2000] ECR I –

Zurstrassen:

Patrick Zurstrassen v. Administration des Contributions Directes (Case C-87/99), 16 May 2000 [2000] ECR I –

Verkooijen:

Staatssecretaris van Financiën v. B.G.M. Verkooijen (Case C-35/98), 6 June 2000 [2000] ECR I –

Belgium (Bonds):

Commission v. Belgium (Case C-478/98), 26 September 2000 [2000] ECR I –

AMID:

Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v. Belgium (Case C-141/99), 14 December 2000 [2000] ECR I –

Metallgesellschaft and Hoechst:

Metallgesellschaft Ltd. and others v. IRC; Hoechst AG v. IRC (Cases C-397/98 and C-410/98)