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HARD LAW AND SOFT LAW INTERACTIONS IN EU CORPORATE TAX REGULATION:
EXPLORATION AND LESSONS FOR THE FUTURE

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ABSTRACT

The EU regulatory framework for direct taxation is composed of three interconnected elements. First, having satisfied the requirement of a unanimous vote, the EU adopted a range of directives on the basis of the general harmonisation provision (Article 115 TFEU). Therefore, a traditional hard law framework harmonising some aspects of direct taxation exists in the EU. Second, case law is an indirect method of exerting influence on the direct tax field. As long as no positive integration has been brought about, the Member States are free to regulate this sphere as they see fit. The boundaries of their regulatory freedom are imposed, however, by negative integration i.e. by the ECJ applying the Treaty rules on non-discrimination. Jurisprudence has been an influential and dominant regulatory tool. Third, corporate taxation has also been regulated through soft law. The key example of a non-legally binding instrument in the direct tax field is the Code of Conduct for Business Taxation.

This thesis investigates interactions between these hard and soft law measures and draws conclusions about the future of EU direct tax regulation. To achieve these aims, two research strands are explored. First, the thesis discusses the nature of the Code. In particular, it is investigated whether the Code can be regarded as an example of a 'pure' soft law measure. It is argued that the nature of the Code is not as clear-cut as is officially presented. Behind soft law terminology, the Code operates as a hard law measure. Supported by an examination of the OECD anti-harmful tax competition initiative, the thesis concludes that the use of soft law in tax regulation has not been wholly successful. The introduction of legally binding solutions is restricted by the requirement of unanimity, which is difficult to attain in the expanding EU. Thus, hard law has instead been introduced through the back door, raising valid questions about regulatory legitimacy.

Second, this thesis explores the relationships between hard and soft law in the wider context of EU direct tax regulation. The extent to which the Code is embedded in the broader environment of tax regulation is analysed. The Code tends to be characterised as a soft law measure situated within the regulatory environment of

taxation that, for years, has been dominated by hard law instruments. At this level, interactions between ECJ jurisprudence and soft law instruments are also explored.

Consequently, the thesis demonstrates that hard law and soft law are not necessarily alternative choices; both approaches can be applied simultaneously to influence one regulatory field, and both offer different strengths and values. In a field as politically sensitive as direct taxation, soft law may prove to be insufficient to bring about real change. The addition of a hard law (or legally binding) element might be necessary to secure effectiveness of regulation. This thesis proposes that the current, disingenuous hybrid regulation of direct taxes in the EU should be replaced with a more transparent hybrid, where hard law measures are openly applied and soft law is given the opportunity to regulate in parallel and to its own distinct potential.

DECLARATION

I declare that I have composed this thesis, that this work is my own and that it has not been submitted for any other degree or professional qualification.

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CHAPTER 1. BETWEEN HARD LAW AND SOFT LAW: THE EUROPEAN UNION REGULATORY INFLUENCE IN THE CONTEXT OF CORPORATE TAXATION

Introduction

Regulation of direct taxation¹ has always presented a challenge to the European Union (hereinafter the EU)² as an economic and a political body.³ Questions about how to govern this field arise regularly in European debates.⁴ Direct tax regulation is an unsettled issue because it represents an area where two values compete. On the one hand, regulation of direct taxes is an important aspect of national sovereignty. Essentially, direct taxes constitute an instrument expressing social, political and economic principles upon which a state is founded. The Member States oppose harmonisation of direct taxes because they want to maintain diverse tax systems supporting different social programmes. On the other hand, direct taxation plays a significant role in the context of creating the internal market. Disparities between national tax systems may cause a misallocation of resources and form an obstacle to freedom of movement.

Finding a satisfactory solution to the issue of direct tax regulation remains highly problematic. Over decades, EU initiatives to exert regulatory influence over the direct tax field accommodated, to a different extent, national and EU interests. Initially, EU attempts were grounded in the harmonisation approach, aiming at the adoption of uniform measures at the EU level. Progress was then rarely achieved and

¹ In this thesis, references to direct taxes relate primarily to corporate taxation. Regulation of personal taxation has not been of great interest to the EU.

² As a result of changes introduced through the ratification of the Lisbon Treaty, the structure of the EU has been simplified. References are generally made to "EU" throughout this thesis because the three pillar structure existing previously was abolished. However, with regard to developments in EU direct taxation before 2009, references to the European Community (hereinafter the EC) are also made.

³ Since the establishment of the European Communities in the 1950s, corporate taxation received particular attention as an element important for the establishment and the completion of the internal market. An overview of early studies is presented in Chapter 2.

⁴ For example, this subject caused heated arguments in the process of adopting the Lisbon Treaty. Arguably, the Irish 'no' in the 2008 referendum can be associated with direct tax harmonisation fears. This campaign resulted in certain guarantees for Ireland. With regard to direct taxation, these guarantees state the obvious fact that the Lisbon Treaty does nothing to change the powers of the Member States regarding taxation. See: 'Lisbon: the Irish Guarantees Explained' available at <http://www.iiea.com/publications/lisbon-the-irish-guarantees-explained>.

only after many years of negotiations. Problems arising from the classic harmonisation approach to direct taxation triggered the application of other regulatory tools. Traditional hard law (directives) was replaced by Court of Justice (hereinafter the ECJ or the Court⁵) direct tax case law. The EU also turned to the soft law regulatory approach.

It is the aim of this thesis to contribute to an understanding of how direct tax regulation in the EU has been approached and how the various regulatory strategies interrelate with one another. Subsequently, the thesis reflects on the future of direct tax regulation in the EU. The first step in gaining this understanding is providing an explanation of the special position of direct taxation. In section 1.1., it is examined why the EU is concerned with regulating national direct tax regimes and what significance direct taxes have from the perspective of national governments.

After investigating the significance of direct taxation, the remainder of the chapter is organised as follows. Section 1.2. briefly characterises the EU as a regulatory body. It is essential to understand the formal architecture of relationships between the EU and its Member States in order to position direct taxation in the EU and to comprehend its regulatory potential. Section 1.3. provides an introduction to the diverse governance approaches that the EU adopts.

Sections 1.4. and 1.5. address the hard law approach and the soft law approach respectively, and their application in the sphere of direct taxes. A definition of hard law is offered in section 1.4., which addresses a legal basis for harmonisation of corporate taxation and voting requirements for legislative proposals regarding corporate taxes. It also sets out the Treaty provisions on the fundamental freedoms enabling the ECJ to strike a balance between the Member States' tax sovereignty and the interests of the EU in this regard. These brief outlines are developed in later chapters of the thesis.⁶

⁵ The ECJ was renamed by the Lisbon Treaty. Its official name is the Court of Justice of the European Union.

⁶ See Chapters 2 and 3.

Section 1.5. is devoted to the soft law approach. A crucial part of this section constitutes a presentation of the origins of the soft law phenomenon and a discussion on its relative advantages and drawbacks in relation to hard law. Examples of soft law measures in the field of direct taxation are then set out.⁷

Finally, section 1.6. establishes the key research objectives of and questions examined in this thesis. The chapter concludes with an explanation of the importance of this research (section 1.7.) and an outline of the thesis structure (section 1.8.).

1.1. Why direct taxation matters

1.1.1. Direct tax regimes and the EU

European integration has been built on the idea of promoting the free movement of persons, goods, services and capital between the Member States.⁸ The rationale for the establishment of the internal market is the fact that free movement of resources facilitates their optimal allocation.⁹ Various physical, technical and fiscal obstacles have to be abolished before ‘an area without internal frontiers in which the free movement is ensured in accordance with the provisions of this Treaty’¹⁰ is achieved with national markets welded together as one market.

When the internal market, as defined in Article 26(2) TFEU, is perceived as an abstract concept, operating in a vacuum, where political constraints can be disregarded, it becomes apparent that *all* types of obstacles to the completion of the internal market have to be abolished. As a result, distortions created by different direct tax systems in the Member States must be addressed. Differences in direct taxation across the EU may hinder cross-border activities and make free movement between the EU Member States difficult, if not impossible.

⁷ See Chapter 4 for detailed analysis of soft law in EU tax regulation.

⁸ The creation of the internal market was a core aim of the EC. See: Articles 2 and 3 TEC. A similar goal was established for the EU in the Treaty on the European Union (as amended by the Lisbon Treaty) in Article 3(3) TEU.

⁹ P Craig, ‘The Evolution of the Single Market’, in C Barnard and J Scott (eds.), *The Law of the Single European Market: Unpacking the Premises*, (Oxford: Hart, 2002), 1-40 at 2.

¹⁰ Article 26(2) TFEU. Previously, the definition of the internal market was included in Article 14(2) TEC. The wording of these two provisions is identical.

Although the Treaties¹¹ do not confer immediate competence on the EU over direct taxation, they provide for measures contributing to the establishment and functioning of the internal market. Therefore, insofar as national direct tax regimes obstruct aspects of the internal market, they are subject to EU action. This action can be of a dual nature. First, economic integration could be reached by setting centralised standards which eliminate national rules (positive integration)¹² on the basis of Article 115 TFEU.¹³ This regulatory strand is investigated in Chapter 2. Second, the removal of barriers to trade can be attained through negative integration¹⁴ on the basis of the Treaty provisions prohibiting discrimination and restrictions against foreign workers, capital, services, and goods, and securing the freedom of establishment.¹⁵ Where national direct taxation regimes compromise the integrity of the internal market, the ECJ will take action upon referral. Fundamentally, there are two roads for tax cases to reach the ECJ. They can be founded on Article 267 TFEU¹⁶ (preliminary ruling procedure) or Article 258 TFEU¹⁷ (infringement procedure).¹⁸ This regulatory path is explored in Chapter 3.

¹¹ The Treaty on the Functioning of the European Union (hereinafter the TFEU), Consolidated version of the Treaty on the Functioning of the European Union, OJ C 2010 83/47 and the Treaty on the European Union (hereinafter the TEU), as amended by the Lisbon Treaty, and its predecessors. Consolidated version of the Treaty on European Union, OJ 2010 C 83/13.

¹² Positive integration is also described as developing market-shaping policies. M Gammie, A Klemm and C Radaelli, *EU Corporate Tax Reform: Report of a CEPS Working Party*, (Brussels: Centre for European Policy Studies, 2001), p. i.

¹³ Chapter 1, section 1.4.2.1. discusses this provision in detail.

¹⁴ This mode of integration indicates the elimination of national rules incompatible with the Treaties through the judicial process. Individuals and companies are the initiators and the ECJ becomes a decision-maker. Negative integration is also described as market-creating policies. M Gammie, A Klemm and C Radaelli, note 12 above, at i.

¹⁵ See Chapter 1, section 1.4.2.3. for an introduction to the fundamental freedoms. That section explains the meaning of Articles 49, 56 and 63 TFEU, relevant to corporate taxation.

¹⁶ A national court or tribunal may (and under certain circumstances, it must) request the ECJ to give a preliminary ruling, if it considers that a decision on a question regarding the interpretation of the Treaty raised before that court or tribunal is necessary to enable it to give judgments. Under this procedure, the national court seeks guidance and help from the ECJ which provides the national court with a binding interpretation. However, the ECJ does not rule in the case at hand. Rather, it is the national court that decides the case and applies the ECJ's preliminary ruling in order to render a final decision.

¹⁷ The infringement procedure requires from the Commission the delivery of a reasoned opinion to a Member State that is considered to have failed to fulfil its Treaty obligations. When the Member State in question does not comply with the Commission's opinion within a specified timescale, the Commission may bring a case before the ECJ. In addition, the Treaty envisages a possibility that one Member State may bring an action against another Member State when it considers that this State has not fulfilled its obligations stemming from the Treaty. See Articles 258-260 TFEU.

¹⁸ See Chapter 3, section 3.3. for statistical data in relation to these two procedures and case law.

In this context, it should be noted that direct tax barriers to the internal market can arise on two levels. First, direct tax barriers can involve rules within a single Member State.¹⁹ They are likely to breach internal market principles because the direct tax measure might be of a discriminatory or restrictive nature. Here, certain benefits are given only to a state's residents or additional burdens created for non-residents. Moreover, rules of direct taxation may restrict access of production factors from other EU countries to the market of a Member State despite being applicable without distinction. Case law can deal with these barriers, as discussed in Chapter 3.

Second, and more challenging to eradicate, are obstacles resulting from the coexistence of two or more different national regimes of direct taxation within the EU.²⁰ As there is no obligation in the Treaty to harmonise direct taxes between the Member States,²¹ direct tax systems can remain largely non-harmonised. This allows the Member States to allocate tax jurisdiction as they wish. Potentially, that leads to the creation of double burdens for taxpayers operating within the EU. Differentials in the tax systems of the Member States maintain the fragmentation of their labour and capital markets along national borders. This may increase compliance costs for businesses and individuals who wish to operate in more than one Member State. This type of direct tax restriction can be removed by harmonisation. If harmonisation is not successful, do double burdens fall within the scope of ECJ review? Chapter 3 returns to this problem.

1.1.2. The importance of direct taxation in the national context

The significance of direct taxation for the Member States is closely linked with the pre-globalisation era dominated by economic nationalism.²² Companies operated largely within the borders of their residence state and individual taxpayers earned

¹⁹ E.g. national rules granting tax credit to resident companies but denying this benefit to branches established by a company resident in another Member State. Such tax rules may discourage companies resident in other Member States from expanding their presence to Member States with such rules.

²⁰ For instance, the corporate tax rate for all companies in the UK is 26%, whereas in Ireland it is 12.5%. The UK does not differentiate between national and foreign companies in imposing its corporate tax rate; thus protectionism/discrimination is not an issue. However, having a higher British tax rate than in Ireland can contribute to market distortions.

²¹ Direct taxes can be harmonised on the basis of Article 115 TFEU.

²² R J Jeffery, *The Impact of State Sovereignty on Global Trade and International Taxation*, (The Hague, London and Boston: Kluwer, 1999) p. 16.

their income within the state of their residence. Foreign investments were rare due to physical frontiers and administrative hindrances that foreign investment might have encountered,²³ but also due to a lack of technological improvements that could facilitate information accessibility for potential investors and enhance the operation of transnational transactions. These factors increased the cost of doing business abroad. A state in the pre-globalised setting was established on a close relationship between the state and its taxpayers.

In the old tax environment,²⁴ the power to impose taxes was regarded as an attribute of a sovereign state,²⁵ holding an ethically justifiable claim²⁶ against income earned by individuals and profits generated by companies within its territory. Taxation referred to the primal function of each state: to protect and promote its national interests. Taxes served as a way to express and exercise the state's jurisdiction, and to realise the social and economic philosophy underpinning the state's structures. The jurisdiction of a sovereign state extended to the point at which the exercise of the state's power would begin to infringe on the rights of other sovereigns.²⁷

²³ For example, more complex rules for foreigners to buy property or establish a business.

²⁴ The label 'old tax world' is used in my research to describe times when tax systems were a purely national enterprise and did not cause tensions on a regional or global level. The 'new tax world' refers to the globalisation era.

²⁵ Sovereignty is a bundle of competencies and rights, encompassing also jurisdiction. Jurisdiction refers to a particular right of regulation of social relationships, via the state's judicial, administrative and legislative competencies. See: R J Jeffery, note 22 above, at 26.

²⁶ Based either on a residence or a source nexus. In the pre-globalised world, income was earned mainly within domestic borders, therefore it was fairly straightforward to justify, impose and collect tax from taxpayers by referring to the residence principle. Residence taxation means that the residence jurisdiction imposes tax on all income of its residents, earned both domestically and abroad. See: B J Arnold and M J McIntyre, *International Tax Primer*, (The Hague, London and New York: Kluwer, 2002), p. 15. Source taxation means that non-residents are taxed by the host country on the income earned in the host country or the capital located there. See: A Easson, *Taxation of Foreign Direct Investment: an Introduction*, (The Hague: Kluwer, 1999), p. 29. The source principle, with regard to corporations, allows the income of any permanent establishment (PE) operating within the source (host) state's borders to be taxed. A PE is a fixed place of business, such as an office, branch or factory. When cross-border transactions were not widespread and the organisational structures of doing business were not complex, keeping track of these transactions was simpler and the application of source taxation easier. Source taxation was justified because the host state protected the assets of the foreign investors and provided them with various benefits, such as infrastructure, educated labour and so on. These benefits should be reflected in taxes paid to the source jurisdiction

²⁷ J H Beale, 'The Jurisdiction of a Sovereign State', (1923) 36:3 *Harvard Law Review* 241-262 at 241.

Integration forces challenged the old tax world and called for a redefinition of the role of taxation. The process of globalisation linked national economies and the world became more of a shared economic and social space.²⁸ A state with an outdated approach to taxation based on a national/foreign distinction does not fit within this new picture because economic integration has dramatically changed the impact of national tax systems upon one another. In the integrating world, uncoordinated national tax systems are not closed to the outside world. Integration brings about tax competition between jurisdictions.²⁹

In the open economy, states can use their tax systems as an enticement for foreign companies, workers, individuals with high income or investment of capital. Owing to the mobility of production factors, a state's potential tax base is larger than it was in the closed economy. States compete over foreign direct investments (FDIs)³⁰ pursued by multinational corporations. They are also interested in competing for financial and commercial activities³¹ which are not tied to a specific location. Since the introduction of new technologies, financial and commercial activities can be carried out almost anywhere in the world.

²⁸ D Held and A McGrew, *Globalization/Anti-Globalization*, (Cambridge: Polity Press, 2003), p. 2.

²⁹ The concept of tax competition is complex and much has been written about it. However, the discourse on tax competition primarily offers reflections from the economic point of view. Economic considerations on tax competition remain, of course, essential because it is inherently an economic phenomenon. There is an expanding body of literature looking at tax competition from the political science perspective. Here, it is presented as one of the important forces determining the allocation and transfer of power, and shaping systems of governance in modern states. See e.g.: R Palan, *Offshore and the Structural Enablement of Sovereignty*, in M P Hampton and J P Abbott (eds.), *Offshore Finance Centres and Tax Havens: the Rise of Global Capitalism*, (New York: Palgrave, 1999), 18-42; M Webb, 'Defining the Boundaries of Legitimate State Practice: Norms, Transnational Actors and the OECD's Project on Harmful Tax Competition', (2004) 11:4 *Review of International Political Economy* 787-827; J Sharman, *Havens in a Storm: the Struggle for Global Tax Regulation*, (Ithaca and London: Cornell University Press, 2006); G Rawlings, 'Taxes and Transnational Treaties: Responsive Regulation and the Reassertion of Offshore Sovereignty', (2007) 29:1 *Law & Policy* 51-66. Unsurprisingly, a legal perspective, with very few exceptions in the EU context, is almost absent in tax competition considerations. See: W Schoen, 'Tax Competition in Europe - the Legal Perspective', (2000) 9:2 *EC Tax Review* 89-105; C Pinto, *Tax Competition and EU Law*, (The Hague, London and New York: Kluwer, 2003); B J Kiegebeld, *Harmful Tax Competition in the European Union: Code of Conduct, Countermeasures and EU law*, (The Netherlands: Kluwer, 2004); L Cerioni, 'Harmful Tax Competition Revisited: Why not a Purely Legal Perspective under EC Law?', (2005) 45:7 *European Taxation* 267-281.

³⁰ A Nov, 'The "Bidding War" to Attract Foreign Direct Investment: the Need for a Global Solution', (2006) 25:3 *Virginia Tax Review* 835-874 at 838. FDI indicates a long-term ownership of assets in one state by a resident of another state in order to control the use of these assets.

³¹ Such as, for instance, distribution centres or offshore banking centres.

Despite a largely negative reception,³² in the legal literature, there is no widely accepted definition of tax competition. In this thesis, tax competition can be defined as a game played between two or more jurisdictions, in which each of the jurisdictions is driven by self-interest and uses its tax system to induce or retain investment. This may arise, first, by introducing general tax measures.³³ Second, tax competition may result from specific tax measures legislated by a jurisdiction.³⁴ The first form of tax competition aims at improving the competitive position of the state in general. Specific measures, on the other hand, are designed to attract tax bases from other states.

One of the greatest anticipated problems caused by tax competition is the race to the bottom and a consequent erosion of national tax revenues. Tax competition can put downward pressure on states to adapt their tax systems to changing circumstances in other countries and the tax behaviour of potential investors.³⁵ In turn, this may lead to a situation where tax revenues decrease and the state is not able to pursue its objectives. There is little *evidence* of harmful tax competition and the race to the bottom, however, when one looks at the tax revenues' data. For instance, a study presented by Devereux, Griffith and Klemm³⁶ shows that although statutory tax rates in EU countries and G7 countries have fallen, tax revenues on corporate income have remained broadly stable as a proportion of GDP. Based on this evidence, some authors state that the race to the bottom did not happen.³⁷ Nevertheless, tax revenue

³² Easson highlights a few of the expressions used in relation to tax competition: 'fiscal degradation', 'tax dumping', 'fiscal piracy' and 'poaching'. A Easson, 'Tax Competition and Investment Incentives', (1996-1997) 2:2 *EC Tax Journal* 63-97 at 64.

³³ Among the general tax incentives which governments may use in order to attract (foreign) investment are reduced rates of direct taxes applicable to all investors, e.g. the Irish 12.5% corporate tax rate.

³⁴ Specific tax incentives include, for instance, special tax exemptions targeted at specific sectors of the economy or special tax rates for a selected category of investors. For example, the Belgian coordination centres regime was developed to attract group financing activities. Moreover, a special rate of 10% was established for companies involved in manufacturing, the International Financial Services Centre (IFSC) or the Shannon Free Zone, to which a general 12.5% tax rate was applied in 2003.

³⁵ The tax factor plays an important role in deciding where to locate investment and how much to invest. This has been confirmed in empirical studies. See e.g. M P Devereux and R Griffith, 'Taxes and the Location of Production: Evidence from a Panel of US Multinationals', (1998) 68:3 *Journal of Public Economics* 335-367.

³⁶ M P Devereux, R Griffith and A Klemm, 'Corporate Income Tax: Reforms and Tax Competition', (2002)17:35 *Economic Policy* 451-495.

³⁷ A Steichen, *Tax Competition in Europe or the Taming of Leviathan*, in W Schoen (ed.), *Tax Competition in Europe*, (Amsterdam: IBFD, 2003), 43-121 at 61.

on corporate income has declined as a percentage of total tax revenue, which confirms that the race to the bottom did occur in some aspects.³⁸

Should the race to the bottom take place, it may cause some possible negative consequences. Governments engaged in the bidding war may not earn enough revenue to cover their spending. They have to decide whether to maintain the level of public spending by shifting the tax burden onto immobile bases³⁹ and/or to change the tax mix to collect enough revenue. In the long run, a shift of tax burden can cause an additional distortion to the economy as the shift of tax burden threatens employment, which worsens the competitive position of the economy. Alternatively, governments may decide to lower levels of public spending to match reduced tax revenues or change how tax revenue is distributed. Certainly, there is a risk that the provision of public goods would not mirror social expectations or the political commitments of the government. When governments decrease corporate tax rates but do not offset the loss of tax revenue (by a shift of the tax burden on individual income taxation or indirect taxes) for fear of worsening unemployment levels, nor do they adjust the level of public services to the level of tax revenue. Thus, the government provides public services it cannot afford. This may cause growing public debt. Tax competition thus impacts not only on current taxes but also has a bearing on future taxes because debt will have to be paid off eventually.

³⁸ For the debate on the race to the bottom in the EU context and the proposed explanation of this paradox see: E G Mendoza and L L Tesar, 'Why Hasn't Tax Competition Triggered a Race to the Bottom? Some Quantitative Lessons from the EU', (2005)52:1 *Journal of Monetary Economics* 163-204; A Fourçans and T Warin, *Can Tax Competition Lead to a Race to the Bottom in Europe? A Skeptical View*, Middlebury College Economics Discussion Paper No. 06-04, 2006, available at <http://sandcat.middlebury.edu/econ/repec/mdl/ancoec/0604.pdf>. They consider the race to the bottom unlikely due to political costs it entails. See: P Genschel, *Globalisation, Tax Competition and the Fiscal Viability of the Welfare State*, MPIfG Working Paper No. 01/1, 2001, available at <http://www.mpifg.de/pu/workpap/wp01-1/wp01-1.html> for an explanation of the absence of the race to the bottom by the fact that during the 1980s and 1990s states faced such problems as slow growth, increasing unemployment and escalating public debts. These had to be tackled and a decrease in tax revenues was not an option. Instead of leading to the race to the bottom, tax competition trapped states between an external pressure to reduce taxation on mobile production factors and an internal need to sustain tax revenues at a high level in order to counter unemployment and public debts.

³⁹ R De Mooij and G Nicodeme, *How Corporate Tax Competition Reduces Personal Tax Revenue?*, CESifo Research Report 1/2008, available at <http://www.cesifo-group.de/portal/pls/portal/docs/1/1193014.PDF>. This research finds that reduced corporate tax rates in comparison to personal tax rates cause income shifting from personal to corporate income. As a consequence, those who are unable to shift income may be subject to effectively higher personal taxation.

1.1.3. The need for evolution

The destructive nature of tax competition necessitates transnational cooperation. The prisoner's dilemma⁴⁰ can provide a scholarly explanation of why states would be inclined to surrender some of their tax sovereignty and cooperate to restrain tax competition. The prisoner's dilemma describes situations where interacting actors face a decision about whether cooperation is in their interest or not. The economic theory predicts that there are situations in which all the actors have an incentive to renounce independent decision making. When all jurisdictions cooperate, the individual gain for each state is not as great as it could be in the non-cooperation scenario but, nevertheless, all states gain.

Coordination of direct tax systems at EU level may turn problematic because of the old tax world view. Notably, any attempts to harmonise (aspects of⁴¹) domestic tax systems are met with protest from some Member States⁴² because harmonisation of domestic tax systems could change the nature of the EU towards that of an even more supranational body taking on the responsibility of looking after state nationals. Member States' reluctance to agree to an extensive framework of direct tax harmonisation measures indicates a lack of political will among those states to take a step closer towards the transformation of the EU into a more integrated body. Opponents of tax harmonisation argue that EU institutions lack direct legitimacy from the *demos* to govern. In effect, the EU *cannot* have tax powers. That view is closely linked with the perception of the role of the state in the pre-globalisation world. A transfer of powers to the EU to decide about the direct tax systems of the Member States would entail formal recognition that a special bond between the nation state and its residents is broken. The concept of a state using its tax system to

⁴⁰ A A Stein, 'Coordination and Collaboration: Regimes in an Anarchic World', (1982) 36:2 *International Organization* 299-324 at 304.

⁴¹ Such as tax rates or tax bases, as opposed to harmonisation of systems of corporate taxation.

⁴² Among the Member States that communicate their lack of acceptance of EU level harmonisation of direct taxation are: Slovakia, Ireland, the United Kingdom and Estonia. See for instance: Slovakia against EU tax harmonisation, available at <http://www.eubusiness.com/news-eu/slovakia-finance.8qw/>. See also C McCreevy, Tax Harmonisation – No thanks, European Business Initiative on Taxation, Brussels, 10 November 2005 available at <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/05/679&format=HTML&aged=0&language=EN&guiLanguage=en>.

protect and express national interests would be compromised. The Member States of the EU do not seem to be ready to abandon this concept.

Some Member States may also oppose tax harmonisation because preferences for redistribution policies across Member States differ significantly and harmonisation would leave less scope for independent action by national governments. Member States are unwilling to part with the illusion of absolute tax sovereignty. However, it must be conceded that the independence of national tax decisions, as it existed in the pre-globalised world, is already lost. This is because national tax systems have spillover effects on other Member States. A national government can structure its tax policy and consider its decisions to be fully sovereign. In practice, the decisions of the national government are affected by tax decisions undertaken in other states and by the tax behaviour of potential investors. The ability to move investment between jurisdictions puts pressure on governments to develop market-friendly policies and causes a shift in the power balance between markets and governments. A decision to cooperate with other jurisdictions may enable states to regain, at least partially, control over their tax policies, counter-intuitive as this may seem.⁴³

As suggested above, direct tax cooperation is desirable at the EU level. The EU made a number of attempts, studied in Chapters 2, 3 and 4, to establish an environment for tax cooperation. And crucially, to develop corporate tax regulation, the EU applied a variety of regulatory mechanisms, which include both hard law and soft law measures.

1.2. Regulatory dynamics in the European Union

Section 1.1.3. introduced the diversity of regulatory tools which the EU may use in influencing a regulatory sphere. This section describes these general regulatory capabilities of the EU in order to explain the background against which regulation of direct taxation continues to evolve.

⁴³ See: C Kellerman, T Rixen and S Uhl, *Europeanizing Corporate Taxation to Regain National Tax Policy Autonomy*, International Policy Analysis, July 2007, available at <http://library.fes.de/pdf-files/id/04760.pdf>.

1.2.1. A hybrid structure

The process of European integration has fluctuated between two adverse methodologies: supranational and intergovernmental.⁴⁴ This dual nature of the EU facilitates its adaptation to changing conditions affecting the integration process. In order to influence various policy areas, which are important to the process of integration, the EU has to display flexibility with regard to applied methods. A diverse range of problem-solving instruments enables the EU to maintain the capacity to operate when the adoption of legislation is not always possible.

Intergovernmentalism is present in the fact that the EU can be perceived as an international organisation, which gives Member States the leading role. The intergovernmental approach to integration relates to arrangements where nation states, in situations and conditions they control, cooperate with one another on matters of common interest.⁴⁵ Some powers are then concentrated in the hands of the Member States and, for that reason, intergovernmental cooperation presents an attractive solution to sensitive problems that those states are not (yet) ready to regulate through supranational mechanisms. Intergovernmentalism can be described as the antithesis of supranationalism. It supports the independence of sovereign states deciding to cooperate within the framework of an organisation; however, the process of cooperation does not lead to the conferral of powers on the organisation as the states retain control over the extent and nature of this cooperation

It should be underlined that the intergovernmental strategy to tackle problems now shapes the minority of EU activities. European integration has principally been built on the basis of supranational solutions. The techniques used to achieve EU goals

⁴⁴ This division was more easily noticeable before the Lisbon Treaty entered into force. The Lisbon Treaty formally abolished the three-pillar framework on the basis of which the EU functioned. The first pillar, the European Community, principally, had a supranational character. With regards to the common foreign and security policy and police and judicial cooperation in criminal matters, the Member States were not willing to subject these areas to supranational methods of decision making. Hence, the second and third pillars were of an intergovernmental nature. See: P Craig and G De Búrca, *EU Law: Text, Cases and Materials*, 4th ed., (Oxford: Oxford University Press, 2008), p. 118-126. Sieberson describes the EU as a 'blended entity'. See: S C Sieberson, *Dividing Lines Between the European Union and its Member States*, (The Hague: T.M.C. Asser Press, 2008), p. 15.

⁴⁵ N Nugent, *The Government and Politics of the European Union*, (Basingstoke: Palgrave Macmillan, 2010), p. 428.

have traditionally been legal. The vision of the EU as a supranational community was articulated by the ECJ in its decision in *Van Gend en Loos*:⁴⁶

*[The EU] constitutes a new legal order of international law for the benefit of which the states have limited their sovereign rights, albeit within limited fields, and the subjects of which comprise not only the Member States but also their nationals.*⁴⁷

The system of laws thus created constitutes a legal system in its own right, existing not only independently from national legal orders but also above them. This new legal order can be described as a body of conferred rights and obligations imposed on the Member States and their nationals. The transfer of these rights and obligations to the EU legal system carries with it a limitation of national sovereign rights, against which a subsequent unilateral act incompatible with EU law cannot prevail.⁴⁸ Thus, the Member States have to ensure that obligations and rights articulated in EU law are respected. If Member States fail to do so, enforcement actions against them can be undertaken.⁴⁹

Under the pre-Lisbon Treaties, it was relatively easy to oversimplify the nature of the EU. The first pillar had a supranational character and was almost automatically associated with the creation of legislation. The second and third pillars, regarded as being of an intergovernmental nature, were linked with soft law. Nevertheless, one must be warned against an overly simplistic understanding of the EU as a regulatory body. The supranational aspects of the EU operation must not be automatically associated with hard law and the intergovernmental sectors of the EU project must not be linked merely with soft methods of governance. The soft and hard law approaches transgressed regulatory spheres across the pillars and can be operative in any policy area. This is evident in the field of corporate taxation. Apart from traditional, hard law measures within the supranational pillar, one can also find

⁴⁶ Case 26/62 *NV Algemene Transport- en Expeditie Onderneming van Gend en Loos v Netherlands Inland Revenue Administration* [1963] ECR 1.

⁴⁷ *Ibid.*

⁴⁸ The primacy principle states that in a sphere where EU law is applicable, the EU norm takes primacy over the conflicting national law, regardless of whether the national norm was enacted before or after the EU norm. Case 6/64 *Flaminio Costa v E.N.E.L* [1964] ECR 585.

⁴⁹ Articles 258-259 TFEU.

initiatives based on cooperation and coordination.⁵⁰ Similarly, in the context of the second or third pillars, one could observe developments and processes that could not simply be classified as soft coordination.⁵¹

1.2.2. EU legal system

According to the Treaties, the EU has law-making competence. This differs from the power of the national legislatures to introduce laws because it is not of a general and inherent nature. The EU can make laws only in those areas in which the Member States, through the Treaties, empowers it to do so. Any action undertaken by the EU has to find its legal basis either in the Treaty or in secondary legislation.

The scope of EU powers has been subject to transformations throughout the history of European integration. Consequently, whilst the Member States remain sovereign in some spheres, in others they agreed to give the EU law-making power. How do the Treaties set out the division of powers between the Member States and the EU?

The EC Treaty⁵² did not precisely demarcate the line between EC and Member State competences. However, for the first time in European integration history, the Lisbon Treaty⁵³ formally introduced provisions dividing competences between the EU and its Member States. Such a solution is hoped to curb the EU's tendency to impinge on areas reserved to the Member States.⁵⁴ Therefore, as far as the division of competences is concerned, three situations are possible. First, the EU has exclusive competence in a specific field.⁵⁵ Here, the Member States are precluded from taking any action in the field.⁵⁶ Second, competences are shared between the EU and

⁵⁰ Direct taxation fell within the scope of the first pillar. The Code of Conduct for Business Taxation is an example of soft law instruments in the supranational environment.

⁵¹ The European Arrest Warrant can be regarded as another example of harder regulation within an intergovernmental setting. Framework Decision 2002/584/JHA on the European Arrest Warrant and the surrender procedures between Member States, OJ 2002 L 190/1.

⁵² Consolidated version of the Treaty establishing the European Community, OJ 2002 C 325/33.

⁵³ Treaty of Lisbon amending the Treaty on European Union and the Treaty establishing the European Community, signed at Lisbon, 13 December 2007, OJ 2007 C 306/1.

⁵⁴ S C Sieberson, note 44 above, at 66.

⁵⁵ Article 3 TFEU. The EU has exclusive competences in e.g.: the customs union, monetary policy, and the establishment of the competition rules necessary for the functioning of the internal market.

⁵⁶ Article 2(1) TFEU. The Member States cannot legislate with regards to an area of exclusive EU competence unless empowered by the EU to do so or in order to implement EU acts.

national governments.⁵⁷ This power has a concurrent nature as the sphere can be regulated either by the EU or by the Member States. However, once the EU takes action, it is assumed that the Union gains exclusive competence within this field. Put differently, both the EU and the Member States can legislate and adopt legally binding measures in these areas. The Member States exercise their competences to the extent that the EU has not exercised or decided to cease exercising its competences.⁵⁸ In addition, the overall boundaries to a Member State's freedom to regulate are imposed by case law.⁵⁹

Third, there are also areas in which Member States have primary competence but the EU may take action to support, coordinate or supplement the Member States' activities.⁶⁰ The EU cannot harmonise these regulatory fields. However it is allowed to take action without suspending the competences of the Member States. The EU can deliver legally binding measures that will constrain the Member States to the extent described in the prepared measure.⁶¹

In addition, the Union has to act within constitutional limits imposed by certain principles, notably subsidiarity and proportionality.⁶² The delineation of the boundaries of EU action as restricted by the subsidiarity principle is provided for in Article 5(3) TEU.⁶³ Subsidiarity allows the EU institutions to act in areas of shared competences only if and so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States at central or local levels. Consequently, the principle of subsidiarity does not apply when the EU holds an exclusive power. A concept closely linked to subsidiarity in the competence debate is proportionality. The proportionality principle requires a reasonable relationship between the measures applied to achieve the goal at hand and the goal itself. It is incorporated into Article 5(4) TEU.

⁵⁷ Article 4 TFEU. The EU shares competences with the Member States in the following fields: the internal market, economic, social and territorial cohesion, environment, transport, and the area of freedom, security and justice.

⁵⁸ Article 2(2) TFEU.

⁵⁹ Case C-279/93 *Finanzamt Köln-Alstadt v Roland Schumacker* [1995] ECR I -225, paragraph 21.

⁶⁰ For instance: industry, tourism, education, vocational training, youth and sport. Article 6 TFEU.

⁶¹ Article 2(5) TFEU.

⁶² Article 5 TEU.

⁶³ It was introduced to the EU by the Treaty of Maastricht as Article 3b TEC.

1.2.3. Instruments to develop EU law

When the EU undertakes the task of regulating, it has a choice of many instruments. Clearly, the type of instrument used to coordinate national tax laws is of great importance to the strength and character that EU regulation will display. Legislative measures in the EU have varying legal effects on the Member States and can be employed to achieve different results. Additionally, different types of instruments may be used within the same regulatory sphere. As explained in Article 288 TFEU, regulations, directives, and decisions are all legally binding (although the scope of the binding effect differs). However, there is no formal hierarchy among different types of the Union legislation. Regardless of whether rules are imposed by a directive, a regulation or a decision, they are all equal with regard to their importance to the law-making process. The EU institutions are also able to issue non-binding recommendations. This form of integration aims at promoting voluntary compliance with rules supported by these non-binding documents.

Directives are addressed to the Member States. States must take measures to ensure conformity of national laws and practices with the rules set out by the directive, within a given time limit. Directives leave some choice to the Member States in relation to the method and form by which to bring national laws into conformity. In essence, directives are binding in respect of the prescribed goal that Member States are obliged to achieve and always call for an implementing measure to be adopted at the national level. It is said that directives are the key instrument applied by the EU in the process of harmonisation where differing national laws are to be coordinated. As a result, directive provisions may represent a compromise between the Member States on a sensitive or difficult problem.⁶⁴ Directives are capable of producing direct effect,⁶⁵ which means that individuals may be able to rely on their provisions in

⁶⁴ P Craig and G De Búrca, note 44 above, at 279.

⁶⁵ Case 41/74 *Van Duyn v Home Office* [1974] ECR 1337, paragraph 12. The doctrine of direct effect was introduced in the *van Gend en Loos* case. Although direct effect was not stated in the EEC Treaty, the ECJ considered that, without it, the effective achievement of the Treaty objectives would not have been possible. The doctrine of direct effect provides that EU law can be invoked before the national courts by individuals when EU law rules are clear and precise. Case 26/62 *van Gend en Loos*, note 46 above, paragraph 12.

national courts. Member States may be found liable for a lack of or inappropriate implementation of a directive.⁶⁶

Similarly to directives, regulations are also capable of having direct effect.⁶⁷ However, unlike directives, regulations are binding on and directly applicable in all EU Member States. In other words, regulations do not require an implementing measure to be adopted at the national level. They constitute part of national legal systems automatically. Regulations serve the purpose of achieving greater uniformity. Article 288 TFEU lists decisions as a third form of legislative measure. They are binding in their entirety on those to whom they are addressed.

Finally, Article 288 TFEU provides for recommendations and opinions as non-legally binding measures introduced to develop EU policies and law-making processes. This list of five categories of instruments applicable in EU law-making processes is not exhaustive. Other measures, such as guidelines, codes of conduct or resolutions have been adopted to develop EU policies. Generally, however, the Treaties do not focus on soft law measures in great detail.

This section touched upon the potential of the EU in regulating corporate taxes. It was shown that the hard law approach was generally the traditional choice for European integration, enshrined strongly in the Treaty framework. However, European integration has also been linked with soft methods of governance. The significance of these developments for the regulatory future of the EU is not fully recognised in the Treaty, even after the Lisbon amendments. This general presentation of the EU regulatory framework is further unfolded in relation to corporate taxes in sections 1.4. and 1.5., and establishes a building block for an in-depth examination of hard law and soft law interactions conducted in the substantive chapters of the thesis.

⁶⁶ An action against a Member State for failing to fulfil an obligation under the Treaties, for instance lack of or improper implementation of a directive, can be brought before the ECJ on the basis of Article 258 TFEU. E.g. Case C-186/09 *European Commission v United Kingdom of Great Britain and Northern Ireland* [2010] ECR I-15. The ECJ decided that the UK failed to implement equal treatment legislation in Gibraltar; Case C-289/07 *Commission of the European Communities v Portuguese Republic* [2008] ECR I-54. See also a provision on sanctions (Article 260 TFEU).

⁶⁷ Case 39/72 *Commission v Italy* [1973] ECR 101, paragraph 3.

1.3. Diversified governance in EU corporate taxation

The fact that direct taxation is one of the most controversial EU regulatory areas is not surprising, as we saw in section 1.1. Reaching a compromise on how to regulate direct taxation has always been difficult. Progress was slow and dependent upon shifting the direction and form of the regulatory approach. Arguably, the EU began to use diversified governance mechanisms to improve its performance with regards to corporate taxes.

Specifically, three ways in which the EU has exerted influence on direct tax can be distinguished. First, having satisfied the requirement of a unanimous vote by the Member States, the EU adopted a range of direct tax directives.⁶⁸ Therefore, a traditional legislative framework harmonising, in a positive way, some aspects of direct taxation exists in the EU. The EU makes law in the direct tax arena on the basis of the general harmonisation provision connected to the establishment and functioning of the internal market.⁶⁹ Thus, harmonisation is not a standalone objective but has to contribute to the creation of the internal market.

But legislation is just a modest contributor to the elimination of impediments to the internal market caused by national direct tax regimes. As long as no positive integration has been brought about, the Member States are in general free to regulate direct taxes as they see fit. However, this does not mean absolute freedom. Even in the field of direct taxation, the Member States must exercise their competence in a manner that respects the non-discrimination rules set out in the Treaty. This is

⁶⁸ Directives regulating direct taxation issues in the EU are: 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 1990 L 225/6; Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ 2003 L 157/49; Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, OJ 2003 L 157/38. Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, OJ 1977 L 336/1. It will be replaced by Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EC, OJ 2011 L 64/1. 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 1990 L 225/1. This Directive was codified in Council Directive 2009/133/EC on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States, OJ 2009 L 310/34.

⁶⁹ Article 115 TFEU.

subject to review by the ECJ.⁷⁰ More recently, corporate taxation has also been influenced through non-legislative means. Such instruments are not unique to the area of direct taxes. The key instrument regulating tax competition in the EU is the Code of Conduct for Business Taxation⁷¹ (hereinafter the Code or the Code of Conduct), a non-binding instrument regarded as an example of soft tax regulation.

The next sections are concerned with providing an introduction to the hard law and soft law approaches displayed in EU corporate tax regulation. Sections 1.4. and 1.5. focus on the legal foundations and features of the three regulatory methods outlined above. Thus, sections 1.4. and 1.5. create the background to Chapters 2, 3 and 4.

1.4. Hard law and corporate tax regulation in the EU

1.4.1. Hard law: general overview

The EU has been described as an institution based on hard law.⁷² Hard law refers to legally binding obligations that are precise and delegate authority for interpreting and implementing the law.⁷³ This is a logical consequence of the fact that the Treaty did not express an ambition merely to set up an association of states. This particular association was ‘supplied with a motor to enable it to develop into its declared goal, the economic and social union of Europe’.⁷⁴ To strengthen this distinctive legal order, the paradigm of European governing was hierarchical and principally supportive of hard law techniques enabling the achievement of the approximation of national rules. The establishment of central institutions empowered to adopt binding norms that are capable of being directly effective within the Member States, and that

⁷⁰ The most significant rulings of the ECJ for the development of direct tax law include: Case C-319/02 *Petri Mikael Manninen* [2004] ECR I -7477; Case C-196/04 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] ECR I -7995; Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* [2007] ECR I -2107; Case C-446/03 *Marks & Spencer plc v David Halsey* [2005] ECR I -10837; Case C-141/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn* [2008] ECR I -3601.

⁷¹ Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy, OJ 1998 C 2/1.

⁷² J J Kirton and M J Trebilcock (eds.), *Hard Choices, Soft Law: Voluntary Standards in Global Trade, Environment and Social Governance*, (Aldershot: Ashgate, 2004), p. 347.

⁷³ D Curtin, ‘European Legal Integration: Paradise Lost?’, in D Curtin (ed.), *European Integration and Law: Four Contributions on the Interplay between European Integration and European and National Law to Celebrate the 25th Anniversary of Maastricht University’s Faculty of Law*, (Antwerp: Intersentia, 2006), 1-54 at 10.

⁷⁴ W Hallstein, *Europe in the Making*, (London: Allen and Unwin, 1972), p. 30.

take priority over national laws in case of a conflict has been central to EU success in bringing the Member States and their legal orders closer together. EU law gained this strong position due to the activities of the ECJ.⁷⁵ Hard law has, therefore, been a traditional but, in reference to certain regulatory spheres, politically challenging road to European integration. Historical analysis shows that the traditional, hard law approach was utilised at the beginning of regulatory attempts in the field of corporate taxation. Initially, efforts were made to harmonise corporate taxes by proposing and adopting directives. The development of hard law through direct tax jurisprudence has become more influential only since the mid 1980s.⁷⁶

The characteristic features of hard law include that it is associated with a system of government, in which the traditional method of command and control is applied.⁷⁷ The concept of hierarchical governing entails that policies come from the central level of the regulatory structure down, and do not allow for discretion on the part of those to whom the policies in question apply. Finally, the policies are binding and can be legally enforced. In essence, hierarchical governing is grounded on a top-down delegation, on legally binding and prescriptive policies.⁷⁸

Hard law is inclined towards uniformity of treatment. As a consequence, within the EU context, the emphasis was placed on harmonisation as a formal tool for the integration of the Member States.⁷⁹ Due to the primacy of EU law, once national laws have been harmonised, EU regulation can no longer be simply replaced by domestic rules. Thus, a homogeneity of solutions for the Member States is reached. In effect, the Treaty's decision-making processes that had strong supranational elements⁸⁰ and the application of the classic Community Method⁸¹ were dominant.

⁷⁵ Weiler states that the ECJ constitutionalised the EU legal structure. J H H Weiler, 'The Transformation of Europe', (1991) 100:8 *Yale Law Journal* 2403-2483 at 2413.

⁷⁶ In 1986, Case 270/83 *Commission of the European Communities v French Republic* [1986] ECR 273 (the *Avoir Fiscal* case) was decided. It is considered to be the first direct tax case before the ECJ.

⁷⁷ U Mörth (ed.), *Soft Law in Governance and Regulation: an Interdisciplinary Analysis*, (Cheltenham: Edward Elgar Publishing, 2004), p. 1.

⁷⁸ See: P Craig and G De Búrca, note 44 above, at 146.

⁷⁹ For a more detailed discussion on the concept of harmonisation and various harmonisation methods see P J Slot, 'Harmonisation', (1996) 21:4 *European Law Review* 378-397; M Dougan, 'Minimum Harmonization and the Internal Market', (2000) 37:4 *Common Market Law Review* 853-885.

⁸⁰ J H H Weiler, note 75 above, at 2423.

The Community Method determines the role of EU institutions and the modes of their interactions. It is premised upon four key features.⁸² First, this mode of governance is characterised by the Commission's monopoly on the right of legislative initiative.⁸³ Second, the classical Community Method operates within the context of a widespread use of qualified majority voting in the Council. Thus, common solutions are decided upon more promptly and deadlocks are avoided. Third, an active role is assigned to the European Parliament, which is present in the legislative process to enhance legitimacy and to allow for a greater recognition of the voice of EU citizens. Fourth, the uniform interpretation of law by the ECJ guarantees respect for the rule of law and facilitates the maintenance of balance among European institutions.⁸⁴ The Community Method technique of decision-making meant that, from a legal viewpoint, the EU developed towards enhanced supranationalism. Thus, obligations created on the basis of these methods were 'for real',⁸⁵ applying to all the Member States.⁸⁶

1.4.2. The Treaty framework for corporate tax integration

1.4.2.1. Positive integration: the Treaty harmonisation provision

As outlined in section 1.2.2., any action of the EU aiming at approximating national laws must be anchored in the provisions of the Treaty. Regulation of direct taxation is no exception. Harmonisation of direct taxes depends on a general, and not specific, Treaty provision, Article 115 TFEU.⁸⁷ It authorises the Council, acting unanimously,

⁸¹ Scott and Trubek indicate the Community Method as a standard against which 'new' forms of governance have to be assessed. J Scott and D M Trubek, 'Mind the Gap: Law and New Approaches to Governance in the European Union', (2002) 8:1 *European Law Journal* 1-18 at 1.

⁸² J Scott and D M Trubek, note 81 above, at 1. See also: European Commission, *European Governance: a White Paper*, COM (2001) 428 final, p. 8. This document calls for re-invigoration of the Community Method through a better adaptation to changing patterns of European governance.

⁸³ The monopoly of the Commission is not absolute. The Treaties depart from this rule in Article 225 TFEU which permits the Parliament, acting by a majority of its Members, to request the Commission to submit any appropriate legislative proposal. Parliament may, at the same time, set a deadline for the submission of such a proposal. Additionally, under Article 11(4) TEU, not less than one million citizens have a right to submit a legislative proposal.

⁸⁴ H Wallace and W Wallace, *Policy-Making in the European Union*, 4th ed., (Oxford: Oxford University Press, 2000), p. 28-29.

⁸⁵ Weiler applies the expression 'for real' to emphasise the fact that Community law was legally binding on the Member States and the avoidance of EC obligations was problematic. In other words, the law was hard. See: J H H Weiler, note 75 above, at 2423, 2426.

⁸⁶ J J Kirton and M J Trebilcock, note 72 above, at 347.

⁸⁷ Previously, Article 94 TEC.

to issue directives ‘for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market.’⁸⁸

Article 115 TFEU provides for the *approximation* of laws of the Member States. The term ‘harmonisation’ is not mentioned in this provision. Are these notions synonymous? According to Easson, the answer is positive.⁸⁹ He claims that a textual analysis of the Treaty does not indicate that any differentiation between the two concepts should be made. An interesting question could be asked about whether it is legitimate under the Treaties to unify national tax systems within the EU. This is a rather under-researched issue. Nevertheless, *expressis verbis*, the term ‘unification’ is not used in the Treaties.⁹⁰ It appears that unification is not therefore supported.

Another important aspect of Article 115 TFEU is the fact that the requirement to harmonise domestic laws (including direct tax rules) appears to be mandatory. The wording is clear and states that the Council *shall* take action. It appears that it is not a question of whether or not to harmonise direct taxes when they affect the establishment and functioning of the internal market. It is simply a question of how to achieve this politically.

Direct tax laws can be subject to an approximation process when a *direct link* can be established between the functioning of the internal market and the influence of direct taxation on the operation of the internal market. Direct tax approximation can only be considered, when it can be directly proved that the internal market would become

⁸⁸ The wording of Article 94 TEC and Article 115 TFEU differs in this regard. Whereas Article 94 TEC entitled the Council to approximate domestic laws in order to contribute to the establishment or functioning of the *common market*, Article 115 TFEU refers to the *internal market*. This is a desirable modification. It constitutes a step towards more uniform terminology. The EC Treaty applied both internal market and common market terms. The relationship between these concepts was not settled; however, it was claimed that both terms could be perceived as synonymous. See: C D Ehlermann, ‘The Internal Market Following the Single European Act’, (1987) 24:3 *Common Market Law Review* 361-409. AG Tesauo also discussed the relationship between the terms internal market and common market. He concluded that these two terms differ in breadth. See: Opinion of Advocate General Tesauo in Case C-300/89 *Commission of the European Communities v Council of the European Communities* (Directive on waste from the titanium dioxide industry) [1991] ECR I-2867.

⁸⁹ A Easson, *Tax Law and Policy in the EEC*, (London: Sweet&Maxwell, 1980), p. 117.

⁹⁰ According to Easson, the degree of coordination of national tax laws is of secondary importance. The more important aspect is achieving a goal prescribed in the coordination initiative, be it by harmonisation or unification. *Ibid.*, at 117

distorted and/or function in a less satisfactory way, had direct tax approximation not occurred. If the link between direct taxes and their impact on the internal market is indirect, harmonisation of direct taxes is not justified. As far as prescribed instruments employed to approximate national direct taxes are concerned, Article 115 TFEU is unambiguous and leaves no room for doubt. The instrument to be employed in the process of approximating direct taxes is a directive.

Since direct tax initiatives at EU level are subject to unanimous voting, arriving at a compromise that would be both acceptable to all the Member States and beneficial for the EU creates a greater challenge when the number of the Member States rises. This position has been exacerbated by successive EU enlargements.⁹¹ The Commission considers that retaining unanimity for all taxation decisions will make it difficult to achieve any of the tax coordination necessary for Europe. During the Convention on the Future of Europe, the Commission has made proposals to move towards qualified majority voting (QMV) in *certain* tax areas.

A proposal was put forward to introduce the QMV procedure for certain aspects of the regulation of company taxation.⁹² Article III-63 of the draft Constitution constituted a new provision. It opened the door for majority voting in the field of company taxation if the Council found that specific measures relating to mutual assistance and exchange of information and cooperation between tax authorities, to combating tax fraud or tax evasion and proposals related to the protection of the environment were necessary for the functioning of the internal market and to avoid distortion of competition. This innovation was not accepted by the inter-governmental conference. The entire provision was abandoned.⁹³

⁹¹ Before the Single European Act in 1986, the Treaty provisions were not explicit about the voting requirement concerning harmonisation of direct taxes. The Single European Act confirmed the sacrosanct position of direct taxes by stating that harmonisation of direct taxes depends on the general Treaty provisions grounded in unanimity. Notably, Article 114(2) TFEU allows, by way of derogation from Article 115 TFEU, the adoption of measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market by qualified majority voting. Nevertheless, this rule was explicitly excluded for tax issues by Article 114(2) TFEU.

⁹² Proposed amendments to the text of the Articles of the Treaty Establishing a Constitution for Europe, available at <http://european-convention.eu.int/amendments.asp?lang=en&Content=827>.

⁹³ Against were, among others, the UK and Ireland. See: Select Committee on Foreign Affairs Minutes of Evidence, available at <http://www.parliament.the-stationery->

Arguments against the shift to QMV in direct taxation were motivated by a number of factors. First, some governments feared that QMV would open the door to higher tax rates. On this view, QMV would enable harmonisation, thereby introducing higher taxes than opposing Member States prefer. Second, the then upcoming Eastern enlargement cannot be disregarded in the context of talks about QMV in corporate taxation. QMV could have been perceived as a way to introduce direct tax regimes similar to regimes in the new Member States (generally lower taxes) and thus, contest higher social programmes in some of the Member States. The Treaty rules on voting over tax proposals have never been amended. But one has to wonder how, in the highly diversified EU, unanimity voting on direct tax proposals can be sustained. The heterogeneity of national tax regimes will make it impossible to pursue further harmonisation plans and thus mark the limits of tax integration.

1.4.2.2. Direct tax legislation: a summary of achievements

Hard law in the form of direct tax directives, adopted on the basis of Article 115 TFEU, has constituted a traditional EU method of influencing the direct tax field. Here, the record of direct tax legislative achievements is briefly outlined. This is short and not impressive, especially when one considers that only five directives have been adopted over a period of 50 years. The historical setting in which these directives were adopted and factors that contributed to the failure of the traditional hard law approach are thoroughly explored in Chapter 2.

The directives harmonising direct taxation are: the 1990 Parent-Subsidiary Directive, which seeks to abolish tax impediments to cross-border payments of dividends within groups of companies when the parent company is resident in a different Member State than the subsidiary; the 1990 Fiscal Merger Directive, which prevents unfavourable treatment of cross-border mergers, divisions, transfer of assets and exchanges of shares in comparison to domestic mergers by introducing a common system of taxation; the 2003 Interest and Royalty Directive, which creates a common system of taxation applicable to interest and royalty payments between associated

office.co.uk/pa/cm199900/cmselect/cmcaff/68/0112107.htm; EPIN Briefing Note: the UK and the Convention, available at http://www.epin.org/new/files/debate_uk.pdf, p.2 and M Persoff, 'The Impact of EU Developments on Member States' Tax Systems', (2004) 15:2 *International Tax Review*, 10-14 at12.

companies from different Member States; the 2003 Savings Interest Directive, which attempts to avoid distortions to the movement of capital and allows effective taxation of interest payments received by individuals in Member States other than the Member State of residence; and finally, the Mutual Assistance Directive, which requires Member States to exchange any information in the field of direct taxation that may enable the correct assessment of taxes (all references were provided in note 68 above).

The EU, at its current level of integration, has thus had a limited impact on direct taxation through traditional hard law. In the direct tax field, the EU resembles an association of nation-states who agreed to transfer very restricted powers to a broader organisation that is authorised to enact laws within specified spheres. However, direct tax achievements should be perceived in a wider context. There is more going on in direct tax regulation than one may notice. The ECJ came to the EU's rescue in regulating direct tax systems.

1.4.2.3. Negative integration: an overview of the fundamental freedoms

The fundamental freedoms aim at abolishing barriers to cross-border activities and at securing the free flow of production factors within the internal market. Although the fundamental freedoms are of a universal character and as such were not conceptualised specifically for the purpose of direct taxation, they have become an important instrument in realising goals of EU law in the field of direct taxes. The free movement principles, as laid down in the Treaty, act as the guidelines that enable the ECJ to reconcile conflicting requirements for integration within the internal market with national tax sovereignty. In particular, when the ECJ is faced with a direct tax case, it employs provisions concerning the free movement of workers (Article 45 TFEU),⁹⁴ freedom of establishment (Article 49 TFEU), freedom to provide and receive services (Article 56 TFEU) and the free movement of capital and payments

⁹⁴ Article 45 TFEU protects the free movement of workers within the EU. It encompasses the right to migrate from one Member State to another to accept employment in the other Member State. Workers should also enjoy the right to enter the job market of another state and to live there (market access). Additionally, differential treatment of workers based on their nationality is forbidden in respect of employment, remuneration and other conditions of work and employment (market equality). Moreover, Regulation 492/2011 of the European Parliament and of the Council of 5 April 2011 on Freedom of Movement for Workers within the Union (OJ 2011 L 141/1) *expressis verbis* provides for the right to equal treatment of workers from other Member States as regards, among others, taxation.

(Article 63 TFEU)⁹⁵ to review discriminatory and restrictive measures. On the basis of these provisions, the ECJ constructed complex hard law regulation.

As this thesis focuses on corporate taxation, the free movement of workers and the rights associated with EU citizenship are disregarded, even though these two categories of internal market operators can – and frequently do - raise questions regarding personal income taxation. This section focuses on an overview of the freedoms that are relevant to corporate taxation.

The right of establishment is conferred upon individuals holding the nationality of an EU Member State. It comprises the right of individuals to take up and pursue activities as self-employed persons in other Member States. It also includes the right of individuals to set up and manage undertakings in another Member State. In addition, freedom of establishment applies to companies and firms that have their registered office, central administration or principal place of business within the EU.⁹⁶ Having met this requirement, a company or a firm is granted a right to establish branches, subsidiaries or agencies in another Member State and for them to be treated as companies resident in that country. The right of establishment has direct effect, which was confirmed in the *Reyners* case.⁹⁷

How did the Court transpose the rights enshrined in Article 49 TFEU to the sphere of direct taxation? For instance, in *Commerzbank*,⁹⁸ it was confirmed that host states were obliged to grant national treatment when companies and individuals from other Member States established themselves on their territory. Thus, a German company with a branch in the UK sought equal treatment with UK resident companies in relation to a repayment supplement granted by the United Kingdom's revenue authorities when tax was overpaid. Similarly, different treatment of branches in the host Member State with regards to tax rates has also forced the ECJ to declare that such host state rules are incompatible with the freedom of establishment. In the

⁹⁵ No attention is devoted here to the free movement of goods because that provision is of major significance in respect of *indirect taxation*.

⁹⁶ Article 54 TFEU.

⁹⁷ Case 2/74 *Jean Reyners v Belgian State* [1974] ECR 631.

⁹⁸ Case C-330/91 *The Queen v Inland Revenue Commissioners, ex parte Commerzbank AG* [1993] ECR I-4017.

Royal Bank of Scotland case,⁹⁹ a branch of a UK bank located in Greece was charged a 40 per cent tax on its branch profits compared to a 35 per cent tax on the branch profits of a bank with its primary establishment in Greece. A lower tax rate was applied to companies with their seat in Greece but not to companies with their seat or registered office in another Member State. The Court analysed whether this different tax treatment of resident and non-resident companies could be justified and held that it could not.

Moreover, to realise a true internal market, not only must freedom of establishment be guaranteed. The free movement of services must also be secured. This freedom encompasses both the provision and the purchase of services. Service providers ought to be able freely to access the market of another Member State and provide services there. While doing so, the service providers are entitled to be treated in the same fashion as domestic providers of services. On the other hand, there must be freedom to purchase or receive services. This includes the right to move to the state of a service provider to receive the service. Apart from the right to provide/receive services in another Member State, Article 56 TFEU also covers the right to provide/receive cross-border services where the provider or the recipient of services need not move.¹⁰⁰ Importantly, the Treaty provisions on the free movement of services are of a residual nature. Thus, they are applicable only when the provisions concerning persons, establishment, capital and goods do not apply.¹⁰¹

However, at times, it may be difficult to distinguish which freedom should apply in a given case. For instance, the distinction between providing services and exercising freedom of establishment may create problems. Confusion of services with establishment appears likely, particularly, where the provision of services is of a regular nature. In the *Gebhard* case,¹⁰² the ECJ made an attempt to draw a line between exercising the freedom to provide services and the freedom of establishment. Fundamentally, the crucial factor differentiating the free movement of

⁹⁹ Case C-311/97 *Royal Bank of Scotland plc v Elliniko Dimosio (Greek State)* [1999] ECR I-2651.

¹⁰⁰ For instance, telecommunication or banking services.

¹⁰¹ Article 57 TFEU.

¹⁰² Case C-55/94 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165.

services from establishment is the fact that establishment as an economic activity is exercised on a stable and continuous basis; services, by contrast, entail a temporary character.¹⁰³ Finally, the free movement of services provisions can confer directly effective rights. This was first acknowledged in the *van Binsbergen* case.¹⁰⁴

Direct tax examples of national rules declared to be infringements of the free movement of services include the *Safir*¹⁰⁵ and *Danner*¹⁰⁶ cases. *Safir* was concerned with the cross-border provision of insurance, which constitutes a service within the meaning of the Treaty. The Swedish rules that providing for the payment of a tax, under specific circumstances, only on premiums paid to a company not established in Sweden were found to breach Article 56 TFEU. In *Danner*,¹⁰⁷ the ECJ found that the refusal to grant Mr Danner, a Finnish resident, a full deduction for pension insurance contributions paid by him to pension insurance schemes operated by German insurance institutions constituted a restriction of the free movement of services and was likely to dissuade individuals from purchasing insurance from institutions established outside Finland.

Within the internal market, undertakings must be able to borrow money or issue shares where they consider it to be most efficient. Investors, on the other hand, must be free to invest their money where they wish to do so. The free movement of capital is thus closely related to the freedom of establishment because cross-border establishment usually means cross-border movements of capital. The free movement of capital is supplemented by the freedom of payments.

In *Sanz de Lera*,¹⁰⁸ the main Treaty provision on the free movement of capital (Article 63 TFEU) was held to have direct effect. The discretion bestowed on the Member States in Article 65(1)(b) TFEU did not prevent Article 63 TFEU from

¹⁰³ *Ibid.*, paragraphs 25 and 26.

¹⁰⁴ Case 33/74 *Johannes Henricus Maria van Binsbergen v Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid* [1974] ECR 1299.

¹⁰⁵ Case C-118/96 *Jessica Safir v Skattemyndigheten i Dalarnas Län, formerly Skattemyndigheten i Kopparbergs Län* [1998] ECR I-1897.

¹⁰⁶ Case C-136/00 *Rolf Dieter Danner* [2002] ECR I-8147.

¹⁰⁷ *Ibid.*

¹⁰⁸ Joined Cases C-163/94, C-165/94 and C-250/94 *Criminal proceedings against Lucas Emilio Sanz de Lera, Raimundo Díaz Jiménez and Figen Kapanoglu* [1995] ECR I-4821.

being directly effective.¹⁰⁹ In addition, the free movement of capital and payments is the only Treaty freedom that extends to relations with third countries. Consequently, all restrictions on the movements of capital and payments between the Member States and the Member States and third countries must also be abolished. In effect, therefore, this freedom does not have purely intra-EU significance.

Classically, the fundamental freedoms are based on deregulation i.e. EU law forbids national rules that can obstruct cross-border activities. The fundamental freedoms in the Treaty are expressed in terms of both an abolition of obstacles and a prohibition on discrimination on grounds of nationality.¹¹⁰ These two aspects mirror two angles from which one can assess the internal market. On the one hand, the internal market calls for the free movement of the factors of production between national markets. Consequently, EU law prohibits measures that render it more difficult for foreign products, services or persons to access the markets of the other Member States. On the other hand, it can be necessary to guarantee the removal of barriers within the national market of a given Member State. In this case, the prohibition of discrimination on grounds of nationality is involved.

All of the fundamental freedoms are considered to represent an application of the prohibition of discrimination and the prohibition of non-discriminatory restrictions, despite the fact that the wording of the provisions outlining them differs. For example, Article 45(2) TFEU provides for the abolition of discrimination. The text of Article 45 does not mention obstacles or restrictions to the free movement of workers. The Court brought non-discriminatory obstacles within Article 45 for the first time in the *Bosman* case.¹¹¹ On the other hand, Article 49(1) TFEU provides that restrictions on the freedom of establishment are prohibited. The principle of equal treatment can be traced, however, in Article 49(2). This states that the right of

¹⁰⁹ Article 65 TFEU states that Article 63 TFEU shall be without prejudice to the right of Member States to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security

¹¹⁰ These two principles are subject to a thorough investigation in Chapter 3.

¹¹¹ Case C-415/93 *Union royale belge des sociétés de football association ASBL v Jean-Marc Bosman, Royal club liégeois SA v Jean-Marc Bosman and others and Union des associations européennes de football (UEFA) v Jean-Marc Bosman* [1995] ECR I-4921.

establishment is conferred on nationals of other Member States ‘under the conditions laid down for its own nationals by the law of the country where the establishment is effected’. Unlike Article 45 TFEU, Article 49 TFEU uses the term ‘restrictions’ as well as indicating the principle of non-discrimination. Similar wording focusing on the prohibition of restriction can be found in Articles 56 and 63 TFEU.

Despite the ambiguous wording of the provisions with respect to specific freedoms, it can be asserted that the term ‘restriction’ constitutes an umbrella concept that encompasses both the prohibition of discriminatory measures and also the prohibition of non-discriminatory restrictions.¹¹² An important conclusion can be drawn from the ECJ’s presumption that the fundamental freedoms comprise both the principle of non-discrimination and a prohibition on creating non-discriminatory obstacles: potentially, the protection granted under the provisions on free movement has an extensive reach. It may require considerable adjustments in national rules to secure compliance with EU law. When this understanding of the free movement principles is transposed to the non-harmonised sphere of direct taxes, a conflict of interests becomes highly possible. Nevertheless, the fundamental freedoms do not have an absolute character and do not always take priority. Even when a violation of a fundamental freedom is established by the ECJ, it may be justified on the ground of explicit exceptions provided for in the Treaty or on the basis of public interest developed by the Court (the rule of reason doctrine).

Finally, it is worth asking which freedom has the greatest significance, in empirical terms, in the field of direct taxation. In the direct tax case law, one can find examples of cases decided on grounds of each of the four freedoms. Nevertheless, a quick scan of these judgments leads to a conclusion that rights regarding the free movement of workers and the freedom of establishment are by far the most widely

¹¹² See Opinion of AG Kokott in Case C-222/07 *Unión de Televisiones Comerciales Asociadas* [2009] ECR I-1407, paragraph 77 and M Dahlberg, *Direct Taxation in Relation to the Freedom of Establishment and the Free Movement of Capital*, (The Hague: Kluwer, 2005), p. 68. Dahlberg referred to the notion of restrictions in a wide sense to include discrimination and non-discriminatory restrictions. Cordewener, on the other hand, uses the term ‘restriction’ as synonymous with a neutral notion of an obstacle. Each individual freedom prohibits obstacles covering both a non-discrimination and a non-restriction component (restriction in a closer sense). See: A Cordewener, ‘The Prohibitions of Discrimination and Restriction within the Framework of the Fully Integrated Internal Market’, in F Vanistendael (ed.), *EU Freedoms and Taxation: EATLP Congress, Paris 3-5 June 2004*, (Amsterdam: IBFD, 2006), 1-46 at 9.

invoked legal bases in disputes.¹¹³ Thus, these freedoms shaped national direct tax systems.¹¹⁴ The free movement of capital was a later starter but recently this freedom has started to be raised more widely in direct tax cases. In 2005, Dahlberg stated that there were relatively few cases on the free movement of capital.¹¹⁵ However, in 2009, a total of 19 direct tax judgments were delivered and 12 of those were decided in relation to the free movement of capital.¹¹⁶

In summary, this section presented provisions on the fundamental freedoms significant to the sphere of corporate taxation. These provisions limit the freedom of the Member States because the fundamental freedoms must be respected even whilst exercising taxation rights.¹¹⁷ Both discriminatory and restrictive tax measures are prohibited in the internal market. To date, in an overwhelming majority of cases, the ECJ has declared elements of national tax systems to be incompliant with EU law on the fundamental freedoms. The outcome of the ECJ's work is extensive and influential, in contrast to the underdeveloped legislative harmonisation framework. In pursuing its judicial review of national direct tax rules, the ECJ has become the key legal force behind European tax integration. Chapter 3 returns to this point and thoroughly analyses the scope of the influence of direct tax case law.

¹¹³ The same conclusion in: B J M Terra and P J Wattel, *European Tax Law*, (The Alphen aan den Rijn: Kluwer, 2008), p. 20

¹¹⁴ For example, these freedoms played an important part in re-defining universally accepted distinctions between residents and non-residents, as well as domestic and foreign-source income, for the purposes of EU law.

¹¹⁵ M Dahlberg, note 112 above, at 275.

¹¹⁶ For instance, Case C-182/08 *Glaxo Wellcome GmbH & Co. KG v Finanzamt München II* [2009] ECR I-8591; Case C-67/08 *Margarete Block v Finanzamt Kaufbeuren* [2009] ECR I-883; Case C-35/08 *Grundstücksgemeinschaft Busley/Cibrian v Finanzamt Stuttgart-Körperschaften* [2009] ECR I-9807.

¹¹⁷ This classic statement of the Court has been reiterated regularly over years. See for example: Case C-279/93 *Schumacker*, note 59 above, paragraph 21; Case C-446/03 *Marks & Spencer*, note 70 above, paragraph 29; Case C-196/04 *Cadbury Schweppes*, note 70 above, paragraph 40; Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I-11673, paragraph 36 and Case C-379/05 *Amurta* [2007] ECR I-9569, paragraph 16.

1.5. Soft law and corporate tax regulation in the EU

1.5.1. The concept of soft law

Before soft law spurred interest among academics exploring EU integration, it had been widely discussed by international law scholars.¹¹⁸ The term soft law,¹¹⁹ which causes heated debates,¹²⁰ is said to have been coined by Lord McNair.¹²¹ It has become widespread and has caused controversies in the international setting since the 1970s.¹²²

According to Mörth, soft law is associated with governance.¹²³ The term governance is typically used in two different ways. First, it is applied in a broad sense to encompass every mode of political steering, including the traditional modes of hierarchical steering within the setting of a government.¹²⁴ Second, governance can be used in a more restrictive sense, referring only to types of political steering in which non-hierarchical modes of guidance are employed. Thus, governance is a

¹¹⁸ There is a vast body of literature on international soft law. See, for example: R R Baxter, 'International Law in "Her Infinite Variety"', (1980) 29:4 *International and Comparative Law Quarterly* 549-566; P Weil, 'Towards Relative Normativity in International Law?', (1983) 77:3 *American Journal of International Law* 413-442; T Gruchalla-Wesierski, 'A Framework for Understanding "Soft Law"', (1984) 30:1 *McGill Law Journal* 37-88; C M Chinkin, 'The Challenge of Soft Law: Development and Change in International Law', (1989) 38:4 *International and Comparative Law Quarterly* 850-866; C Lipson, 'Why are Some International Agreements Informal?', (1991) 45:4 *International Organization* 495-538; J Klabbers, 'The Redundancy of Soft Law', (1996) 65:2 *Nordic Journal of International Law* 167-182; J Klabbers, 'The Undesirability of Soft Law', (1998) 67:4 *Nordic Journal of International Law* 381-391; A E Boyle, 'Some Reflections on the Relationship of Treaties and Soft Law', (1999) 48:4 *International and Comparative Law Quarterly* 901-913; D Shelton (ed.), *Commitment and Compliance: the Role of Non-binding Norms in the International Legal System*, (Oxford: Oxford University Press, 2000).

¹¹⁹ Soft law is occasionally called 'weak law'. See: R R Baxter, note 118 above, at 550; P Weil, note 118 above, at 414.

¹²⁰ The term soft law is highly criticised because it is claimed that it is a contradiction in terms. Such a view is supported by scholars who are in favour of a binary concept of law. For example: H Hillelberg, 'A Fresh Look at Soft Law', (1999) 10:3 *European Journal of International Law* 499-515.

¹²¹ A J P Tammes, 'Soft Law', in M Bos (ed.), *Essays on International and Comparative Law in Honour of Judge Erades Presented by the Board of the Netherlands International Law Review*, (The Hague: Martinus Nijhoff Publishers, 1983), 187-195 at 187; J Sztucki, 'Reflections on International "Soft Law"', in J Ramberg, O Bring, and S Mahmoudi (eds.), *Festkrift till Lars Hjerner: Studies in International Law*, (Stockholm: Norstedts, 1990), 549-575 at 554.

¹²² J Sztucki, note 121 above, at 554.

¹²³ U Mörth, note 77 above, at ix.

¹²⁴ The words government and governance share the same etymological roots. The more encompassing understanding of governance is expressed in O Treib, H Bähr and G Falkner, *Modes of Governance: a Note Towards Conceptual Clarification*, European Governance Papers Eurgov No. N-05-02, p. 6, available at <http://www.connex-network.org/eurogov/pdf/egp-newgov-N-05-02.pdf>.

counter-concept to government.¹²⁵ This latter, limited meaning of governance is the one applicable throughout the thesis. Governance summarises ‘new’ styles of governing¹²⁶ and places less emphasis on legally embedded institutions that produce enforceable decisions. Its nature is inclusive and participatory because governance relies on the engagement of public and private, legal and non-legal actors in the process of decision-making. Governance is about the inclusion of all relevant stakeholders - citizens, groups and public authorities - in deciding on pursued policies. The methods of achieving a satisfactory result in managing communities are not prescribed by law.

Despite fundamental questions that the issue of soft law stimulates, such as questions of power, legitimacy and democracy, there is no agreement among scholars about the significance and regulatory potential of the soft law phenomenon. Soft law is disputed and criticised for its misleading character.¹²⁷ In essence, it is associated with norms of behaviour that do not create legal obligations. Hence, these norms do not have a legally binding force on the addressees of the norms. The opponents of the soft law concept reason that if norms do not produce any legal obligations, then such norms cannot be called *law*. That understanding of law is reflected in a binary vision of law: there is either law or politics and there are no grey areas in between that could be compared to hard law.¹²⁸ If non-legally binding measures are called soft law, there is a risk of blurring the division of what might or might not be binding.

¹²⁵ Such an understanding of governance is used by S Smismans, *New Modes of Governance and the Participatory Myth*, European Governance Papers No. N-06-01, available at <http://www.connex-network.org/eurogov/pdf/egp-newgov-N-06-01.pdf>, B Eberlein and D Kerwer, ‘New Governance in the European Union: a Theoretical Perspective’, (2004) 42:1 *Journal of Common Market Studies* 121-142.

¹²⁶ See Chapter 1, section 1.5.3. for a discussion on new governance in the context of the EU.

¹²⁷ See: K Zemanek, ‘Is the Term “Soft Law” Convenient?’, in G Hafner, G Loibl, A Rest, L Sucharipa-Behrmann and K Zemanek (eds.), *Liber Amicorum: Professor Ignaz Seidl-Hohenveldern in Honour of his 80th Birthday*. 1998, (The Hague, London, Boston: Kluwer, 1998), 843-862. Zemanek calls for a subtle differentiation. He states that if non-binding rules have merely a subsidiary function to hard law, then such norms should not be named soft law. Soft law is a relevant term only when its norms will lead to hard law measures.

¹²⁸ Among distinguished critics of the concept of soft law are Klabbbers and Weil. Weil warns that soft law is a pathological phenomenon of international normativity. P Weil, note 118 above, at 416. For arguments against soft law see also: J Klabbbers (1998), note 118 above, at 381-391; J Klabbbers (1996), note 118 above, at 167-182.

Additionally, it is worth mentioning that soft law is not the only term used to depict the phenomenon of the increasing application of non-legally binding devices. In legal writing, uncomfortable with naming regulation without legal effects as soft *law*, notions such as ‘informal instruments’¹²⁹ or ‘quasi-legislation’¹³⁰ have been applied.

It is interesting to note a shift in the approach to soft law presented by Klabbbers. Initially, his criticism of soft law was moderate. He merely claimed that it was redundant. In his view, hard law had the capacity to fulfil all functions that were usually assigned to soft law.¹³¹ Hard law ‘can accommodate various shades of grey without losing its binary character’.¹³² In effect, soft law served no identifiable purpose. A few years later, Klabbbers modified his position towards a more radical stance.¹³³ He asserted that soft law was not only redundant but it was generally undesirable because soft law had the potential to undermine entire legal systems by endangering the rule of law. This is because even non-legally binding norms have the potential to influence behaviour and fulfil functions traditionally assigned to law, namely the regulation of behaviour.

Undoubtedly, soft law has been a challenge as far as traditional sources of law and structures of law-making were concerned. It provides for greater diversity and a wider scope of choices in regulation. However, soft law plays an important role in developing law, in general. Its evolution might be an indication that there is a need for a change in the theory of law. Some argue that law does not have to be understood in a solely positivist sense. Soft law is best perceived as a point on the continuum running between fully binding hard norms and politics. In effect, soft law is also law and cannot be deprived of this quality because a failure to observe soft law does not constitute a breach of legal obligation. In other words, soft law is not

¹²⁹ A Aust, ‘The Theory and Practice of Informal International Instruments’, (1986) 35:4 *International and Comparative Law Quarterly* 787-812 at 787.

¹³⁰ G Ganz, *Quasi-legislation: Recent Developments in Secondary Legislation*, (London: Sweet&Maxwell, 1987). Ganz takes as a subject of investigation quasi-legal norms in the national setting.

¹³¹ Essentially, these functions are gap-filling by serving as an interpretive guide.

¹³² J Klabbbers (1996), note 118 above, at 181.

¹³³ J Klabbbers (1998), note 118 above.

legally irrelevant because it can bring results in practice.¹³⁴ It has to be clarified also that soft law cannot be described as ‘unsanctioned’.¹³⁵ Some authors speak of soft responsibility or soft liability as a counterpart of soft law.¹³⁶ Although soft law does not create legal obligations, it is not a phenomenon that governments necessarily ignore and that would not impose extra-legal pressures, due to the fact that soft law instruments may incorporate compliance procedures.

There are many channels through which soft law measures can exert influence and affect and change behaviour despite the absence of a legally-binding nature. Trubek, Cottrell and Nance¹³⁷ describe how soft law can influence behaviour. First, naming and shaming can deter states from non-compliance with a soft law measure. States are induced to follow soft law measure in order to avoid criticism and being pointed out as non-compliant. In this context, a reputation mechanism plays a part. Reputation cost is taken into consideration when deciding on whether to comply with the soft law instrument or not.

Second, discourse and debates can lead to the development among states of a common approach to a problem. The development of a common vocabulary can help soft law regulation to become influential. Third, networking facilitates the process of learning among states. Fourth, when a proposal of behaviour laid down by the relevant institutions in the form of a soft law measure forms a coherent policy model, states are encouraged to copy this behaviour in practice. Consequently, they are assessed against this standard. Fifth, exchange of policy knowledge and deliberation allows actors to learn about each other’s governing systems and thus promotes a common identity through this interaction. A long-term exchange of information on practices may lead to decentralised learning networks. Consequently, despite being

¹³⁴ A E Boyle, note 118 above, at 901-913; F Beveridge and S Nott, ‘A Hard Look at Soft Law’, in P Craig and C Harlow (eds.), *Lawmaking in the European Union*, (London: Kluwer, 1998), 285-309 at 291; F. Snyder, ‘Soft Law and Institutional Practice in the European Community’, in S Martin (ed.), *The Construction of Europe: Essays in Honour of Emile Noël*, (Dordrecht: Kluwer, 1994), 197-225 at 198.

¹³⁵ A J P Tammes, note 121 above, at 195.

¹³⁶ *Ibid.*, at 189; J Sztucki, note 121 above, at 569.

¹³⁷ D Trubek, P Cottrell and M Nance, ‘Soft Law, Hard Law and EU Integration’, in G De Búrca and J Scott (eds.), *Law and New Governance in the EU and the US*, (Oxford: Hart Publishing, 2006) 65-94 at 78-79.

of a non-legally binding nature, soft law can affect behaviour and may result in changes being introduced through legislative measures in the future.

As a result of the lack of common agreement as to whether or not one should acknowledge soft law as a regulatory device that is different from both hard law and politics, it becomes difficult to find a definition of soft law that reflects its complexities. At times, soft law is compared to a shadow area existing between politics and law.¹³⁸ Some scholars have attempted to introduce a definition of soft law by differentiating between ‘legal soft law’ and ‘non-legal soft law’.¹³⁹ Legal soft law is considered to mean treaties (generally a hard law measure) which include flexibility in scope and imprecise norms, alongside legally binding norms. Non-legal soft law encompasses non-binding, voluntary resolutions or codes of conduct. Soft law instruments in this sense are a consequence of the intention of parties to limit the power to bind states. Such a differentiation between legal and non-legal soft law places an emphasis on the importance of the content of regulatory measures largely disregarding their form. In effect, the legal character of a treaty is uncertain. It can be classed both as a hard law measure and as legal soft law, depending on the nature of its provisions. This dualism in the legal nature of a regulatory measure is undesirable.

Gruchalla-Wesierski also proposes a confusing definition of soft law. He states that soft law *sensu largo* encompasses both legal and non-legal norms. But such a definition is unclear because it does not assist in distinguishing between soft law and hard law.¹⁴⁰ For the purpose of this thesis, this broad understanding of soft law does not add value. Soft law in this thesis does not mean both legal and non-legal norms. A clear division is required.

In this thesis, the classic definition of soft law constructed by Snyder is adopted. Snyder defines soft law as ‘rules of conduct, which, in principle, have no legally binding force but which nevertheless may have practical effects.’¹⁴¹ There are three elements of the soft law phenomenon captured by this definition. The first aspect is

¹³⁸ L Senden, *Soft Law in European Community Law*, (Oxford: Hart Publishing, 2004), p.19.

¹³⁹ C M Chinkin, note 118 above, at 851. See: J Sztucki, note 121 above, at 552. Sztucki also remarks that the division between these two types of soft law measures is not unproblematic to carry out.

¹⁴⁰ T Gruchalla-Wesierski, note 118 above, at 44.

¹⁴¹ F Snyder, note 134 above, at 198.

related to the fact that one can only speak of a soft law instrument when this measure invites addressees to adopt certain ways of behaviour or conduct. Thus, purely political statements or measures merely providing information do not fall within the scope of soft law.¹⁴² The second aspect concerns the lack of legally binding force of such instruments. Third, however, these measures are not devoid of all legal effect. Actually, they may lead to some practical results by influencing behaviour.

1.5.2. Hard law-soft law relationships

Soft law and hard law interact in many ways. Soft law and hard law measures can be classified as 'alternatives' to each other. They can also be rival to each other. The coexistence of hard and soft laws can also be described as complementary. Finally, the interaction of soft and hard laws can take a very close form and lead to a merger or a hybrid construction.¹⁴³ These issues shall now be unpacked in more detail.

The attributes and deficiencies of soft and hard laws as *alternatives* is widely recognised in the literature.¹⁴⁴ Without denying the regulatory value of both hard law and soft law instruments, it is admitted that hard and soft are simply different. They respond to different regulatory needs and thus offset each other's shortcomings. In other words, soft law offers answers to problems created by hard law regulation and hard law instruments prevent problems that soft law could create.

When hard law and soft law are perceived as alternatives, offering different advantages for different contexts, neither regulatory approach appears superior or more preferable than the other. Hard law and soft law are alternatives that call for pragmatism in choosing which instrument, hard or soft, should be applied. Depending on the character of the problem to be tackled, different measures might be more desirable. In this setting, soft and hard laws operate on their own terms.

¹⁴² In practice, it might be controversial to delimit what the purpose of a regulatory measure is and whether the goal that the measure seeks to achieve is merely political or attempts to influence behaviour.

¹⁴³ This classification of soft law-hard law interactions is based on D M Trubek and L G Trubek, 'New Governance and Legal Regulation: Complementarity, Rivalry, and Transformation', (2007) 13:3 *Columbia Journal of European Law* 539-594; G C Shaffer and M A Pollack, *Hard vs. Soft Law: Alternatives, Complements and Antagonists in International Governance*, University of Minnesota, Law School Legal Studies Research Paper Series, Research Paper No. 09-23, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1426123.

¹⁴⁴ L Senden, note 138 above, at 117.

With regard to the different strengths of hard law and soft law, it is first claimed that soft law is capable of incorporating greater tolerance for diversity among states. This can be observed in the context of the EU where the Member States are highly diverse and the need to preserve differences is voiced. Hard law generally proposes uniform solutions and in some cases, as with direct taxation, reaching a compromise among the Member States towards adopting uniform solutions might not be politically possible. In such cases, soft law presents itself as a solution to the potential deadlock on the road to integration. In addition, soft law allows for greater flexibility, enabling the adaptation of regulatory measures to changing circumstances more easily. Regulation through soft law seems to require less time to conclude. Hard law, on the other hand, is associated with time-consuming processes of agreeing over proposed regulation. Second, it is also claimed that soft law presents more democratic solutions because the process of developing soft law instruments is founded on the participation of many stakeholders. Thus, soft law is believed to enhance the legitimacy of the EU.¹⁴⁵ The activity of the EU might become more acceptable to its citizens because their influence and control over regulatory processes are increased.

However, soft law is not always presented as an ideal concept. It is criticised for the fact that it can challenge the rule of law and change the traditional conception of the legal framework created in the EU.¹⁴⁶ In the context of the EU, soft law might raise concerns about the division of competences. It is claimed that soft law might be misused and utilised to introduce legislation through the back door.¹⁴⁷ This appears to be a real danger where soft law is treated as the introduction of hard law solutions in disguise when the Member States are reluctant to cede their powers through traditional hard law means. In this sense, soft law measures might aim at the

¹⁴⁵ For a different view on the legitimacy argument, see: S Smismans, note 125 above, at 19. Smismans attempts to challenge the normative claim that new governance entails more democratic results due to the fact that it is characterised by heterarchy and pluralism of actors involved in a decision making process. He draws upon the example of the Community occupational health and safety policy.

¹⁴⁶ In this context, however, it is interesting to note the proposal of Dawson. He claims that the possible conflict between soft law and the rule of law might necessitate a search for a reflexive, more dynamic rule of law in the contemporary EU. See: M Dawson, *Soft Law and the Rule of Law in the European Union: Revision or Redundancy?* EUI Working Papers 2009/24, available at http://cadmus.eui.eu/bitstream/handle/1814/11416/RSCAS%202009_24.pdf;jsessionid=08A345AD248BCFE21484B89C2C131E11?sequence=1.

¹⁴⁷ A J Martín Jiménez, *Towards Corporate Tax Harmonization in the European Community: an Institutional and Procedural Analysis*, (London, The Hague and Boston: Kluwer, 1999), p.302, 309.

imposition of legal obligations. The increasing significance and more common application of soft law measures question the established understanding of EU law developed in the Treaties and by the ECJ in the landmark decisions discussed earlier. Where the EU has legislative competence, the way to act is through the adoption of legislation. It is only by adopting legislation through the proper institutional procedures that legal certainty and respect for the fundamental principles of law may be secured. By introducing new and difficult to define soft measures, it is a challenge to pinpoint what EU law encompasses and the values of legal certainty are compromised.

Finally, it is also said that soft law might distort the institutional balance by circumventing certain institutions in the decision making process.¹⁴⁸ This negative opinion about soft law, which undermines proper institutional procedures fostering the rule of law, stems mainly from the Parliament.¹⁴⁹ As there are no procedures for consulting Parliament on proposed soft law instruments, the institutional balance may be disturbed.

An extreme case of the alternative relationship between hard and soft law occurs when soft law and legally binding measures are potential *antagonists*. In this relationship, both systems compete for dominance. The rivalry between systems can stem from developing both hard and soft law as equally valid roads to integration within one regulatory sphere or when soft law is applied as a preferred solution; however, old, hard law measures are still in place.

So far, the concepts of hard law and soft law were explored as alternative ideas. However, their *coexistence and engagement* must also be acknowledged. Hard law and soft law can be *complementary* to each other. This is achieved when these two regulatory approaches operate within the same regulatory area and build on each

¹⁴⁸ L. Senden, 'Soft Law and its Implications for Institutional Balance in the EC', (2005) 1:2 *Utrecht Law Review* 87-92.

¹⁴⁹ European Parliament Report of 28 June 2007 on institutional and legal implications of the use of "soft law" instruments, Rapporteur: Manuel Medina Ortega, A6-0259/2007, available at <http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A6-2007-0259&language=EN>.

other with a view to achieving the same goals.¹⁵⁰ Hard and soft law can be complementary either when soft law leads to the adoption of legally binding measures or where hard law is developed through soft law measures. The first example refers to a situation when a soft law measure is adopted first and the adoption of a hard law instrument follows as a result of the ground being prepared by the soft law measure. Thus, soft regulation provided the Member States with time for the political will to harmonise national rules to mature. The second situation occurs when soft and hard law measures exist at the same time. Soft law instruments might be produced in order to explain the meaning of the hard law means and to clarify the goals it attains.

The most thought-provoking interplay that can occur is when these two regulatory processes become a *hybrid* structure. The notion of hybridity in relation to interactions of soft law and hard law can have two meanings. De Búrca and Scott¹⁵¹ invoke a concept of hybridity *sensu largo*. It encompasses complementarity and the transformations of both soft and hard law systems. Trubek and Trubek¹⁵², on the other hand, understand hybridity in a narrower fashion. They relate it only to transformations, to mergers of two regulatory systems. Complementarity represents another way of describing these narrower soft law-hard law interactions. In general, hybridity suggests a more intense relationship than in other cases of hard-soft law interplay. It implies that our understanding of law has to alter. Soft law and hard law fuse together and a distinction between what is legally binding and what is not becomes a secondary issue. The regulatory system is developed to the point where soft law elements cannot exist without hard law regulation and vice versa. According to Trubek, Cottrell and Nance, two policy domains can be described as hybrid structures. These are the employment policy and fiscal policy.¹⁵³

¹⁵⁰ EU attempts to deal with discrimination against women in the workplace are pointed out as an example of a regulatory field where soft law and hard law act in a complementary manner. See: D M Trubek and L G Trubek, note 143 above, at 544.

¹⁵¹ G De Búrca and J Scott, 'Introduction: New Governance, Law and Constitutionalism', in G De Búrca and J Scott (eds.), *Law and New Governance in the EU and the USA*, (Oxford: Hart Publishing, 2006), 1-12 at 6.

¹⁵² D M Trubek and L G Trubek, note 143 above.

¹⁵³ D Trubek, P Cottrell and M Nance, note 137 above, at 65-94.

At the outset of the thesis, it is submitted that existing EU corporate tax regulation resembles a hybrid of interacting soft and hard law measures, reflecting the definition of that term proposed by de Búrca and Scott. The nature of this hybrid is examined in the substantive chapters of the thesis. Chapter 6 returns to the idea of a direct tax hybrid to offer recommendations regarding its improvement and future potential.

1.5.3. New modes of governance in the European Union

As outlined in section 1.5.1., in recent years, the concept of governance has spread over numerous disciplines. It became important to the EU, where one can observe a shift in the paradigm of European governance. A distinction between old governance and new governance naturally developed. Section 1.4. presented the significance of hard law to the process of European integration. It became apparent that integration through hard law played a crucial role in the success of the early years of building the European Community. Old governance in the EU is therefore associated with governing through law. New governance, on the other hand, can mean governing without law. Such a conceptualisation is more precise than governing without a government as the EU does not have a government.

This section places the phenomenon of new governance in the EU at the heart of the discussion, exploring its origins and, subsequently, some distinctive forms of new governance. Soft law is one of the practical manifestations of the new governance. It has to be emphasised that the old forms of governance do not disappear when new governance emerges. It is not implied either that ‘new’ governance forms were not in existence before. What seems new in certain policy areas may have been widespread in other regulatory fields. Therefore, when one speaks about ‘new’ governance in the EU, one refers to the general shift towards less prescriptive and less uniformity-focused approaches in regulating certain areas without assuming that ‘new’ forms eradicate the ‘old’ ways of governing or that the ‘new’ measures have just been discovered. In temporal terms, these ‘new’ regulatory measures are not actually new. Rather, these non-traditional measures and ways of governing started to attract more

attention and comment when the process of European integration turned to seeking more flexibility and differentiation.¹⁵⁴

1.5.3.1. *The emergence of new governance in the EU*

Particularly over the last 20 years, the nature of the instruments used to achieve the goals of the EU has altered because of the changing requirements of European integration. The proliferation of soft law regulatory devices occurred within a broader context of developments that were not without consequences for decision-making and the process of establishing legislation. It is a huge simplification to summarise the development of solutions for governing in the EU in just a few paragraphs; nonetheless, it is sufficient for the purpose of this chapter, which does not seek to provide a comprehensive history of EU governance. It highlights the most significant aspects of developing governance to create the background for a debate on soft and hard law.

The growth of the new modes of governance can be attributed to accommodating the changing needs of the EU and limitations of existing mechanisms of law-making. One of the key developments that contributed to governance modifications was the erosion of the Community Method.¹⁵⁵ This regulatory approach became incapable of responding to all EU needs because of the changing circumstances of the integration process. The substantive scope of EU action and its regulatory interest expanded beyond market integration. More sensitive issues, such as social and environmental policy, also became of interest to the EU. In other words, the magnitude of the tasks that the EU started to face increased. These non-economic goals called for a solution beyond the Community Method. As these policy fields were sensitive, the Member States would not cede their competence even though they shared common concerns. However, the lack of competence was not the only barrier to introducing hard law in

¹⁵⁴ See G De Búrca and J Scott, note 151 above, at 2, L Senden, note 148 above, at 1. In this context, Colin Scott constructs a notion of ‘new-ish governance’. Consequently, he underlines the fact that alternative, ‘new’ modes of governance are not in fact so new in temporal terms. They have always been present in the EU context; however, only recently have they become more commonly used. Their significance is growing. See: C Scott, ‘Governing without Law or Governing without Government? ‘New-ish Governance and the Legitimacy of the EU’, (2009) 15:2 *European Law Journal* 160-173 at 161.

¹⁵⁵ G Majone, *Dilemmas of European Integration*, (Oxford: Oxford University Press, 2005), p. 51.

certain policy fields. Preserving a degree of diversity added to the complexity of the situation. Hard law was not capable of securing national diversity.

The uniformity of solutions promoted by hard law can be difficult to maintain in the ever-growing EU with an increasing number of Member States. Not only has the number of the Member States risen to 27 but also the diversity of supported interests among the Member States has expanded. Consequently, it may be problematic for the EU to reach unanimous agreements on legally-binding regulation catering for diversified national interests. The 2004 and 2007 enlargements turned the EU into a much varied area as far as corporate tax regimes are concerned. Generally, the old EU supported higher taxation, opting for more advanced social support. On the other hand, the newer Member States can be broadly characterised by lower taxation and participation in tax competition. The task of adopting a legally binding solution recognising a wide range of tax priorities becomes all the more challenging under the principle of unanimity. The soft approach responded to this issue.

New governance is also perceived as a partial attempt to address the problem of the EU's democratic deficit. The EU has been perceived as lacking in democracy and has seemed inaccessible to the ordinary citizen because its methods of operating are complex. It is claimed that new governance might be a partial solution to this deficit. Since it is expected to secure more legitimacy for EU policy making through greater deliberation and the alleged participation of various actors in the process of decision-making, the democratic deficit of the EU is potentially to be reduced.¹⁵⁶

European debates about new governance reached their apogee when the White Paper on European Governance was published in 2001.¹⁵⁷ In this document, the Commission attempted to address the question of the EU's ability to be closer to European citizens, to produce more effective legislation and to reinforce democracy in the Union. For the first time, the issue of governance was discussed in the EU in a systematic way. The White Paper refers to various existing forms of governance. It acknowledges the need to promote greater use of different policy tools because

¹⁵⁶ J Scott and D M Trubek, note 81 above, at 8.

¹⁵⁷ *European Governance*, note 82 above.

diversity in modes of governance is regarded as a necessary element in securing the effectiveness, legitimacy and transparency of EU action.¹⁵⁸ Under the White Paper, legislation is often perceived to be only part of a broader solution. Thus, it is essential to combine formal rules with non-binding tools such as recommendations, guidelines. This highlights the need for close coherence between the use of different policy instruments and for more thought to be given to their selection.¹⁵⁹ The use of regulations, framework directives, co-regulation and the open method of coordination is promoted.¹⁶⁰ The use of the open method of coordination must not dilute the achievement of common objectives in the Treaty or the political responsibility of the institutions. It should not be used when legislative action under the Community Method is possible.¹⁶¹ Yet, the White Paper claims also that there is a need for reinvigoration of the Community Method. The Community Method has served the Union well for almost half a century. It can continue to do so, but it must be brought up to date.¹⁶²

Arguably, various modes of governing may be required to achieve different results. The White Paper does not opt for use of any one of the regulatory methods in the EU but appears to favour a mixed approach. Both new governance mechanisms and the Community Method have their particular strengths. These issues were touched upon in section 1.5.2., presenting potential relationships between hard law and soft law. The soft law approach secures flexibility and diversity of proposed solutions. Hard law, on the other hand, does not carry these values though it is enforceable and does not rely on voluntary obedience. In some situations, a legally-binding element may be necessary for a regulatory measure to operate.

¹⁵⁸ A similar opinion is expressed in the Commission Staff Working Document *Instruments for a modernised single market policy*, accompanying Document to the Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: *A Single Market for the 21st Century Europe*, SEC(2007) 1518. It considers non-binding measures to be an alternative or a complement to legislation in order to build a more responsive and inclusive market.

¹⁵⁹ *European Governance*, note 82 above.

¹⁶⁰ *Ibid.*, at 21-23.

¹⁶¹ *Ibid.*, at 22.

¹⁶² *Ibid.*, at 34.

1.5.3.2. Examples of the new approach

New governance is multifaceted and its presence can be detected in a number of forms within the EU. This section demonstrates that the new regulatory approach can stretch from being a modest modification of the traditional approach to a method of regulation that departs dramatically from the Community Method.

The first indications of a modified regulatory approach took place in the 1980s when minimum harmonisation was proposed. The time consuming process of adopting detailed directives was replaced with the process of adopting directives which set minimum standards. The process of issuing directives prescribing all aspects of a certain matter had resulted in a crisis of Community legislation. Criticism of European legislation was grounded on two premises. First, legislation was held to be excessive in quantity. Second, its quality was also questioned.¹⁶³

A partial solution to the eroding Community Method, the stagnation of European integration and the call for increased flexibility and diversity of regulatory solutions was expected through the enhanced cooperation mechanism.¹⁶⁴ The aim of greater flexibility was officially incorporated by the Treaty of Amsterdam in 1997. The enhanced cooperation procedure is based on greater flexibility in the process of integration. It allows those Member States that wish to continue to work more closely together to do so, whilst respecting the single institutional framework of the Union. The Member States could thus move forward at different speeds and/or towards different goals. However, enhanced cooperation does not allow for the extension of powers as laid down by the Treaties. Moreover, it may be undertaken only as a last resort, when it is established within the Council that the objectives of such cooperation cannot be attained within a reasonable period by applying the relevant provisions of the Treaties.

Enhanced cooperation represents one of the many faces of new EU governance. Although the development of enhanced cooperation is a move in the direction of new governance, the enhanced cooperation mechanism is not an example of the *pure* new

¹⁶³ L Senden, note 138 above, at 9-13.

¹⁶⁴ Currently incorporated in Title IV of the TEU.

approach to governing. Whilst advocating greater flexibility of regulation, enhanced cooperation does not cut ties with hard law. Enhanced cooperation can operate in the realm of legally binding instruments, for example, when this mechanism is adopted in the context of a directive or a regulation.¹⁶⁵ In relation to tax policy, it is worth noting that the enhanced cooperation procedure is seen as an option in implementing the Common Consolidated Corporate Tax Base (CCCTB).¹⁶⁶

The purest soft, non-binding methods of regulation are exemplified in the open method of coordination. They have been widely used in certain regulatory spheres in the EU and have attracted a number of empirical case studies.¹⁶⁷ The open method of coordination (hereinafter the OMC)¹⁶⁸ was introduced to the EU during the Lisbon Summit in 2000. This form of cooperation is characterised by specific elements. First, the OMC refers to fixing guidelines for the EU combined with specific timetables for achieving goals. Second, it establishes quantitative and qualitative indicators and benchmarks against which national practices are assessed. Third, the European guidelines are translated into national and regional policies by establishing specific targets and adopting measures which recognise national and regional differences. Fourth, the OMC entails periodic monitoring, evaluation and peer review

¹⁶⁵ See Chapter 2, section 2.3.2. for more information about enhanced cooperation and measures adopted in this context.

¹⁶⁶ The idea for the CCCTB was incorporated into a Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee *Towards an Internal Market without Tax Obstacles: a Strategy for Providing Companies with a Consolidated Corporate Tax Case for their EU-wide Activities*, COM (2001) 582 final. See further Chapter 2, section 2.3.

¹⁶⁷ With regard to employment policy, see, for instance: C Kilpatrick, 'New EU Employment Governance and Constitutionalism', in G De Búrca and J Scott (eds.), note 151 above, at 121-153; J S Mosher and D M Trubek, 'Alternative Approaches to Governance in the EU: EU Social Policy and the European Employment Strategy', (2003) 41:1 *Journal of Common Market Studies* 63-88. In the context of State aid policy, see: M Cini, 'The Soft Law Approach: Commission Rule-Making in the EU's State Aid Regime', (2001) 8:2 *Journal of European Public Policy* 192-207; M Aldestam, 'Soft Law and the State Aid Policy Area' in U Mörth, note 77 above, p. 11-37.

¹⁶⁸ Literature on the OMC is well-developed. See for example: G De Búrca and J Zeitlin, *Constitutionalising the Open Method of Coordination: What Should the Convention Propose?*, CEPS Policy Brief No. 31, 2003, available at <http://www.isn.ethz.ch/isn/Digital-Library/Publications/Detail/?ots591=eb06339b-2726-928e-0216-1b3f15392dd8&lng=en&id=26231>; J Zeitlin and P Pochet, *The Open Method of Co-ordination in Action: the European Employment and Social Inclusion*, (Brussels, Bern, Berlin: P.I.E.- Peter Lang, 2005); V Hatzopoulos, 'Why the Open Method of Coordination Is Bad for You: a Letter to the EU', (2007) 13:3 *European Law Journal* 309-342; B P Ter Haar, 'Open Method of Coordination: a New Stepping Stone in the Legal Order of International and European Relations', (2008) 77:3 *Nordic Journal of International Law* 235-251.

leading to mutual learning.¹⁶⁹ Since its launch, the OMC has been used in a broad range of policies, for instance, research and development, healthcare, social inclusion and the information society.¹⁷⁰

One of the manifestations of this new regulatory culture in the EU was also the more prevalent application of soft law measures. Nevertheless, despite the increasing importance of these new regulatory instruments, their significance is not yet fully reflected in the text of the Treaties. Soft regulation is not strongly embedded in the Treaty; however, this is not to say that the Treaty does not allow for a softer approach. The Treaty imposes a restrictive understanding of the idea of soft law. Article 288 TFEU only names recommendations and opinions as measures with no legally binding force. The wording of other provisions of the Treaties and observation of the regulatory practice in the EU imply that many other soft law measures are also in use.¹⁷¹

1.5.4. Classification of soft law measures in the EU

Soft law measures come in an ‘infinite variety’.¹⁷² Apart from recommendations and opinions, listed in Article 288 TFEU as measures with non-binding force, there are other instruments that fall within the scope of the soft law definition. These include resolutions, declarations, decisions of the representatives of the Member States in the Council and guidelines. To bring some order to the debate on the soft law phenomenon, an attempt to classify soft law instruments is desirable. A categorisation proposed by Senden appears to be most relevant in the context of the interplay that occurs between soft and hard law.¹⁷³ The point of departure is the nature and function of soft law instruments.

¹⁶⁹ European Council, Lisbon European Council 23 and 24 March 2000, Presidency Conclusions, paragraph 37, available at http://www.europarl.europa.eu/summits/lis1_en.htm.

¹⁷⁰ B Laffan and C Shaw, *Classifying and Mapping OMC in Different Policy Areas*, 2005, NewGov New Modes of Governance Project 02/D09, available at http://www.eu-newgov.org/database/DELIV/D02D09_Classifying_and_Mapping_OMC.pdf, p. 16; E Szyszczak, ‘Experimental Governance: the Open Method of Coordination’, (2006) 12:4 *European Law Journal* 486-502 at 494.

¹⁷¹ Senden asserts that the Treaty allows for a highly imaginative use of soft law measures. L Senden, note 148 above, at 107. E.g. in practice, instruments such as White Papers or communications are used.

¹⁷² R R Baxter, note 118 above, at 549-566.

¹⁷³ L Senden, note 148 above, at 81-83.

The first group of soft law instruments serves *preparatory and informative* functions. They fulfil a pre-law function because they attempt to prepare the ground for EU law. These soft law measures are adopted in order to spur public debates and consultation or are introduced to pave the way for the future adoption of legislation. Thus, informative or preparatory soft law instruments set out proposals for future legislative action in certain areas. Examples of preparatory and informative measures include White Papers, action programmes and informative communications.¹⁷⁴

Instruments belonging to the second category are of an *interpretative and decisional* nature. Their role is to provide guidance on the understanding and application of EU law. They do not aim at setting new rules because they have a goal of enabling the application of the existing measures. Therefore, it can be argued that such means fulfil a post-law function. The core role of the interpretative measure is to provide a summary and an explanation of the interpretation that should be given to certain EU law provisions. Such instruments are often used by the Commission, which issues communications on, for example, the basis of case law.¹⁷⁵ Decisional instruments, on the other hand, go further than outlining the desirable interpretation of EU law. They indicate how the EU institutions will apply EU law in individual cases where an institution has discretion. Most commonly, decisional instruments take the form of guidelines, codes and frameworks.¹⁷⁶ The Commission is said to use these measures most frequently.¹⁷⁷

¹⁷⁴ For example: *Completing the Internal Market*: White Paper from the Commission to the European Council (Milan, 28-29 June 1985), COM (85) 310 final.

¹⁷⁵ For example, responding to direct tax case law, see: Communication of 19 December 2006 from the Commission to the Council, the European Parliament and the European Economic and Social Committee on *Exit Taxation and the Need for Co-ordination of Member States' Tax Policies*, COM (2006) 825 final; Communication of 10 December 2007 from the Commission to the Council, the European Parliament and the European Economic and Social Committee on the *Application of Anti-abuse Rules in the Area of Direct Taxation* COM (2007) 785 final; Communication of 19 December 2006 from the Commission to the Council, the European Parliament and the European Economic and Social Committee on *Tax Treatment of Losses in Cross-Border Situations* COM (2006) 824 final.

¹⁷⁶ L Senden and S Prechal, 'Differentiation in and through Community Soft Law', in B De Witte, D Harif and E Vos (eds.), *The Many Faces of Differentiation in EU Law*, (Antwerpen, Oxford and New York: Intersentia, 2001), 181-199, at 195.

¹⁷⁷ For instance: Community Guidelines on State aid for Small and Medium-sized Enterprises (SMEs), OJ 1992 C 213/4.

Finally, the third category of soft law measures encompasses soft law *steering* instruments. As they are applied instead of or as an alternative to legislation, they act as para-legal measures. Steering measures are adopted when there is no desire, agreement or need to legislate or the competence to do so is lacking, although some degree of regulation is essential. Thus, the steering instruments provide for rules of conduct that aim at establishing closer cooperation between the Member States. Generally, codes of conduct, recommendations as well as resolutions of the Council, declarations and conclusions fall within the scope of this group of soft law measures.¹⁷⁸

As shown in the next section, the classification of soft law measures can be difficult. The names of regulatory instruments should not determine the category of soft law to which they belong. When assessing the role that a soft law measure plays in the regulatory structure, the environment in which they operate and regulatory developments also have to be taken into consideration.

1.5.5. Soft law in the field of direct taxation

The area of direct taxation in the EU is considerably influenced by soft law means.¹⁷⁹ Three very different groups of soft law regulatory instruments form some of the most important examples of such regulation. First, in 1993, the Commission adopted a non-legally binding measure in the form of a recommendation regarding non-resident workers.¹⁸⁰ It suggested a common system for taxing the income of non-resident workers. The principles of the Recommendation were largely confirmed by the ECJ in the *Schumacker* case.¹⁸¹ The *Schumacker* ruling has been further confirmed in later judgments such as *Gschwind*,¹⁸² *Gerritse*¹⁸³ and *Wallentin*.¹⁸⁴ Due to these developments regarding the 1993 Recommendation, under Senden's classification,

¹⁷⁸ L Senden and S Prechal, note 176 above, at 192.

¹⁷⁹ Chapter 3 outlines soft law related to the direct tax jurisprudence of the ECJ. Chapters 4 and 5 discuss the nature of the Code of Conduct in detail.

¹⁸⁰ 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 1994 L 39/22. In 1980, a proposal for a directive concerning harmonisation of income tax provisions with regards to the free movement of workers in the Community was submitted.

¹⁸¹ Case C-279/93 *Schumacker*, note 59 above.

¹⁸² Case C-391/97 *Frans Gschwind v Finanzamt Aachen-Außenstadt* [1999] ECR I-5451.

¹⁸³ Case C-234/01 *Arnoud Gerritse v Finanzamt Neukölln-Nord* [2003] ECR I-5933.

¹⁸⁴ Case C-169/03 *Florian W. Wallentin v Riksskatteverket* [2004] ECR I-6443.

this measure can be categorised as a preparatory soft law measure. The principles enshrined in the Recommendation were transposed by the ECJ to its jurisprudence. Hence, soft law played a pre-law role. However, this could only be established *ex post*. Had the Court not transposed the Recommendation principles to hard law regulation, the Recommendation could have been grouped as a steering measure

Second, the Code of Conduct for Business Taxation remains the principal measure introduced to limit tax competition among the Member States. The Code, adopted by the Council in 1997, is one of three parts of a tax package, discussed in Chapters 4 and 5. It has the form of a non-binding resolution of the Council and the representatives of the governments of the Member States. Moreover, the preamble of the Code provides that it is a ‘political commitment and does not affect the Member States’ rights and obligations or the respective spheres of competence of the Member States and the Community resulting from the Treaty’.¹⁸⁵ According to Senden’s classification, the Code falls within the scope of the steering measures. It appears that it was introduced because a hard law measure had been unattainable. Chapter 4 returns to this point.

Third, the last category of soft law measures comprises Commission Communications. As a result of jurisprudence of the ECJ, three Communications related to the problems of exit taxation,¹⁸⁶ anti-abuse measures¹⁸⁷ and cross-border losses¹⁸⁸ were published by the Commission as part of the programme to promote better coordination among national tax systems. In these Communications, the Commission explains how certain judgments of the Court of Justice should be understood. Nevertheless, these interpretations are not binding. If a Member State followed a communication that was later rejected by the ECJ in one of its decisions, the Court’s case law would constitute a source of EU law and not the communication. The Court of Justice has the ultimate authority in that respect. At

¹⁸⁵ Preamble of the Code of Conduct, note 71 above.

¹⁸⁶ Communication *Exit Taxation and the Need for Co-ordination of Member States’ Tax Policies*, note 175 above.

¹⁸⁷ Communication *Application of Anti-abuse Rules in the Area of Direct Taxation*, note 175 above.

¹⁸⁸ Communication *Tax Treatment of Losses in Cross-Border Situations*, note 175 above.

face value, the Communications act as interpretative measures. Chapter 3 probes into the character of the three Communications in more depth.

1.6. Research objectives

This chapter has shown that existing regulation of corporate taxation in the EU resembles a puzzle that consists of three core elements i.e. directives, case law and soft law. The overarching research objective of this thesis is to investigate and analyse how these various pieces of the regulatory puzzle interplay and fit together. It is essential to bear in mind that a discourse on the specifics of EU tax regulation has two inevitably interacting aspects. The first element of EU tax regulation is the legal framework with which the EU is formally equipped by the Treaties. Secondly, there is a political side to EU attempts to regulate taxation. This second element of the problem can either place limitations on regulatory initiatives or give them a green light to go ahead. For the purpose of my thesis, attention is paid largely to the legal framework within which the EU can undertake regulatory actions. As the author is not a political scientist and this thesis is a legal work, political limitations on the regulatory processes are not of primary importance. However, they offer an interesting additional insight into the nature of these processes and are therefore discussed where relevant.

In order to understand the complex network of interactions between soft law and hard law measures in the context of corporate taxation in the EU, five research problems are investigated. First, the nature of the Code of Conduct for Business Taxation is discussed. Critically, this thesis investigates whether the Code can be regarded as an example of a pure soft law measure. The example of EU tax competition regulation is employed as a case study in order to argue that the nature of this Code is not as clear-cut as it appears a first sight. In essence, it is argued that the Code has a hybrid character displaying both soft and hard law features.

Second, this thesis explores the relationships between hard law and soft law in the wider context of EU direct tax regulation. It analyses how the Code of Conduct is embedded in the broader environment of tax regulation. The Code tends to be characterised as a soft law measure situated within the regulatory environment of

taxation that, for years, has been dominated by hard law instruments. At this broader level, interactions between ECJ jurisprudence and soft law instruments are also explored.

Third, the application of both hard law and soft law approaches to coordination of national direct tax systems is scrutinised with regard to the evolution of integration and the parallel evolution of governance. It is suggested that it has been realised that the harmonisation approach in the tax field does not have to be the only viable way of European integration. As tentatively suggested in section 1.5.2., corporate tax regulation in the EU forms a *hybrid* structure. In the broader context, the application of soft law alongside hard law would constitute part of a wider phenomenon occurring in different regulatory areas in the EU where a shift from harmonisation to a more flexible approach took place. Against the backdrop of direct taxation, the discussion about soft and hard laws introduces a question of why the emergence and proliferation of regulatory forms occurred and what consequences it may have for traditional concepts of EU law.

Fourth, the problem of soft law regulation is placed in the international realm. By referring to the anti-harmful tax competition initiative carried out by the OECD, a comparative study is presented. This will enrich the background to deliberations on the Code of Conduct. Tentatively, it is expected that OECD work has been becoming 'harder' due to the ineffectiveness of its soft approach to tax competition.

Fifth, this presentation of direct tax legislative and jurisprudential achievements and the assessment of results achieved by soft law measures introduced to EU direct tax regulation lead to the research problem of the future of corporate tax regulation in the EU. This thesis does not attempt to determine a conclusive solution. It merely endeavours to suggest whether a harmonisation approach or a more flexible approach grounded primarily in soft law or perhaps a combination of both appears to be (should be) preferable in EU tax regulation.

1.7. Value of research into hard and soft law interplay

There is a great need to conduct research into interactions between different parts of EU direct tax regulation, primarily so that better understanding of the EU's approach to the issues raised by direct taxation can be gained. Additionally, this research can advance understanding of EU law and its limits more generally. It can be argued that, despite relatively abundant literature on the problem of direct taxes in the EU, there is a gap within the existing body of knowledge about EU direct tax regulation. This gap has a dual character. First, there is a lack of focus on the phenomenon of soft law and little recognition of its significance for the question of direct tax regulation within the EU. As regards soft law regulation, this is more commonly examined in relation to regulatory fields that traditionally have not been influenced by the hard law approach.¹⁸⁹ The discussion about soft law in relation to direct taxation is largely absent.

According to Armstrong and Shaw, EU law scholarship was originally focused on emphasising the dominance of law. This positivist and doctrinal approach to EU studies has led to the neglect by legal scholars of the meaning of soft law developments for law in the EU.¹⁹⁰ Among the rare studies of soft law in tax regulation, one can mention investigations carried out by Gribnau¹⁹¹ and Radaelli with Kraemer.¹⁹² However, their writings do not amount to a comprehensive understanding of the issues in question because they concentrate on describing the *status quo* and do not explore in-depth the nature of the Code of Conduct or the consequences of introducing new governance to the area of direct taxation. The

¹⁸⁹ E.g. employment policy and social policy. J S Mosher and D M Trubek, note 167 above, at 63-88; D M Trubek and L G Trubek, 'Hard and Soft Law in the Construction of Social Europe: the Role of the Open Method of Coordination', (2005) 11:3 *European Law Journal* 343-364.

¹⁹⁰ See: K A Armstrong and J Shaw, 'Integrating Law: An Introduction', (1998) 36:2 *Journal of Common Market Studies* 147-154 at 148, 150; K A Armstrong, 'Legal Integration: Theorizing the Legal Dimension of European Integration', (1998) 36:2 *Journal of Common Market Studies* 155-174 at 155.

¹⁹¹ See for example: H Gribnau, 'Improving the Legitimacy of Soft Law in the EU Tax Law', (2007) 35:1 *Intertax* 30-44; H Gribnau, 'Soft Law and Taxation: EU and International Aspects', (2008) 2:2 *Legisprudence* 67-117.

¹⁹² C M Radaelli and U S Kraemer, 'Governance Areas in EU Direct Tax Policy', (2008) 46:2 *Journal of Common Market Studies* 315-336; C M Radaelli and U S Kraemer, 'Final Project Report, Project 22: Changing Governance Architecture of International Taxation (TAXGOV)', NEWGOV New Modes of Governance available at http://www.eu-newgov.org/database/DELIV/D22D10_Final_Project_Report.pdf.

studies by Gribnau and Radaelli constitute merely a foundation for further investigation of the problem of various regulatory approaches in the field of direct taxation. Radaelli and Kraemer take a governance approach in discussing a problem of tax regulation. However, they do not focus their attention on the relevant tax policy instruments. Radaelli and Kraemer approach the problem from the perspective of actors involved in developing the governance of direct taxation.

The second feature of the lacunae in the direct tax literature is that despite the fact that, overall, there have been many attempts to describe taxation in the EU context, the discourse on EU tax regulation predominantly treated each of the three pieces of the regulatory puzzle as a separate element.¹⁹³ There exists literature providing an overall description of European tax regulation; however, it takes the form of textbooks, focused on a descriptive survey of the issue.¹⁹⁴ EU tax law textbooks, by their nature, do not concentrate on the mutual interaction and ties between hard law and soft law. Thus, this research contributes to better understanding of direct tax regulation as a whole.

On the other hand, a complaint about insufficient research interest cannot be raised with regard to hard law. Criticism of the analysis of hard law tax regulation can be voiced instead on the grounds of a dominantly unilateral approach presented by scholarship. Research into direct tax hard law primarily offers reflections from a technical point of view in the sense that taxation in the EU is considered through a

¹⁹³ The most voluminous literature exists with regards to direct tax jurisprudence in the context of the internal market. Direct tax judgments grounded on the provisions of direct tax directives seem unnoticed by commentators. See, for instance: M Dahlberg, note 112 above; F Vanistendael, note 112 above; M Lang, J Schuch and C Staringer, *ECJ: Recent Developments in Direct Taxation*, (The Hague: Kluwer, 2006); J R Hines Jr., M. Lang and R S Avi-Yonah, *Comparative Fiscal Federalism: Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence*, (Alphen aan den Rijn: Kluwer, 2007); D Weber (ed.), *The Influence of European Law on Direct Taxation : Recent and Future Developments*, (Alphen aan den Rijn: Kluwer, 2007). As far as direct tax legislation is concerned, see: D Weber, 'The Proposed EC Interest and Royalty Directive', (2000) 9:1 *EC Tax Review* 15-30; S Bell, 'EU Directive on the Taxation of Savings Income', (2001) 4 *British Tax Review* 261-272; C Panayi, 'The Proposed Amendments to the Savings Directive', (2009) 49:4 *European Taxation* 179-184.

¹⁹⁴ P Farmer and R Lyal, *EC Tax Law*, (Oxford: Clarendon Press, 1994); L W Gormley, *EU Taxation Law*, (Richmond: Richmond Law&Tax, 2006); B J M Terra and P J Wattel, note 113 above; M Helminen, *EU Tax Law – Direct Taxation*, (Amsterdam: IBFD, 2009).

prism of tax and issues specific to tax law.¹⁹⁵ Taxation in the broader context of EU law is not debated. Similarly, considerations about direct tax jurisprudence focus on describing the rules of taxation and specific tax solutions that the ECJ appears to support or not. In other words, tax scholars seem to be mainly preoccupied with unveiling which tax system is preferred by the ECJ.¹⁹⁶ Consideration of direct tax case law in the wider context of EU law has not attracted much attention. More recently, however, legal scholars appear to have shown interest in the problem of interactions between different freedoms and how the relationship between various fundamental freedoms is approached by the ECJ in direct tax cases.¹⁹⁷

Overall, therefore, this thesis seeks to address existing research gaps in the investigation of the direct tax problem in the EU. It looks at the regulation of direct taxation as a whole, as a network of interconnected and reinforcing trends. In effect, direct taxation in the EU is presented as a dynamic area where governance drivers and modes are subject to changes and developments. Additionally, this thesis focuses on embedding the significance of soft law into deliberations about direct tax regulation. Soft law devices appear to have become an influential development that may contribute to shaping the future of regulation in the Union. For that reason they deserve close insight.

At this stage of investigation, certain intuitions about these research problems can be offered. The approach to the research problem is grounded on not simply treating soft law and hard law as regulatory *alternatives*. Soft law and hard law in direct tax regulation by the EU are not *rivals*. It appears that hard law and soft law in the context of EU direct tax regulation are applied simultaneously and do not operate in a parallel, unrelated fashion; rather, they create a network of connections that complement each other. Due to the inability of the Member States to overcome the

¹⁹⁵ M Lang, P Pistone, J Schuch and C Staringer, *Introduction to European Tax Law: Direct Taxation*, (Biddles: Spiramus, 2008); B J M Terra and P J Wattel, note 113 above.

¹⁹⁶ As such, the majority of academic comments on direct tax jurisprudence have a fairly technical nature. See, *inter alia*: M Dahlberg, note 112 above; M Lang, J Schuch and C Staringer, note 193 above; F Vanistendael, note 112 above; D Weber, note 193 above; J R Hines Jr., M. Lang and R S Avi-Yonah, note 193 above.

¹⁹⁷ S Kingston, 'A Light in the Darkness: Recent Developments in the ECJ's Direct Tax Jurisprudence', (2007) 44:5 *Common Market Law Review* 1321-1359; J Snell, 'Non-discriminatory Tax Obstacles in Community Law', (2007) 56:2 *International and Comparative Law Quarterly* 339-370.

differences in their national tax systems through the traditional Community Method, alternative roads to tax coordination were sought. Hard and soft law measures regulating corporate taxation in the EU have similar values behind them and seek to achieve similar goals by utilising different means. They are not mutually exclusive and they can both be used depending on the level of political commitment and will to pursue change.

Currently, direct tax jurisprudence and soft law measures appear to be the only realistic solutions to progress EU direct tax regulation. Coordination of direct tax systems in the internal market is necessary, as is shown in section 1.1.3., but harmonisation to a large extent is not, because that would mean a step towards a creation of a state. This is clearly not what the Member States wish to achieve at the current level of EU integration. It would breach principles of ‘no taxation without representation’ and would entail serious reconstruction of EU structures.

Consequently, EU direct tax regulation will remain a complex *hybrid*. These intuitions may not be relevant outside the area of direct taxation. Trying to provide an answer in one specific regulatory field, this thesis does not purport to propose a solution that works in general. It only addresses the corporate tax field. General comments and conclusions on the problems of soft law and hard law are difficult to make as such an approach always creates a risk of oversimplification. It is more beneficial to perceive soft law and hard law within the context of a specific regulatory area that they influence. Each regulatory sphere has its specific political and economic setting that might affect our views on effectiveness and the relationship between different regulatory means.

1.8. The structure of the thesis

This thesis is composed of six chapters. This first chapter sought to prepare a foundation for the discussion of the interactions between hard law and soft law regulatory measures operating in the field of direct taxation that is developed in later chapters.

After introducing the concepts of soft law and hard law and placing the EU within this context as a regulatory body, the thesis proceeds to examine various forms of EU corporate tax regulation in detail. Chapters 2 and 3, concerning legislation and case law on direct taxes, represent a sphere subjected to hard law regulation. Chapter 2 tells a story of generally unsuccessful positive integration through traditional legislative measures. Reasons for this failure of hard law legislation are investigated. Chapter 3 investigates the specific role of the ECJ in the process of coordinating direct taxation. Since 1986, the Court has decided numerous cases involving various aspects of the Member States' direct tax systems and its influence within EU tax regulation has been impressive. This chapter contrasts achievements in direct tax jurisprudence with the scope of the relatively unimpressive legislative framework for direct taxes. A hybrid network of soft and hard law is also introduced here by looking at soft measures responding to case law.

Chapter 4 then turns to address the question of regulating direct taxation through soft law measures. This chapter is focused on an instrument regarded as an especially significant example of soft law in the context of corporate taxation, namely, the Code of Conduct for Business Taxation. Through a comparative study, Chapter 4 shows that the soft law approach to tax issues is not exclusive to the EU but has also been employed at the international level by the OECD. Lessons learned in that context will help to flesh out the problems and advantages associated with transnational regulation of direct tax through soft law means. This section finds that the soft law initiative of the OECD evolved towards hard law measures. Soft law did not seem to have been sufficient to achieve regulatory goals. This finding provokes the question of whether the same problem arises regarding the Code of Conduct.

The question of whether the Code can be regarded as a pure soft law measure is subject to comprehensive discussion in Chapter 5. It investigates whether the soft law approach to tax problems, imparted through the Code, was a more productive solution in the EU. Essentially, it is argued that the Code can be described as a rather hard law measure as far as its operation is concerned. This chapter aspires to clarify the gravity of introducing hard law aspects within the context of a regulatory measure officially presented as a soft law instrument. It is claimed, however, that the

hard law features of the Code determined the success of the anti-harmful tax competition project and contributed to imposing restrictions on national tax sovereignty. A hard law element in regulating a sensitive regulatory area may prove essential in securing effectiveness of EU regulation. Lastly, Chapter 6 offers conclusions.

Conclusions

This chapter argued that direct taxation is a sphere that is important to the EU and also to individual Member States. Direct taxation requires some form of EU regulation because of the internal market goal set in the Treaties. However, national tax sovereignty must also be respected. Consequently, this chapter discovered that in order to combine national interests and EU ambitions regarding direct taxes, a complex regulatory structure was created. That regulatory structure is composed of closely interlinked soft law and hard law tools.

Whilst the hard law approach has been generally the traditional method for European integration, its renewed dynamics have been linked to the emergence of new voluntary methods of governance. EU integration established on one regulatory approach became untenable because of EU enlargements. These developments increased differences between the interests of the Member States and the diversity of the tackled issues.

It appears that a combination of soft law and hard law might be the most appropriate and feasible regulatory method to address problems of corporate taxation in the EU. This hypothesis is subject to scrutiny throughout this thesis. In effect, this enquiry can contribute to constructing an answer about the future direction of EU direct tax regulation. This is the core value of this thesis. A satisfactory solution on how to regulate direct taxation will not be found unless the Member States and the European administration are ready to conduct a more open discourse. The debate on direct taxation is still in an embryonic form. Some Member States are not, as a matter of principle, willing to talk about any form of tax coordination. The more nuanced, diversity-accommodating and novel approach to direct tax governance explained in this thesis offers prospects for real change in this respect.

CHAPTER 2. THE HARD LAW APPROACH TO DIRECT TAXATION: LEGISLATIVE ACHIEVEMENTS

Introduction

Harmonisation of national rules has been a basic tool of EU law to establish the internal market. Therefore, enactment of hard law directives¹ constituted a conventional solution to achieving European integration in the direct tax field, which has been on the regulatory agenda since the 1960s.² Despite the fact that positive integration has been the traditional way in which the EU exerted its regulatory influence, such a far-reaching method of influencing direct taxes has proven, and will most likely continue to prove, to be unsuccessful and politically challenging.³ This chapter presents this traditional⁴ segment of hard law regulation of direct taxes as a modest contributor to the elimination of obstacles to the internal market. Only five directives have been adopted in over five decades of EU integration.

In section 2.1., this chapter demonstrates that initial plans for harmonisation of direct taxes in the EU were founded on the hard law approach and, originally, even suggested the introduction of a common corporate tax system.⁵ However, the attainment of expansive harmonisation in the context of direct taxation was difficult. Consequently, only five directives with a limited regulatory scope were adopted.

The five directives (and one multinational agreement) are briefly outlined in section 2.2. This section conveys the main thrust of these instruments and concisely explains what issues they resolve. A thorough investigation into the substance of the directives goes beyond the purpose of this chapter. Section 2.2. confirms the reflection that not only is the number of adopted measures disappointing but so is

¹ Chapter 1, section 1.4.2.1. outlines Article 115 TFEU employed in the process of harmonising direct tax laws.

² See Chapter 1, section 1.1.1.

³ Reasons for the failure of the hard law approach through directives are explored in Chapter 2, section 2.4.

⁴ The second element of hard law regulation is created by the growing volume and regulatory impact of direct tax jurisprudence: see Chapter 3.

⁵ The early plans of the Commission to pursue proposals for a corporate tax system were described as 'grandiose'. See: C Radaelli, and M Gammie, *The Future of Tax Policy in the EU: from Harmful Tax Competition to EU Corporate Tax Reform. Report of the CEPS Tax Task Force*, (Brussels: Centre for European Policy Studies, 2000), p. 29.

their regulatory scope. Consequently, this presentation of the essence of these instruments adds to the argument that the overall impact of traditional hard law on the sphere of direct taxation has been minimal and has not fulfilled initial European ambitions.

Section 2.3. analyses the latest developments regarding the harmonisation of direct tax systems i.e. the revived plans for the adoption of the common consolidated corporate tax base (CCCTB). The Directive proposal was eventually tabled on 16 March 2011.⁶ This recent example testifies to how time-consuming the process of introducing EU law to the sphere of direct taxation can be. While the idea for the establishment of the CCCTB was formally initiated in 2001, the unofficial idea of a CCCTB had appeared already in 1987.⁷ The example of the CCCTB project also indicates that the EU had started to consider solutions in the form of alternatives to uniform hard law regulation, which would allow the integration of national tax regimes to progress. Should a unanimous agreement on the Directive proposal prove impossible, the application of the CCCTB is potentially linked with enhanced coordination, a vehicle which enables a degree of heterogeneity and voluntarism in regulation through hard law measures. In the final section 2.4., reasons behind the disappointing results of positive integration are examined.

2.1. Harmonisation of corporate taxation in the EU: a historical overview

2.1.1. Failed initiatives in direct tax harmonisation

Since the 1960s, frequent attempts were made to agree on directives which would introduce uniform solutions in the sphere of direct taxes. Ideas ranged from a common corporate tax system to harmonisation of selected aspects of direct tax regimes. However, the majority of the harmonisation initiatives proved futile. Until the 1990s, only one directive was adopted as the process of adopting directives was rather arduous. The remaining four were agreed after a shift in approaching harmonisation.

⁶ Proposal for a Council Directive on a Common Consolidated Corporate Tax Base, COM (2011) 121/4, available at http://ec.europa.eu/prelex/detail_dossier_real.cfm?CL=en&DosId=200263.

⁷ F Vanistendael, 'The Ruding Committee Report: a Personal View', (1992) 13:2 *Fiscal Studies* 85-95 at 85.

2.1.1.1. The Neumark Report

In April 1960, the Fiscal and Financial Committee⁸ was established to examine whether, and if so to what extent, differences between national tax systems may impinge on the operation of the internal market and what measures could be implemented to mitigate these disparities.⁹ In 1962, with the Neumark Report,¹⁰ deliberations about which corporate tax system to select as the common system began.

The Neumark Committee suggested that the process of harmonisation should be conducted in three stages. The first stage would revolve around the reform of turnover taxes. In the second phase, company taxation reforms and a degree of harmonisation in personal income taxation would be considered. Additionally, the Report concluded that a multilateral convention for the avoidance of double taxation should be adopted.¹¹ In the third phase of harmonisation, coordination of national tax administrations would become necessary. As regards corporate taxation, the Neumark Report supported the introduction of a single tax on income with the same structure of scales in all Member States. It proposed that a split rate corporation tax system¹² should be introduced in the Member States.¹³

2.1.1.2. The 1969 Directive proposals

After the publication of the Neumark Report, it was apparent that the EEC would endeavour to harmonise direct taxes. Subsequently, in 1967, the Commission formulated a programme for the harmonisation of direct taxes.¹⁴ According to the

⁸ The Fiscal and Financial Committee is known as the Neumark Committee.

⁹ Report of the Fiscal and Financial Committee in *The EEC Reports on Tax Harmonization: the Report of the Fiscal and Financial Committee and the Reports of the Sub-Groups A, B and C*. An unofficial translation was prepared by Dr. H. Thurston, (Amsterdam: IBFD, 1963), p. 98, (Neumark Report).

¹⁰ *Ibid*. The study was general in nature and concerned both indirect and direct taxation systems.

¹¹ *Ibid*, at 154.

¹² A split rate tax system taxes retained earnings at a different tax rate from profits paid out as dividends. Thus, it encourages companies to have lower retention of profits and, instead, distribute higher dividends because the retained profits are taxed higher than dividends. This system retains double taxation. See: A Lymer and J Hasseldine (eds), *The International Taxation System*, (Boston: Kluwer, 2002), p. 264.

¹³ Neumark Report, note 9 above, at 139.

¹⁴ Memorandum to the Council of 26 June 1967, Supplement to the Bulletin of the European Economic Community 8-67.

programme, the most urgent issues concerned the elimination of obstacles to the free movement of capital and to the restructuring or concentration of companies across the EEC. A harmonised basis of assessment for company taxation was also on the agenda. In relation to the free movement of capital, the alignment of national tax systems was required with respect to withholding taxes on dividends and interest payments. Next, methods of relieving double taxation of dividends and interest should have been coordinated and, thus, fiscal neutrality secured. Taxation of holding companies and tax treatment of investment through intermediaries had to be dealt with in order to enable unrestricted movement of capital.

As regards the taxation of industrial combinations, disparities between national tax laws obstructed mergers and acquisitions between companies located in different Member States. The goal was therefore to introduce solutions which would guarantee tax neutrality between domestic and cross-border combinations between enterprises. The Commission was convinced that obstacles to the free movement of capital were caused by varying tax systems and tax rates, and also by differences in computing profits for tax purposes. The need to harmonise national rules on categories of taxable income, approximation of tax rates and coordination of tax collection was therefore identified. A general tax on company profits, based on similar methods of assessment and rates, was to become a long-term aim for the EU.

The 1967 programme can be characterised as ambitious. It proposed solutions beyond tackling cross-border impediments to the freedom of movement. It laid down the plan for long-term harmonisation of corporate tax systems. The formal proposal was published in 1975. Additionally, as a result of the 1967 programme, two Directives were proposed in 1969. They addressed tax issues associated with cross-border mergers¹⁵ and tax problems arising in relations between related companies in

¹⁵ Proposal for a Council Directive of 15 January 1969 on the common system of taxation applicable to mergers, divisions and contributions of assets involving companies of different Member States, COM (69) 5 final, OJ 1969 C 39/1. This document is only available in French, German, Dutch and Italian.

different Member States.¹⁶ These proposals were shelved for 20 years and were not adopted until the beginning of the 1990s.¹⁷

2.1.1.3. *The ambitious plan for a corporate tax system*

In July 1975, the Commission submitted a long-awaited proposal for a Directive on the harmonisation of company taxation systems and withholding taxes on dividends.¹⁸ This development confirmed the comprehensive approach of the Commission to direct tax harmonisation as non-harmonised corporate tax systems were considered to have impeded free circulation in the internal market. Unlike the Neumark Report, which supported the split rate tax system¹⁹ or the 1970 Van den Tempel Report which advocated the classical system,²⁰ the 1975 Directive proposal opted for the imputation system²¹ and a common system of withholding taxes on dividends. It has to be stated that, overall, tax sovereignty was seriously restricted by the 1975 directive proposal. The proposal was not adopted; however, it was not yet formally rejected either. It became an element of the Burke Report in a last attempt to promote a harmonised corporate tax system.

¹⁶ Proposal for a Council Directive of 15 January 1969 on the common system of taxation applicable to parent companies and their subsidiaries of different Member States, COM (69) 6 final, OJ 1969 C 39/7.

¹⁷ See Chapter 2, sections 2.2.2. and 2.2.3. discussing these two legislative measures.

¹⁸ Proposal for a Council Directive concerning the harmonization of systems of company taxation and of withholding taxes on dividends, COM (75) 392 final, OJ 1975 C 253/2.

¹⁹ See footnote 12 above.

²⁰ The classical system is built on the assumption that a corporation constitutes a separate legal entity from its shareholders. As such, it does not allow a deduction of profit distributions to shareholders. Such distributions are taxed at the corporation level as corporate profits and they are taxed again in full in the hands of shareholders. In effect, distributed profits are overtaxed. Double taxation of distributed profits might encourage a company to retain its profits. Moreover, this system is biased towards financing a company through debt rather than equity because dividends are not deductible from income for tax purposes, whereas interest generally is. S Cnossen, 'What Kind of Corporation Tax?', in C Sandford (ed.), *Key Issues in Tax Reform*, (Bath: Fiscal Publications, 1993), 40-69 at 41, 47.

²¹ Under the dividend imputation system, to reduce distortions stemming from the double taxation of dividends, credit is given to shareholders for the corporation tax imposed on their dividend receipts. R R Officer, 'The Cost of Capital of a Company under an Imputation Tax System', (1994) 34:1 *Accounting and Finance* 1-17 at 2.

2.1.1.4. Facing the reality

Another attempt to support the adoption of a common tax system was undertaken in 1980. Nevertheless, the Burke Report²² was a rather faint-hearted effort lacking conviction to support the far-reaching harmonisation idea. The 1980 Report imparted a message of uncertainty about the future of the harmonisation agenda. On the one hand, the Burke Report underlined the need to harmonise taxation in order for the EU to be able to carry out its responsibilities.²³ As far as corporate taxation was concerned, the Burke Report provided that harmonisation of corporation tax systems meant the introduction of a common tax system, similar tax rates and a common basis for assessment.²⁴ The Report called for the adoption of the far-reaching proposal of the common tax system from 1975.

On the other hand, the Burke Report drew attention to the role that direct tax systems played in realising the social and economic aims of national economies.²⁵ Contradicting its earlier encouragement to pursue the 1975 harmonisation plan, the Commission argued that, although a common system might have been desirable on competition grounds, any attempt to adopt a common system by way of harmonisation would probably be doomed to failure. The Commission concluded that harmonisation had to be a ‘very gradual, stage-by-stage process, avoiding any upheavals’²⁶ and felt that the time was not ripe for setting a schedule for the measures to be taken.²⁷ The necessity for an emergence of political will among the Member States to harmonise direct tax systems was emphasised.²⁸

Generally, the Burke Report constituted a realistic review of the situation in the context of establishing European rules for corporate taxation. It showed the first signs of the realisation by the Commission that its broad plans for corporate tax harmonisation might have been too ambitious. Plans for a corporate tax system

²² Report from the Commission to the Council on the scope for convergence of tax systems in the Community adopted on 26 March 1980, COM (80) 139 final, Bulletin of the European Communities, Supplement 1/80, Burke Report.

²³ *Ibid*, paragraph 4.

²⁴ *Ibid*, paragraph 87.

²⁵ *Ibid*, paragraph 5a.

²⁶ *Ibid*, paragraph 107b.

²⁷ *Ibid*, paragraph 110.

²⁸ *Ibid*, paragraph 107a.

proved unacceptable for the Member States. The step-by-step approach to harmonisation of national direct tax regimes, founded on tackling separate problems of double taxation before deciding to harmonise entire direct tax systems, was a more pragmatic approach.

The acknowledgement of the difficulties with adopting a harmonised tax system and the lack of political will among the Member States to pursue an extensive programme of harmonisation, expressed in the Burke Report, eventually led to the abandonment of the ambitious plan of creating an EU corporate tax system. The need for this alteration in approach to regulation of direct taxes was formalised when Commissioner Scrivener took over responsibilities for the sphere of taxation. She decided to abandon the centralist approach of the Commission and withdrew ambitious, controversial harmonisation proposals in order to facilitate a compromise among the Members of the Council.²⁹ In April 1990, the Commission abandoned the 1975 draft directive proposal³⁰ to symbolise the shift in EU approach.

2.1.1.5. *The issue of loss relief*³¹

One of the unresolved problems in the internal market remains the tax treatment of losses. Two aspects of losses regulation were in the scope of the Commission's interest. First, the problem was the carry-over of losses. Rules on carry-over differed across the Member States.³² Differences in treating the off-setting of losses could become a barrier to investing in other Member States as it would, for instance,

²⁹ A similar summary of the Scrivener approach to company taxation is given by Martín Jiménez on the basis of a personal interview with Scrivener. A J Martín Jiménez, *Towards Corporate Tax Harmonization in the European Community: an Institutional and Procedural Analysis*, (London, The Hague and Boston: Kluwer, 1999), p. 138.

³⁰ M Gammie, *The Ruding Committee Report: an Initial Response*, The Institute for Fiscal Studies, March 1992, available at <http://www.ifs.org.uk/comms/comm30.pdf>, p. 5.

³¹ The aim of this section is to indicate two legislative proposals regarding direct tax which have failed. As such, a detailed discussion about loss relief goes beyond its purpose. For a debate on loss off-setting see: W C Heslehner, 'Cross-border Loss Relief for Permanent Establishments under EC Law', (2010) 64:1 *Bulletin for International Taxation* 33-44; R Kok, 'Domestic and Cross-border Loss Relief in the European Union', (2010) 38:12 *Intertax* 663-671.

³² Coopers and Lybrand, *EC Initiatives in Direct Taxation and the National Responses*, (Deventer, Boston: Kluwer, 1992), p. 137. Germany, Ireland, the Netherlands and the UK allowed losses to be carried back. Ireland and the UK also allowed losses to carry-forward with no time limit. The other states imposed a limit of five years. A Easson, *Taxation and the European Community*, (London and Atlantic Highlands, NJ: The Athlone Press, 1993), p. 228.

impose an additional administrative burden through having to deal with two separate tax rules.

To tackle this problem, in 1984, the Commission issued a draft Directive proposing that certain rules on loss relief for corporations be harmonised, in particular in relation to the unlimited carry-back and carry forward of losses.³³ The proposal intended to harmonise *domestic* laws on the off-set of losses but no suggestion was made that loss off-setting should be available in a cross-border context.³⁴ Under the proposal, a Member State could decide to include losses of foreign permanent establishments and subsidiaries in the losses which could be carried forward or back. The 1984 proposal on loss compensation was withdrawn in 1996. The Commission's arguments followed the subsidiarity reasoning. It was claimed that domestic loss compensation was a matter of national competence.³⁵

Second, the treatment of *cross-border* losses within a group of companies became a concern. An impediment to cross-border movement was created when a parent company could not claim a relief against tax on its profits for losses which the company incurred by its foreign subsidiary. A claim was possible in relation to losses incurred by a subsidiary in the same Member State but not in relation to losses of a subsidiary resident in another Member State. This creates a barrier to entering other markets and distorts business decisions within the internal market. Companies could refrain from investing in other Member States because losses from domestic investments are taken into account, while losses incurred in another Member State are excluded from the relief. Consequently, in 1990 a proposal regarding harmonisation for intragroup losses was submitted to the Council.³⁶

³³ Proposal for a Directive of the Council on the harmonization of the laws of the Member States relating to tax arrangements for the carry-over of losses of undertakings, COM (84) 404 final, OJ 1985 C 46/84.

³⁴ This problem was partially dealt with in Case C-446/03 *Marks & Spencer plc v David Halsey* [2005] ECR I -10837 and in the Communication of 19 December 2006 from the Commission to the Council, the European Parliament and the European Economic and Social Committee on *Tax Treatment of Losses in Cross-Border Situations* COM (2006) 824 final. See Chapter 3 for more details about both the *Marks & Spencer* case and the Communication.

³⁵ Commission Staff Working Paper of 23 October 2011, *Company Taxation in the Internal Market*, SEC (2001) 1681, p. 340.

³⁶ Proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishment and subsidiaries situated in other Member States, COM (90) 595 final, OJ 1991 C 53/30. It was withdrawn by the Commission in 2001.

Under the proposal, Member States would be obliged to relieve losses incurred by permanent establishments and subsidiaries situated in Member States other than the home state of the parent company. The proposal left some issues unanswered³⁷ and imposed strict qualifying conditions. It was not positively received in the Council and was eventually withdrawn in 2001³⁸ because some Member States preferred to deal first with losses of permanent establishments and only later with losses of subsidiaries, as this would involve little immediate change for many Member States.³⁹ It was also said that the proposal 'after more than a decade, was, in some respects in need of technical revision'.⁴⁰ The Commission hoped that developments before the ECJ would contribute to an increasing acceptance among European tax policy makers of the need for action in this area. Consequently, cross-border loss relief was left for the ECJ to tackle.⁴¹ The Commission's initiative refocused on developing guidance on Member States' respective obligations through the interpretation of the loss relief jurisprudence.⁴²

2.1.2. Infrequent successes

2.1.2.1. The first directive

In parallel to proposing a common corporate tax system, the Commission focused on the possibility of increasing tax cooperation between national tax authorities. The impetus came from the Communication of 22 November 1974 from the Commission on the problem of international tax evasion and avoidance⁴³ and a subsequent

³⁷ For example: the problem of indirect shareholdings or treatment of partnerships,

³⁸ Communication from the Commission, Withdrawal of Commission Proposals which are no Longer Topical, COM (2001) 763final/2, p. 24.

³⁹ P Farmer and R Lyal, *EC Tax Law*, (Oxford: Clarendon Press, 1994), p. 296.

⁴⁰ Communication of 23 November 2003 from the Commission to the Council, the European Parliament and the European Economic and Social Committee *An Internal Market without Company Tax Obstacles: Achievements, Ongoing Initiatives and Remaining Challenges*, COM (2003) 726 final, p. 9.

⁴¹ A body of case law deals with the problem of cross-border loss relief: Case C-446/03 *Marks & Spencer*, note 34 above; Case C-141/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn* [2008] ECR I -3601; Case C-293/06 *Deutsche Shell GmbH v Finanzamt für Großunternehmen in Hamburg* [2008] ECR I-1129; Case C-527/06 *R. H. H. Renneberg v Staatssecretaris van Financiën* [2008] ECR I-7735.

⁴² Communication *Tax Treatment of Losses in Cross-Border Situations*, note 34 above. Chapter 3, section 3.2. questions whether the Commission understood the ECJ's loss relief case law.

⁴³ Communication and draft resolution of the Commission to the Council, COM (74) 1971 final. The Communication is mentioned in Council of the European Communities Resolution of 10 February 1975 on the measures to be taken by the EU in order to combat international tax evasion and avoidance, OJ 1975 C 35/1.

Council resolution⁴⁴ drawing attention to risks created by tax evasion and tax avoidance. These practices led to budget losses, distortions in capital movements and conditions of competition within the internal market. It was desirable for action to be taken initially on the mutual exchange between Member States of all information suitable for making correct assessments for taxes, in every case where there appeared to have been artificial transfer of profits between undertakings in different countries, where transactions were carried out between undertakings in two Member States through a third country in order to obtain tax advantages, or where the tax had been or may be evaded for any reason. Pursuant to these instructions, the Commission submitted a proposal in 1976 for a Directive on mutual assistance. It was adopted in 1977.⁴⁵

The Mutual Assistance Directive can be described simultaneously as an important and disappointing development. The Directive was significant because it was the very first Directive adopted by the EEC in the field of direct taxation. It turned out that, for many years, it was also the only legislative achievement in the field of direct taxes. However, from a regulatory point of view, the Directive could hardly be described as a radical achievement. This sole legislative success of this period operates in the interests of the Member States, assisting them in combating tax avoidance and evasion, rather than addressing taxpayers' concerns relating to double taxation and administrative difficulties.

2.1.2.2. A new strategy

The success of adopting the 1977 Directive was not repeated for many years. Tax integration reached an impasse. Taking into account the repeated failures of the grand plans to pursue a harmonised company tax system, a new strategy was necessary. The Commission decided instead to concentrate on more limited measures essential for completing the internal market. The focal point therefore became proposing tax instruments which would tackle the issue of double taxation. This new strategy was driven by a number of factors. Among them, the most significant determinants were the appointment of a commissioner responsible for the sphere of

⁴⁴ Council of the European Communities Resolution of 10 February 1975, note 43 above.

⁴⁵ See Chapter 2, section 2.2.1. for a brief outline of this legislative measure.

taxation in the EU, development of the internal market programme and the subsidiarity principle.

As stated above, the Burke Report expressed the view that the Commission's aspiration of pioneering a harmonised company tax system might be destined to fail. The creation of the position of a tax commissioner in the Commission played a significant part in shifting the approach to harmonisation of direct taxation. The first tax Commissioner was Christine Scrivener in 1989. Her approach to direct tax problems can be characterised as pragmatic and realistic. It was grounded in subsidiarity, the completion of the internal market and concentration, which meant that all plans regarding direct taxation were expected to be agreed in close cooperation with all relevant parties.⁴⁶ The centralist approach of the Commission was abandoned. This resulted in the Commission's withdrawal of the controversial 1975 harmonisation proposals in April 1990 in order to facilitate a compromise among the Members of the Council.⁴⁷ Simultaneously, Commissioner Scrivener presented to the Council a series of specific proposals designed to reduce double taxation.

It has to be emphasised that the shift in approaching direct taxation by Commissioner Scrivener was not revolutionary or ground-breaking. It was just a modification of a traditional approach based on limiting the scope of proposals. Initially, the Commission promoted an extensive programme of harmonisation by adopting directives. When the shift in the approach of the Commission to direct taxes took place, the hard law approach was not surrendered. The Commission still relied on directives to achieve restricted in scope direct tax goals.

The decision to downsize harmonisation goals could also be attributed to the publication of the 1985 White Paper.⁴⁸ The White Paper must be considered in its broader context because it was born out of the general stagnation in the process of European integration evident since the 1970s. The lack of progress was not confined

⁴⁶ M Gammie, note 30 above, at 4-5.

⁴⁷ *Ibid.*, at 5.

⁴⁸ *Completing the Internal Market: White Paper from the Commission to the European Council* (Milan, 28-29 June 1985), COM (85) 310 final.

to the area of taxation and was caused by numerous factors.⁴⁹ A fresh initiative was required to breathe new life into the European project. In the 1980s, a political consensus developed and led to new impetus being given to work on tax harmonisation. A goal expressed in June 1985 in the Commission's White Paper⁵⁰ was the completion of the internal market, without physical, technical and fiscal barriers. Essentially, the White Paper drew attention to the need to abolish internal frontiers and create the internal market by 1992.

Arguably, this document became a catalyst for a re-born interest in harmonising taxation as the elimination of tax barriers was an essential element of the completion of the internal market. The White Paper contained several provisions referring to taxation.⁵¹ However, those provisions almost exclusively concerned indirect taxation. As the document pointed out, physical barriers continued to exist, despite the abolition of customs duties, because customs posts were still used by Member States to check compliance with national indirect tax rules.⁵² As regards direct taxes, the White Paper urged the Council to finalise work on three directive proposals: on tax treatment of parent and subsidiary companies, on taxation of mergers, and on the arbitration directive. It also called for prioritising work on cross-border losses.⁵³ The expected date of adoption of these measures by the Council was 1985.⁵⁴ It was anticipated that after releasing the White Paper, the three existing draft directives would be quickly approved by the Council. Given that the proposals had been put aside for consideration since the late 1960s and the mid 1970s, it appears that much hope was entrusted in one document to secure progress. As will be highlighted, the ambition of adopting the directives by 1985 was not met.

⁴⁹ The stagnation can be attributed primarily to the accession processes of 1973 and 1980, energy crises and economic recession and debates over the budget. See: A Easson, 'Harmonization of Direct Taxation in the European Community: from Neumark to Ruding', (1992) 40:3 *Canadian Tax Journal* 600-638 at 608-609.

⁵⁰ *Completing the Internal Market*, note 48 above.

⁵¹ 58 out of 222 paragraphs of the White Paper are devoted to taxation.

⁵² *Completing the Internal Market*, note 48 above, paragraph 26.

⁵³ *Ibid.*, paragraph 151.

⁵⁴ Annex to the White Paper: Time Table for Completing the Internal Market by 1992, p. 31.

Thinking about direct tax harmonisation was also influenced by the principle of subsidiarity which was central in the Maastricht negotiations.⁵⁵ The principle of subsidiarity attempted to regulate the question of the exercise of competences between the Union and the Member States. It is based on the premise that the EU shall act only within the limits of the powers conferred upon it by the Treaties and of the objectives assigned to the Union. In areas which are not within exclusive Union competence, it can act only when the objectives of the proposed action cannot be sufficiently achieved by the Member States and, by reason of scale or effects of the proposed action, it would be better achieved by the Union. Moreover, any action by the Union must meet the criterion of proportionality i.e. it cannot go beyond what is necessary to achieve the goals of the Treaty.⁵⁶

As competence over direct taxation was not conferred on the EU by the Member States, the EU could not act on its own initiative on this matter. Any action that the EU wished to undertake regarding direct taxes had to be justifiable under the principle of subsidiarity. In other words, harmonisation of direct taxes had to be proven to be the best way of achieving the goals laid down in the Treaties.

2.1.2.1. Two directives and an arbitration convention

The new approach to harmonisation of direct taxes was contained in the Guidelines for Company Taxation (hereinafter the Guidelines).⁵⁷ This document officially marked a change in the Commission's approach to harmonisation of corporate tax systems. According to the Guidelines, any form of company taxation could bring economic distortions. Thus, the harmonisation of company tax systems was justifiable to secure tax neutrality in the Union. However, subsidiarity was a good reason for the EU to reconsider its approach to harmonisation of company taxation. Indeed, the Member States should be free to determine their own tax arrangements except when this would lead to *major* distortions in the single market whilst at the same time recognising that differential corporate tax systems would continue to lead

⁵⁵ P Craig and G De Búrca, *EU Law: Text, Cases and Materials*, 4th ed., (Oxford: Oxford University Press, 2008), p. 100.

⁵⁶ Article 5 TEC. This provision is currently codified in Article 5(2) TEU.

⁵⁷ Commission Communication to Parliament and the Council, *Guidelines to Company Taxation*, 20 April 1990, SEC (90) 601 final.

to distortion.⁵⁸ A far-reaching plan for a common European corporate tax system was described as ‘theoretical’.⁵⁹

With regard to short term goals of direct tax regulation, the Guidelines gave priority to three already-published proposals, which were considered essential for the completion of the internal market. These measures were adopted later that year: the Directives on the treatment of capital gains arising when companies merge; the parent companies and subsidiaries Directive, eliminating double taxation of dividends paid by a subsidiary in one Member State to a parent company in another; and the arbitration Convention, which introduced procedures for settling disputes concerning the profits of associated companies in different Member States.⁶⁰

With regard to the Arbitration Convention, in 1976, the Commission had published a proposal for a Directive establishing an arbitration procedure to avoid double taxation in connection with the adjustment of transfers of profits between associated enterprises.⁶¹ The key goal of the proposed Directive was to tackle problems caused by establishing different transfer prices for the same transaction by different tax authorities. The proposal on the arbitration procedure was anticipated to become a legal basis for approving a common transfer price between national tax authorities. As we know, a regulatory measure concerned with setting a common transfer price was not adopted until 1990; however, it then took the form of a mutual international agreement, not a directive.⁶²

As regards longer-term plans of direct tax harmonisation, the Guidelines stated that future work in the area of corporate taxation should follow from a further study. To examine whether or not new measures were advisable, the Commission expressed a need for a fresh study which would consider, first, the current state of, and prospects

⁵⁸ *Ibid.*, paragraph 5.

⁵⁹ *Ibid.*

⁶⁰ 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 1990 L 225/10.

⁶¹ Proposal for a Council Directive establishing an arbitration procedure to avoid double taxation in connection with the adjustment of transfers of profits between associated enterprises, COM (76) 611 final, OJ 1976 C 301/4.

⁶² Convention 90/463/EEC, note 60 above. See Chapter 2, section 2.2.6. for a more comprehensive presentation of this regulatory measure.

for, further Union integration and, second, the results of the tax reforms of the 1980s, both inside and outside the EU.⁶³

Progress achieved in 1990 suggests that the Council finally accepted that the sole adoption of the Mutual Assistance Directive in 1977 was not sufficient for the creation of the internal market. Thus, the narrative of the internal market programme, revived since the mid 1980s, enabled more coordination of direct taxation to be introduced.

2.1.3. The Ruding Report:⁶⁴ a new impulse for harmonisation?

As envisaged in the 1990 Guidelines, a committee of independent experts was established to gain a deeper understanding of the long-term measures necessary in the field of corporate taxation. The Ruding Committee addressed three questions.⁶⁵ First, the Committee had to determine whether the disparities between corporation taxes and the tax burdens on companies among Member States induced distortions in investment decisions affecting the functioning of the internal market.

Second, if the answer to the first question was affirmative, the Committee had to explore whether these distortions could be eliminated simply through the interplay of market forces and competition between national systems, or if harmonising measures were necessary to eradicate these distortions. Third, it was asked whether any action at EU level should concentrate on one or more elements of company taxation, namely different corporation tax systems, the differences in tax treatment associated with the legal status of companies, and the tax base or rates.

The Committee reported in 1992,⁶⁶ having conducted extensive economic research.⁶⁷ It concluded that considerable differences between the corporate tax systems of the Member States existed despite some convergence of certain aspects of Member States' corporation tax regimes. These discrepancies related to the nature of tax

⁶³ *Guidelines to Company Taxation*, note 57 above, paragraphs 34-35.

⁶⁴ Conclusions and Recommendations of the Committee of Independent Experts on Company Taxation, 1992, available at http://aei.pitt.edu/1332/1/ruding_tax_report.pdf.

⁶⁵ *Guidelines to Company Taxation*, note 57 above, paragraphs 35.

⁶⁶ Ruding Report, note 64 above.

⁶⁷ F Vanistendael, note 7 above, at 86.

systems, statutory tax rates and tax bases. Tax treatment of cross-border income also differed among the Member States. The reliance on tax competition and market forces to resolve distortions to the operation of the internal market was perceived as an inadequate response.⁶⁸ The distortions could only be removed by measures agreed at EU level.

Accordingly, the Ruding Committee presented a number of recommendations to mitigate the negative effects of the distortions. The Committee emphasised that it had regard to a number of considerations, including the principle of subsidiarity, the requirement for unanimity on tax matters and the fact that the Member States wanted to retain as much flexibility as possible in collecting tax revenues from direct taxes.⁶⁹

The Committee stated that EU action regarding direct taxes should concentrate on removing those discriminatory and distorting features of national tax regimes that obstructed cross-border activities. However, a minimum level of statutory tax rate and common rules for a minimum tax base were also suggested. Finally, the Committee recommended maximum transparency in tax incentives.⁷⁰ With regard to harmonisation of corporate tax systems, the Committee asserted that it did not propose a harmonised system at this stage of integration. A harmonised corporate tax system was regarded as a desirable long-term objective.⁷¹

The specific policy recommendations of the Ruding Committee were expected to be implemented in three phases. The first phase encompassed the period until the end of 1994. It included those instruments whose implementation was regarded as urgent. The first phase contained the proposals which tackled most evident discrimination and most problematic obstacles to multinational companies operating in the internal market. As such, these proposals were expected to raise few problems as far as their adoption was concerned. Among the measures recommended to be taken in the first phase was the extension of the parent-subsidiary directive so that it included all enterprises subject to corporation tax, irrespective of their legal form. The Committee

⁶⁸ Ruding Report, note 64 above, at 27.

⁶⁹ *Ibid.*, at 27.

⁷⁰ *Ibid.*, at 27-28.

⁷¹ *Ibid.*, at 28.

also recommended the adoption of the three proposed directives on withholding taxes on interest and royalty payments, on relief of cross-border losses and on carryover of losses. In addition, the Arbitration Convention should be ratified as soon as possible. A draft directive setting a minimum statutory corporate tax rate of 30% for all corporations, on retained and distributed profits, was to be prepared.

The second phase was to be developed in parallel with work on the second stage of economic and monetary union (before 1999). The scope of the parent-subsidiary directive was to be extended to apply to all enterprises subject to income tax. All Member States should also introduce a maximum corporate tax rate of 40%. A proposal of a withholding tax of 30 % on dividends distributed by EC resident companies should be submitted. The withholding tax was to be waived when arrangements allowing the identification of the recipient of dividends were in place. Finally, full vertical and horizontal offsetting of losses within corporate groups at the level of a Member State were to be secured.

In the long run, the third phase covered implementation of measures concurrently with full economic and monetary union.⁷² During this stage, full EU-wide loss offsetting within corporate groups should be allowed. Moreover, the possibility of adopting a common system of corporate taxation should be considered.

The Ruding Committee Report constituted another attempt to give the EU an impetus to take action regarding company taxation. The scope of the recommended measures over the three stages was extensive. In its recommendations, the Report referred largely to the plans of the Commission which were already formulated as directive proposals or drafts in various stages of readiness. However, it also put forward such controversial ideas as common tax rates and tax bases. Arguably, the Report constituted an attempt to provide these proposals with economic justifications.

⁷² *Ibid.*

A member of the Ruding Committee described the Report as a milestone on the road of corporate tax developments in the European Union.⁷³ However, this seems to have been premature optimism. As shown in the next section, most recommendations of the Ruding Committee were not adopted or they were implemented at a date much later than anticipated by the experts. The Commission endorsed the recommendations of the Ruding Committee on a general level as far as the elimination of double taxation was concerned because these recommendations corresponded with the plans of the Commission.⁷⁴ The message from the Commission was that, from the variety of measures suggested by the Ruding Committee, the Commission would focus on a restricted number of them. The Commission declared its intention to extend the scope of the Parent-Subsidiary Directive and the Fiscal Merger Directive; however, it was cautious about recommendations on corporate tax systems' harmonisation. The Commission urged the Council to adopt the proposals concerning cross-border losses and the abolition of withholding taxes on interest and royalty payments made between associated companies in different Member States.⁷⁵ As we know, the problem of loss relief has not been tackled through legislation but has been partially addressed in case law. The interest and royalty payments directive was only later adopted in the context of the tax package.

2.1.4. The tax package strategy

Acting in response to the recommendations of the Ruding Committee, some momentum to deal with direct taxation was needed. A new strategy for achieving progress in direct taxation regulation was centred on the notion of tackling harmful tax competition.⁷⁶ The chosen method for reaching this goal was unique because the Commission decided to present regulatory proposals as a tax package composed of

⁷³ F Vanistendael, note 7 above, at 85.

⁷⁴ The Commission expressed its view in the Commission Communication of 26 June 1992 to the Council and to Parliament subsequent to the conclusions of the Ruding Committee indicating guidelines on company taxation linked to the further development of the internal market, SEC (92) 118 final.

⁷⁵ *Ibid.*, at 30.

⁷⁶ See Chapter 1 for an analysis of the issue of harmful tax competition.

three interwoven regulatory instruments.⁷⁷ Two elements of this package were formed by two directive proposals. As a result of an initiative from Commissioner Monti, the Council of Ministers for Economic Affairs and Finance (ECOFIN) met in Verona in April 1996 to discuss his paper, *Taxation in the European Union*.⁷⁸ In terms of content, the Verona Council initiated an EU tax strategy based on a comprehensive approach and a simultaneous and linked discussion about a number of important tax issues. Work initiated by Monti resulted in two drafts of a tax package to tackle harmful tax competition.⁷⁹

With regard to direct taxation, three measures required to be adopted: measures to eliminate distortions in taxation of interest and savings, measures to eliminate withholding taxes on cross-border payments of interest and royalties between companies, and a non-binding Code of Conduct for Business Taxation to tackle harmful tax competition.⁸⁰ Proposals regarding taxation of cross-border interest and royalty payments⁸¹ as well as savings taxation had appeared earlier and were also recommended by the Ruding Report but were not yet adopted. Monti's Commission took up the challenge once more.

2.1.4.1. Taxation of interest and royalty payments

The first hard law segment of the tax package was the proposal on the elimination of withholding taxes on interest and royalty payments. The Directive had already been proposed in November 1990,⁸² and, according to Easson, it was not expected that its

⁷⁷ Here, only developments regarding the two directives are described. Chapter 4 also refers to this stage of development in the history of harmonising direct taxes. It is focused on the third element of the tax package-the Code of Conduct.

⁷⁸ European Commission, *Taxation in the European Union*, SEC (96) 487 final. This document is also known as the Verona Memorandum, Monti Memorandum or the First Monti Report. See: A J Martín Jiménez, note 29 above, at 143.

⁷⁹ Proposals were contained in the Communication from the Commission to the Council of 1 October 1997: *Towards Tax Co-ordination in the European Union: a Package to Tackle Harmful Tax Competition*, COM (97) 495 final and Communication from the Commission to the Council and the European Parliament: *A Package to Tackle Harmful Tax Competition in the European Union*, COM (97) 564 final.

⁸⁰ A substantive analysis of the Code of Conduct is provided in Chapter 4, section 4.2.

⁸¹ In 1989, the Commission proposed a Directive on a withholding tax on interest income. See: Proposal for a Directive of a Council on a common system of withholding tax on interest income, COM (1989) 60 final, OJ 1989 C 141/5.

⁸² Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States, COM (90) 571 final, OJ 1991 C 53/26.

adoption would cause difficulties.⁸³ A positive view on the future of this proposal was grounded in the fact that its role was perceived as complementary to the Parent-Subsidiary Directive. Moreover, the budgetary consequences were anticipated to be insignificant. Most Member States already exempted such payments from a withholding tax. However, the deadlock in adopting this proposal could be attributed to the fact that some countries were large net exporters of capital and would lose tax revenues as a consequence of this directive. Greece and Portugal were two primary examples.⁸⁴

Despite a revision two years later⁸⁵ and a positive opinion from Parliament, the proposal was not adopted. It was withdrawn as a result of failure to agree in the Council, reflecting the Commission's new approach based on rationality and practical capability to achieve agreements by not pushing legislative proposals at any cost.⁸⁶ A new proposal was prepared in 1998⁸⁷ as part of the Monti package.⁸⁸ The Directive was formally adopted in June 2003 when issues relating to the Directive on savings were also settled.

2.1.4.2. Savings taxation

The second element of the tax package was a Directive tackling non-harmonised taxation of savings income. Together with bank secrecy, differing tax systems of savings income did not allow for effective taxation of non-residents' income from savings within the EU, because lack of information exchange between tax authorities

⁸³ A Easson, note 32 above, at 212.

⁸⁴ Coopers and Lybrand, note 32 above, at 132.

⁸⁵ Amended proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between parent companies and subsidiaries in different Member States, COM (93) 196 final, OJ 1993 C 178/18.

⁸⁶ The Commission recommended withdrawal of the Commission proposal for a directive abolishing withholding tax on interest and royalty payments between companies, Press release of 8 November 1994, IP/94/1023, available at:

<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/94/1023&format=HTML&aged=1&language=EN&guiLanguage=en>.

⁸⁷ 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 (1998) 67 final, OJ 1998 C 123/9.

⁸⁸ See also Chapter 4 for a debate about the Monti package.

enabled tax evasion. In order to prevent distortions of the internal market⁸⁹ and to counter tax evasion, a legislative solution was needed.

In 1989, the Commission proposed a Directive on a withholding tax on interest income.⁹⁰ The proposal outlined a system for a withholding tax which was to be imposed on interest paid in a source state. Where Member States adopted a system of automatic declaration by banks to tax authorities, the withholding tax did not have to be introduced. The proposal was not enthusiastically received. For example, the Netherlands and Denmark thought that a system of information exchange was a more efficient solution. The UK considered the withholding tax as a way to discourage investors from activities in the Community. This risk was confirmed when Germany introduced a withholding tax on interest and suffered an outflow of investment.⁹¹ The Commission soon decided to withdraw the proposal.

Nevertheless, the idea of finding a solution to potential tax fraud and untaxed revenues was not abandoned. It was revived in the context of the tax package. The first draft of the tax package proposed the acceptance of the so-called 'coexistence model'. This model, based on providing information on savings income to other Member States, can be characterised as a preferred option; however, a Member State would be permitted to operate a minimum withholding tax. A Member State could also implement both systems.⁹²

In the second draft of the tax package, it was reported that despite positive movements in the area of taxation of capital income from savings, discussions revealed that some substantial differences which hampered progress in the past still existed among Council members. In 1998, the Commission adopted a new proposal for a directive on savings,⁹³ based on the key elements agreed by the ECOFIN

⁸⁹ Among them were: formalities, cash flow losses, double taxation. Proposals were contained in the Communication *Towards Tax Co-ordination in the European Union: a Package to Tackle Harmful Tax Competition*, note 79 above, paragraph 20.

⁹⁰ Proposal for a Directive of the Council on a common system of withholding tax on interest income, note 81 above.

⁹¹ A Easson, note 32 above, at 220-221.

⁹² Communication *Towards Tax Co-ordination in the European Union: a Package to Tackle Harmful Tax Competition*, note 79 above, paragraph 19.

⁹³ Proposal for a Directive to ensure minimum of effective taxation of savings income in the form of interest payments within the Community, COM (1998) 295 final, OJ 1998 C 212/13.

Council on 1 December 1997 when the tax package was finally agreed. In essence, the Commission suggested the coexistence of a withholding tax and a system for information exchange.

From December 1997, separate discussions in each of the three areas of the tax package were conducted. This method of agreeing on each of the package components in isolation coupled with their co-dependency showed its limitations at the Helsinki European Council in 1999. The issue of savings taxation brought the progress to deadlock. There was no compromise between the Member States on whether a system of information exchange or a withholding tax on savings should be applied, putting the existence of the whole package at risk.

The proposal of a withholding tax on income on savings raised objections from some of the Member States, especially the UK. With London being a leading investment city, the UK Government worried that a withholding tax would drive capital away from the UK and the EU.⁹⁴ For that reason, the debate was steered towards exchange of information as the best option. Nevertheless, Austria, Belgium and Luxembourg contested this solution as they were unwilling to compromise their rules on bank secrecy. Under pressure from the UK, a compromise was reached at the Santa Maria da Feira European Council of 2000 in the form of a political decision on savings. It recognised the possibility to opt for a coexistence model *for a limited time*, followed by a switch to a regime of information exchange by all the Member States. In effect, the Commission submitted a new proposal which replaced the proposal from 1998.⁹⁵ In 2000, an agreement was reached for one system of information exchange with transitional periods granted to Austria, Belgium and Luxembourg. The Directive was adopted in June 2003. The agreement on the implementation of the savings Directive was subject to third countries adopting equivalent measures. Most of these

⁹⁴ HM Treasury, International Bonds and the Draft Directive on Taxation of Savings: a Paper by the United Kingdom, September 1999, available at <http://archive.treasury.gov.uk/docs/1999/eusavingst.html>; C M Radaelli, 'The Political Economy of EU Direct Tax Policy', in A Lymer and D Salter (eds.), *Contemporary Issues in Taxation Research*, (Aldershot: Ashgate, 2003), 145-165 at 156.

⁹⁵ Proposal for a Council Directive to ensure minimum of effective taxation of savings income in the form of interest payments within the Community, COM (2001) 400 final, OJ 2001 C 270/259.

negotiations were undertaken towards the end of 2004. The Directive has been applicable since 1 July 2005.

2.2. A summary of the limited legislative achievements

The previous section described time-consuming processes that eventually led to the adoption of some measures. Having outlined the context in which five direct tax directives were adopted, this section briefly presents the substantive content of these legislative measures.

2.2.1. The Mutual Assistance Directive

To establish an efficient exchange of information between the Member States to combat tax evasion and tax avoidance, the Member States accepted that economic integration would require greater cooperation in the direct tax field. For that reason, Directive 77/799/EEC was adopted.⁹⁶ It aimed at enhancing cooperation between tax authorities. The exchange of information under the Directive facilitates the assessment of taxes. Consequently, this Directive does not aim at the recovery of taxes but only at determination of tax liability.⁹⁷

Directive 77/799/EEC was regarded as not sufficiently effective to ensure appropriate administrative cooperation and no longer appropriate to fight tax fraud. It was designed in a different context to the current internal market requirements and a new legislative measure was felt to be needed.⁹⁸ Consequently, in 2009, the

⁹⁶ Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation and taxation of insurance premiums, OJ 1977 L 336/15. This directive will be repealed in 2013. Literature on the old and new mutual assistance directives includes: C Urtz, 'Admissibility in Austria of Spontaneous Exchange of Information under the EC Mutual Assistance Directive', (1996) 5:4 *EC Tax Review* 171-174; M Shilcher, 'The Directives on the Mutual Assistance in the Assessment and in the Recovery of Tax Claims in the Field of Direct Taxation', in M Lang, P Pistone, J Schuch and C Staringer, *Introduction to European Tax Law: Direct Taxation*, (Biddles: Spiramus, 2008), at 161-174; S J C Hemels, 'References to the Mutual Assistance Directive in the Case Law of the ECJ: a Systematic Approach', (2009) 49:12 *European Taxation* 583-589.

⁹⁷ The task of enabling the recovery of tax claims is fulfilled by a Directive on mutual assistance in the tax collection of direct and indirect taxes. See: Council Directive 76/308/EEC of 15 March 1976 on mutual assistance for the recovery of claims resulting from operations forming part of the system of financing the European Agricultural Guidance and Guarantee Fund, and of the agricultural levies and customs duties, OJ 1976 L 73/18.

⁹⁸ Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EC, OJ 2011 L 64/1.

Commission proposed a new Directive⁹⁹ which was formally adopted in 2011.¹⁰⁰ The deadline for transposition of the Directive into national law is 1 January 2013. Directive 77/799/EEC will be then repealed.

According to the Directive's preamble, due to the tremendous development of the mobility of taxpayers and increasing number of cross-border transactions, it became difficult properly to assess taxes due. This problem influences the functioning of taxation systems and entails double taxation, which encourages tax fraud and evasion. Thus, the functioning of the internal market is compromised. An individual Member State cannot manage its internal taxation system without receiving information from other Member States. In order to overcome the negative effects of this phenomenon, it is essential to develop new cooperation between the tax administrations.

One of the key elements of the new Directive is that Member States will not be in a position to invoke bank secrecy in order to refuse cross border tax co-operation. The 1977 Directive imposes no obligation to carry out enquiries or to provide information if the Member State, which should furnish the information, would be prevented by its laws or administrative practices from doing so.¹⁰¹ In effect, a Member State was not obliged to supply information protected by national banking secrecy rules. The change under the new Directive has to be evaluated as positive. Banking secrecy rules have been a significant problem in developing tax cooperation and information exchange within the EU.¹⁰² The revelation of the Lichtenstein affair in February 2008¹⁰³ and the strong political condemnation¹⁰³ of tax evasion practices that followed provoked a reaction in the EU.

⁹⁹ See the Proposal for a Council Directive on administrative cooperation in the field of taxation, COM (2009) 29 final, OJ 2010 C 76/16.

¹⁰⁰ Council Directive 2011/16/EU, note 98 above.

¹⁰¹ Article 8(1) of the Council Directive 77/799/EEC, note 96 above.

¹⁰² This problem had an impact on the process of adopting the savings directive, as illustrated in the previous section.

¹⁰³ [The Liechtenstein Affair: German Banks Suspected of Helping Clients Evade Taxes, 21 February 2008, Spiegel Online International, available at http://www.spiegel.de/international/business/0,1518,536777,00.html](http://www.spiegel.de/international/business/0,1518,536777,00.html). The Liechtenstein tax affair refers to a string of tax investigations carried out by a number of states which suspected their citizens of tax evasion via banks or trusts in Liechtenstein. For example, tax investigators in Germany found evidence that some German financial institutions may have been engaged in tax evasion via foundations in Liechtenstein.

The new measure establishes time limits for the provision of information on request and other administrative enquiries. Information shall be provided as quickly as possible, and no later than six months from the date of receipt of the request. However, where the requested authority is already in possession of that information, the information must be transmitted within two months of that date.¹⁰⁴

The new Directive defines three types of information exchange. Exchange of information on request means a request made by a requesting Member State to a requested Member State in a specific case.¹⁰⁵ Automatic exchange means the systematic communication of predefined information to another Member State, without prior request, at pre-established regular intervals. Spontaneous exchange means the non-systematic communication, at any moment and without prior request, of information to another Member State.¹⁰⁶

The Directive also sets out a step-by-step approach to ensure mandatory automatic exchange of information for eight categories of taxes on income and capital. From 1 January 2014, Member States must automatically communicate information for a maximum of five categories, if that that information is available.¹⁰⁷ Before 1 July 2016, Member States must annually provide the Commission with statistics on the volume of automatic exchanges and, to the extent possible, with information on the administrative and other relevant costs and benefits relating to exchanges that have taken place and any potential changes, for both tax administrations and third parties. By 1 July 2017, the Commission will provide a report and, if necessary, a proposal for changes. The Council will examine such a proposal with the aim of removing the condition of availability and extending the number of categories from five to eight. As from 1 January 2017, the list of taxes on which information is exchanged would be extended to include taxes on dividends, capital gains and royalties.¹⁰⁸

¹⁰⁴ Article 5(1) of Council Directive 2011/16/EU, note 98 above.

¹⁰⁵ Article 3(8) *ibid.*

¹⁰⁶ Article 3(10) *ibid.*

¹⁰⁷ Article 8 *ibid.* This provision applies to income from employment, director's fees, life insurance products not covered by other Union legal instruments on exchange of information and other similar measures, pensions, ownership of and income from immovable property.

¹⁰⁸ Article 8(5)(a) *ibid.*

2.2.2. The Fiscal Merger Directive

The Fiscal Merger Directive¹⁰⁹ has a long history which spans from 1969 when the proposal for the Directive was presented until recent amendments.¹¹⁰ The aim of the Directive is to facilitate transnational reorganisations of companies. It provides for a common treatment applicable to asset mergers, divisions (where the dividing company is dissolved), partial divisions (where the dividing company survives and retains a branch of activity), transfers of assets, exchanges of shares and transfers of a registered office of a *societas europea* or a *societas cooperative europea*.

The Directive recognised that national tax regimes often discriminated against cross-border mergers in comparison with purely national transactions. Cross-border reorganisations could result in taxation of unrealised capital gains and tax-free reserves linked to transferred assets or exchanged shares. Simultaneously, the possibility of offsetting unexhausted losses from previous years related to the transferred business disappears.¹¹¹ Domestic reorganisations could usually take advantage of some sort of tax deferral or the possibility to carry-over unexhausted losses. This unfavourable approach towards cross-border mergers and acquisitions could cause distortions in the internal market, by discouraging cross-border reorganizations, and limit company expansions. For that reason, a measure securing tax neutrality in the internal market was necessary.

¹⁰⁹ 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 1990 L 225/1. This Directive was subject to extensive academic literature. See, for example: J M Cougnon, *The E.E.C. Merger and Parent-Subsidiary Directives of 23 July 1990 in Practice: Their Implementation in Belgium, France, Germany, the Netherlands and the United Kingdom*, (Bruxelles: Bruylant, 1992); D Weber, 'A Closer Look at the General Anti-abuse Clause in the Parent-Subsidiary Directive and the Merger Directive', (1996) 5:2 *EC Tax Review* 63-69; M Aurelio, 'An Analysis of the 2005 Amendments to the Merger Directive', (2006) 34:6-7 *Intertax* 333-352; R Russo and R Offermanns, 'The 2005 Amendments to the EC Merger Directive', (2006) 46:6 *European Taxation* 250-257; M Hofstaetter and D Hehenwarter, 'The Merger Directive', in M Lang, P Pistone, J Schuch and C Staringer, note 96 above, at 111-133; K Lozev, 'Survey of Implementation of the EC Merger Directive: a Summary with Comments', (2010) 50:2 *European Taxation* 3 84-95.

¹¹⁰ Council Directive 2005/19/EC of 17 February 2005 amending Directive 90/434/EEC 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 2005 L 58/19. As it was amended several times, the need for consolidation was established: see Council Directive 2009/133/EC on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States, OJ 2009 L 310/34.

¹¹¹ B J M Terra and P J Wattel, *European Tax Law*, (The Alphen aan den Rijn: Kluwer, 2008), p. 247.

The Merger Directive offers a solution only to short-term tax problems in relation to cross-border mergers and other reorganisations. It allows for a deferral of capital gains tax resulting from reorganisations. This is achieved by a roll-over of basis. In other words, the value of transferred assets, liabilities and shares is carried over for tax purposes. Member States have to refrain from taxing any capital gains realised by any reorganisation falling under the Directive. The acquiring company must include all the transferred assets and liabilities in its accounts. When the acquiring company later disposes of the transferred assets, a tax will be levied on the value difference between the disposal value and the original value. The long-term problems of transfrontier reorganisation are not dealt with by the Merger Directive. For instance, the Directive does not regulate the problem which may arise when shares are transferred to shareholders who will be subject to tax on the received dividends from a merger.

2.2.3. The Parent-Subsidiary Directive

The Parent-Subsidiary Directive¹¹² is said to have the most immediate influence on intranational transactions within the EU because it provides for comprehensive tax relief for dividend circulation between parent companies and their subsidiaries from different Member States.¹¹³ Before this Directive was adopted, tax relief for double taxation of dividend flows was governed by a network of bilateral tax treaties. However, they do not offer an ideal solution because they do not cover all bilateral relations between the Member States. They do not resolve issues arising in the context of triangular cases. A treaty is concluded between two parties and outlines rules for tax relationships between them. If a parent company sets up a subsidiary in a state with which its home state has no tax treaty, dividends transferred between this subsidiary and the parent company might be double taxed.

¹¹² 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 1990 L 225/6. For a detailed discussion on the parent-subsidiary directives see: F Vanistendael, 'Looking Back: a Decade of Parent-Subsidiary Directive-the Case of Belgium', (2001) *EC Tax Review* 10:3 154-164; J D B Oliver, 'The Parent-Subsidiary Directive of 23 July 1990: a United Kingdom Perspective', (2001) *EC Tax Review* 10:4 211-219; C Brokelind, 'The Proposed Amendments to the Parent-Subsidiary Directive: Some Progress?', (2003) *European Taxation*, 43:12 451-456; G Maisto, 'The 2003 Amendments to the EC Parent-Subsidiary Directive: What's Next?', (2004) *EC Tax Review* 13:4 164-181.

¹¹³ IBFD, W F G Wijnen, (coordinating author), *Survey of the Implementation of the EC Corporate Tax Directives*, (IBFD: Amsterdam, 1995), p. 360.

Taxation of dividend flows between Member States could become problematic when a subsidiary resident in one Member State distributes its profits to a parent company resident in another Member State. The state of the subsidiary could impose a withholding tax on outbound dividends whilst the home state of the parent company may include incoming dividends in the taxable income. In effect, double taxation of dividends occurs. Therefore, cross-border payments of dividends within a group of companies could be disadvantaged.

Through the Parent-Subsidiary Directive, the Member States agreed to abolish the potential impediments to cross-border transactions between qualifying parent and subsidiary companies. The Directive establishes a common system founded on the fact that intragroup cross-border profit distributions paid out by a subsidiary must be exempt from a withholding tax in the source Member State whilst the Member State of the recipient parent company must refrain from levying tax on the incoming dividends or having taxed incoming dividends, the Member State of the parent company must grant tax credit for the corporation tax paid by the subsidiary.

2.2.4. The Interest and Royalty Directive

In 2003, 13 years after the adoption of the Fiscal Merger Directive and the Parent-Subsidiary Directive, having seen the first proposal for a Directive on the interest and royalty payments in 1990 (withdrawn in 1994), the Council accepted a third legislative measure in the sphere of direct taxation.¹¹⁴ The Interest and Royalty Directive contributes to the elimination of double taxation of cross-border flows of income and assists in allowing EU-based groups to compete with non-EU based competitors.

¹¹⁴ Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ 2003 L 157/49. For a more in-depth presentation of this legislative measure see, *inter alia*: D Weber, 'The Proposed EC Interest and Royalty Directive', (2000) 9:1 *EC Tax Review* 15-30; S Raventós, 'On the Interest and Royalties Directive, or How an Espresso Measure Amy Become a Decaf One', (2000) 40:7 *European Taxation* 286-287, C Brokelind, 'Royalty Payments: Unresolved Issues in the Interest and Royalties Directive', (2004) 44:5 *European Taxation* 252-258; M Distaso and R Russon, 'The EC Interest and Royalties Directive: a Comment', (2004) 44:4 *European Taxation* 143-154; D Hristov, 'The Interest and Royalty Directive', in M Lang, P Pistone, J Schuch and C Staringer, note 96 above, at 135-149.

Unilateral laws coupled with international tax agreements attempted to eliminate double taxation. However, a more comprehensive EU instrument was necessary because national measures and bilateral tax treaties do not always abolish double taxation. For example, this occurs when a full tax credit¹¹⁵ is not granted for an incurred withholding tax. Moreover, the application of varying national laws or tax treaties by companies can involve burdensome administrative formalities. Additionally, even where full credit is granted for a paid withholding tax, the time gap between the payment of withholding tax in the source company and the actual date of receiving the tax credit in the receiving state may lead to cash flow difficulties. Consequently, the Directive appeared to have been a more successful solution to ensure that interest and royalty payments are subject to tax only once within the EU.

The Directive is established on the assumption that interest and royalty payments between associated companies residing in different Member States should not be treated less favourably than the same payments between companies of the same Member State. The Interest and Royalty Directive provides for an exemption¹¹⁶ from source state tax for interest and royalty payments. As such, it can be argued that this Directive constitutes a natural complement to the Parent-Subsidiary Directive.¹¹⁷ It is intended to enable associated companies from various Member States to benefit to a greater degree from the internal market by abolishing certain forms of double taxation.

2.2.5. The Savings Interest Directive

It should be first clarified that this Directive¹¹⁸ does not cover corporate taxation. It is, nevertheless, worth mentioning in this chapter for two reasons. First, it was

¹¹⁵ Tax credit is based on the fact that the state of residence of the recipient company gives this company credit against tax paid by a subsidiary in another state. When full tax credit is provided, the credit received equals the amount of tax paid by the subsidiary.

¹¹⁶ Tax exemption means that the source state of the paying company or its branch exempts from a withholding tax outbound payments made to an associated company or its branch in another Member State. See Article 1 of the Interest and Royalty Directive.

¹¹⁷ It has to be clarified that withholding taxes imposed on cross-border interest and royalty payments is less likely to cause a double taxation problem than withholding taxes on dividends.

¹¹⁸ Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, OJ 2003 L 157/49. This legislative measure provoked several comments from academia. See, for example: B Larking, 'Another Go at the Savings Directive: Third Time Lucky?', (2001) 10:4

adopted as part of the tax package which was composed of three elements, two of which dealt with corporate tax. The link between business and personal taxation in combating harmful tax competition was thus emphasised. Second, the Directive falls within the scope of direct taxation. It underlines the fact that progress in harmonising personal taxes has been even less successful than in business taxes.¹¹⁹ Thus, for a complete regulatory picture of direct taxation, the Savings Directive should not be neglected.

The Directive has its roots in the liberalisation of capital movements. This was facilitated by Directive 88/361/EEC.¹²⁰ Moreover, amendments to the Treaty after the Maastricht negotiations resulted in Article 63 TFEU¹²¹ establishing the free movement of capital within the EC including in relation to third countries. In addition, in 1999, the EU gained a common currency. As a consequence of these developments, there was a risk that income might remain unreported and, hence, untaxed in any of the Member States. A significant problem arose with respect to portfolio capital income. In order to eliminate these distortions, the Savings Directive was introduced. In essence, it aimed at effective taxation of cross-border interest payments in the state of residence of the beneficial owner. The goal was to discourage residents of the Member States from relocating their savings to other Member States or outside the EU for tax evasion purposes.

Under the Directive, ultimately, all Member States are expected to establish an exchange of information system. All Member States, apart from Belgium, Luxembourg and Austria, immediately introduced such a system of information

EC Tax Review 220-234; S Bell, 'EU Directive in the Taxation of Savings Income', (2001) 4 *British Tax Review* 261-272; S Bell, 'Updated Proposal for a Council Directive on the Taxation of Savings Income', (2002) 1 *British Tax Review* 32-41; S Bell, 'EU Directive on the Taxation of Savings Income', (2001) 4 *British Tax Review* 261-272; A J Martín Jiménez, 'Loopholes in the EU Savings Directive', (2006) 60:12 *Bulletin for International Taxation* 480-494; F Vanistendael, 'The European Interest Savings Directive: an Appraisal and Proposals for Reform', (2009) 63:4 *Bulletin for International Taxation* 152-162; C Panayi, 'The Proposed Amendments to the Savings Directive', (2009) 49:4 *European Taxation* 179-184; M Aujean, 'Savings Taxation: Is Automatic Exchange of Information Becoming a Panacea?', (2010) 19:1 *EC Tax Review* 2-3.

¹¹⁹ See Chapter 3, section 3.3., discussing limited successes in legislating on personal taxation. The core achievements were further absorbed and developed by the ECJ.

¹²⁰ Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, OJ 1988 L 178/5.

¹²¹ Previously, Article 56 TEC.

reporting. A transitional system was secured for Belgium, Luxembourg and Austria. Belgium ceased the transitional withholding tax as of 1 January 2010 and decided to exchange information as of that date. Therefore, currently only Luxembourg and Austria were entitled to impose a withholding tax at a rate of 15% for the first three years (until 30 June 2008), 20% until 30 June 2011 and 35% thereafter in place of the information exchange system. They transfer 75% of the revenue of this withholding tax to the investor's state of residence. The rate of the applied withholding tax increases with time to convince investors to declare their cross-border interest income in their residency state. Under the Savings Directive, Austria and Luxembourg should refrain from imposing withholding taxes when the individuals decide to opt for exchange of information. These two Member States are entitled to receive information from other Member States.

The implementation of the Directive was conditional on equivalent measures being concluded with selected third countries. This condition seems reasonable as the Directive would be ineffective if EU residents could circumvent the requirements of the Directive by transferring their savings outside the EU. The agreements for equivalent or similar measures were signed with five states (Andorra, Liechtenstein, Monaco, San Marino and Switzerland¹²²) and with ten dependent and associated territories (Aruba, Anguilla, Guernsey, Jersey, the Isle of Man, Cayman Islands, British Virgin Islands, Netherland Antilles, Montserrat, Turks and Caicos Islands). A conclusion can be drawn that investors are still able to evade taxes by shifting their income to banks in financial centres or tax havens which do not fall in the realm of

¹²² Agreement between the European Community and the Swiss Confederation providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, OJ 2004 L 385/30; Agreement between the European Community and the Principality of Andorra providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, OJ 2004 L 359/33; Agreement between the European Community and the Principality of Liechtenstein providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, OJ 2004 L 379/83; Agreement between the European Community and the Republic of San Marino providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, OJ 2004 L 381/32; Agreement between the European Community and the Principality of Monaco providing for measures equivalent to those laid down in Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, OJ 2005 L 019/53.

the Directive and its related agreements.¹²³ The existence of jurisdictions not ensuring a minimum level of taxation or an exchange of information on income paid to non-residents undermines the positive outcomes of the Directive.

2.2.6. The Arbitration Convention

In the light of its legal form, the Arbitration Convention¹²⁴ does not entirely qualify to be discussed in this section. However, the Arbitration Convention should be mentioned here for a comprehensive picture of achievements in influencing national direct taxation. As stated, an inaugural proposal regarding arbitration procedures in transfer pricing disputes had the shape of a directive.¹²⁵ The White Paper from 1985 also referred to this proposal.¹²⁶ As a directive, this measure was designed to be a counterpart to the Mutual Assistance Directive. It was expected that more intense information exchange would result in more frequent cases of double taxation.¹²⁷ Nevertheless, after long negotiations in the Council, the Commission proposal was transformed into an intergovernmental Convention and it was signed in July 1990.

Multinational companies may encounter problems with double taxation resulting from price adjustments of cross-border transactions by tax authorities. Fundamentally, cooperation between associated companies is regarded as structured in a different fashion from transactions concluded between non-associated companies. When transactions are carried out by the associated enterprises, the

¹²³ The most frequently mentioned examples of places where investors could redirect their income are Hong Kong, Dubai, Panama, Singapore and Macao. See: T Hemmelgarn and G Nicodème, *Tax Co-ordination in Europe: Assessing the First Years of the EU-Savings Taxation Directive*, CESIFO Working Paper No. 2675, June 2009, available at <http://www.ifo.de/portal/pls/portal/docs/1/1186252.PDF>.

¹²⁴ Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, OJ 1990 L 225/10. For a comprehensive analysis of this regulatory instrument see: D R Tilinghast, 'Issues in the Implementation of the Arbitration of Disputes Arising under Income Tax Treaties', (2002) 56:3 *Bulletin for International Taxation* 90-99; P Adonnino, 'Some Thoughts on the EC Arbitration Convention', (2003) 43:11 *European Taxation* 403-408; O Rouselle, 'The EC Arbitration Convention: an Overview of the Current Position', (2005) 45:1 *European Taxation* 14-18; P Plansky, 'The EC Arbitration Convention', in M Lang, P Pistone, J Schuch and C Staringer, note 96 above, at 175-185; M van Herksen, 'How the Arbitration convention Lost its Lustre: the Threat of Triangular Cases', (2008) 36:8-9 *Intertax* 332-345.

¹²⁵ Proposal for a Council Directive establishing an arbitration procedure, note 61 above.

¹²⁶ See Chapter 2, section 2.1.2.2.

¹²⁷ A Lahodny-Karner, 'Transfer Pricing, Mutual Agreement Procedure and EU Arbitration Procedure', in W Gassner, M Lang, E Lechner (eds.), *Tax Treaties and EC Law*, (London, the Hague, Boston: Kluwer, 1997), 187-210 at 188.

conditions of the transaction can be shaped by forces other than market forces. Transfer prices are applicable between associated companies to allocate profits in a state with a more favourable tax system. Thus, the process of transfer pricing creates the risk of undermining national tax revenues. As a consequence, tax administrations scrutinise cross-border transactions to ensure that they receive their fair share of the tax base.

To establish the correct price of a cross-border transaction between related enterprises, national tax authorities utilise the arm's length principle.¹²⁸ Under this principle, the price of a transaction between associated companies should reflect conditions that independent companies would apply in a similar situation.¹²⁹ The process of establishing an acceptable arm's length price is not automatic. There is no guarantee that an upward adjustment of profit in one state would be matched by a downward adjustment in another state. If this does not happen, double taxation of part of the profit is possible. The main goal of the Convention is the elimination of double taxation resulting from profit adjustments by tax authorities in one Member State without corresponding adjustments carried out in another Member State. It provides a foundation for arbitration in unresolved transfer pricing disagreements between national tax authorities.

As regards the legal basis of the Convention, it was adopted on the ground of Article 293 TEC, repealed after the Lisbon Treaty. This provision read that Member States shall, so far as was necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals the abolition of double taxation within the EU. As Article 293 TEC constituted the legal foundation for the adoption of the Convention, the Convention is not an EU law instrument. It represents an example of an international law measure. It can be suggested that the core reason for the change of the legal form of the instrument in question was the reluctance of the Member States to compromise their tax sovereignty. In the case of a directive, Member States

¹²⁸ M O'Shaughnessy, J Banach, S Lebda, A Reszka, K Szydłowska and P Wiewiórka, *Ceny transferowe*, (Warszawa: C.H.Beck, 2003), p. 4.

¹²⁹ S Sojak and D Baćkowski, *Ceny transferowe. Aspekt podatkowy*, (Warszawa: Dom Wydawniczy ABC, 2003), p. 29.

abandon a larger number of sovereign rights than in the case of a multilateral agreement.¹³⁰

The Convention confers no interpretative jurisdiction on the ECJ and does not allow it to develop comprehensive and consistent case law in this sphere. The final interpreters of the Convention are national judges. There is therefore a risk that various interpretations of the Convention are possible. The possibility of incoherent interpretation was one of the reasons for establishment of a joint transfer pricing forum.¹³¹ This forum was entrusted with producing recommendations and non-legislative solutions to practical problems posed by transfer pricing practices in the EU. On the basis of the recommendations, the Council endorsed a Code of Conduct for the Effective Implementation of the Arbitration Convention in 2004.¹³² In 2006, a Code of Conduct which aims at standardising the documentation that multinationals must provide to tax authorities on their pricing of cross-border intra-group transactions¹³³ was prepared.

2.3. Modifying the hard law approach: a chance for the CCCTB?

2.3.1. Beyond uniform hard law

The dawn of new governance in the EU¹³⁴ and reflection on the difficult path of harmonisation through directives brought about changes in approach to the regulation of direct taxation. A new tax policy was set out by the Commission in a 2001 Communication.¹³⁵ It expresses that there is no need to harmonise Member States' tax systems but that greater tax coordination is nonetheless necessary.¹³⁶ While, in the Commission's view, a move to qualified majority voting, at least for

¹³⁰ A Lahodny-Karner, note 127 above, at 188.

¹³¹ Information on the Joint Transfer Pricing Forum available at

http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm.

¹³² Code of Conduct for the Effective Implementation of the Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, OJ 2006 C 176/8.

¹³³ Resolution of the Council and of the Representatives of the Governments of the Member States of 20 June 2006, Meeting within the Council of on a Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the European Union (EU TPD), 9738/06 FISC 74 OC 405.

¹³⁴ See Chapter 1, section 1.5.3. for an overview of the origins of new governance in the EU.

¹³⁵ Communication of 23 May 2001 from the Commission to the Council, the European Parliament and the European Economic and Social Committee on *Tax Policy in the European Union: Priorities for the Years Ahead*, COM (2001) 260 final.

¹³⁶ *Ibid.*, at 8.

certain tax issues, is essential, unanimity still remains.¹³⁷ Given the difficulties in reaching unanimous decisions on legislative proposals, which have been compounded by recent EU enlargements, the EU started to consider the use of alternative instruments as a basis for initiatives in the tax field.

The Communication highlights that the Commission traditionally relied on proposing directives or regulations as a way of achieving progress in the field of direct taxation. These two legislative instruments are said to provide legal certainty. However, the hard law approach had not been successful.¹³⁸ Its disappointing outcome gave rise to debates about the range of policy instruments which could be applied in governing national tax regimes. The Communication openly admits that soft legislation may be an additional means of making progress in the direct tax field.¹³⁹ Instruments such as communications, recommendations, guidelines and interpretative notices can provide guidance to Member States on the application of the Treaty principles and promote the removal of impediments to the internal market. Additionally, the 2001 Communication drew attention to enhanced cooperation.¹⁴⁰ Enhanced cooperation was regarded as a suitable method to produce benefits for participating countries so that non-participants would then be motivated to become involved.

The approach of the Commission after 2001 is driven by the realisation that pure, traditional hard law solutions cannot resolve all direct tax problems. Directives, securing uniformity and centralising regulatory solutions, are valuable but not achievable at all times. The EU appears to understand the necessity of opening up alternative paths of integration and the need to adjust the traditional Community Method of regulation to specific direct tax circumstances. In effect, a more nuanced picture of EU law develops by recognising the significance of accepting the broader context within which EU law functions. The soft law perspective or the recognition

¹³⁷ See Chapter 1, section 1.4.2.1. analysing the Treaty provisions relevant to the harmonisation of direct taxes.

¹³⁸ Communication *Tax Policy in the European Union: Priorities for the Years Ahead*, note 135 above, at 20. See also Chapter 2, sections 2.1. and 2.2.

¹³⁹ Communication *Tax Policy in the European Union: Priorities for the Years Ahead*, note 135 above, at 22.

¹⁴⁰ *Ibid.*, at 23.

of the potential of enhanced cooperation may enable greater effectiveness of a legal system, whilst redefining the well-established understanding of law.

2.3.2. Enhanced cooperation

Enhanced cooperation came into existence from discussions prior to the Treaty of Amsterdam about deeply rooted differences among the Member States about the pace and direction of European integration.¹⁴¹ It is a manifestation of the acknowledgement that the traditional hard law approach commonly used by the EU, inclined towards uniformity of treatment and policies coming down from the central level of the regulatory structure, and not allowing for the exercise of discretion by those to whom the policies in question apply, may require rethinking in the context of increasingly complex relations within the Union.

The procedure of enhanced cooperation must be adopted only as a last resort when the objectives of such cooperation cannot be attained within a reasonable period by the EU as a whole.¹⁴² It enables at least nine Member States that wish to establish closer cooperation in areas covered by the Treaties, with the exception of fields where the EU has exclusive competence, to do so even when other Member States are not ready to proceed with closer integration. In the context of direct taxation, it means that if there is not unanimous agreement for EU direct tax legislation, enhanced cooperation is a way of facilitating closer cooperation between those Member States that are ready to progress integration, without restricting the tax sovereignty of non-participating Member States.

Measures adopted as a result of enhanced cooperation are not considered to constitute part of EU *acquis communautaire*.¹⁴³ Moreover, non-participating Member States can influence the procedure of enhanced cooperation because they must be allowed to take part in debates leading to the adoption of legislation; however, they

¹⁴¹ D Chalmers, G Davies and G Monti, *European Union Law*, 2nd ed., (Oxford: Oxford University Press, 2010), p. 113.

¹⁴² Article 20(2) TEU.

¹⁴³ Article 20(4) TEU.

are not permitted to vote.¹⁴⁴ Non-participating Member States can decide to join the cooperation process later.¹⁴⁵

As indicated, requirements which have to be met before enhanced cooperation is established are detailed. This does not come as a surprise that the enhanced cooperation provisions have not been extensively applied. As of March 2011, enhanced cooperation has been authorised in two areas: divorce law and patent law.¹⁴⁶ The next section outlines that enhanced cooperation in relation to direct taxation has been proposed, however, and is currently being considered.

It should be emphasised that the idea of enhanced cooperation incorporated into the field of direct taxation does not necessarily signify the abandonment of regulation through hard law instruments. With regard to enhanced cooperation in the field of EU patent, the Commission adopted a proposal for a Council Regulation¹⁴⁷ which falls into the category of hard law measures. Consequently, enhanced cooperation in direct taxation might also produce a hard law regulatory measure. Nevertheless, greater flexibility and voluntarism in EU direct tax integration with regard to traditional legislative instruments seem to be more openly accepted by the Commission. In other words, a direct tax hard law instrument associated with the enhanced cooperation vehicle suggests a compromised hard law approach.

2.3.3. Common Consolidated Corporate Tax Base: the latest Directive proposal

The possibility of applying enhanced cooperation to the field of direct taxes arises in respect of the proposal for the CCCTB for EU-wide company activities. Ideas about a common tax base surfaced in 1988 to match the 1975 proposal for harmonised tax rates. Having a common tax base and common tax rates with shared systems would

¹⁴⁴ Article 20(3) TEU.

¹⁴⁵ Article 331 TFEU.

¹⁴⁶ A First in EU History: Enhanced Cooperation to Help International Couples is in Force, 05 August 2010, IP/10/1035, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1035>. Patents: Commission Opens the Way for Some Member States to Move Forward on a Unitary Patent, IP/10/1714, 14 December 2010, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1714>.

¹⁴⁷ Proposal for a Council Regulation implementing enhanced cooperation in the area of the creation of unitary patent protection with regard to the applicable translation arrangements, COM (2011) 16 final.

ensure little difference between the corporate tax systems of various Member States.¹⁴⁸ A draft proposal for the harmonisation of the tax base of enterprises was never transformed into a formal draft directive due to the reluctance of most Member States.

The EU returned to the idea of a common tax base for multinational companies in the 2000s. The CCCTB was considered to offer a solution to issues of transfer pricing problems and to reduce the cost of compliance with 27 varying tax systems. It was also expected to enhance tax transparency.¹⁴⁹ The Commission embarked on a project to submit a legislative proposal for the CCCTB by 2008.¹⁵⁰ In September 2008, however, it announced a delay in releasing the highly anticipated proposal. According to Commissioner Kovács, the CCCTB project was postponed because some technical aspects required more work and consideration.¹⁵¹

While this explanation provides an official justification, the political context should not be disregarded. The Irish no-vote over the Lisbon Treaty in June 2008 showed that, in Ireland, there was no political support for the tax harmonisation agenda. It was claimed that a common tax base would bring about ideas for the harmonisation of corporate tax rates which are an important element of Irish tax sovereignty. In light of these events, the Commission might have not wanted to take any risks pending a second referendum in Ireland.¹⁵²

¹⁴⁸ M Deveraux and M Pearson, 'Harmonising Corporate Taxes in Europe', (1990) 2:1 *Fiscal Studies* 21-35 at 30.

¹⁴⁹ K Andersson, 'An Optimal Common Consolidated Corporate Tax Base in the European Union', in K Andersson, L Eberhartinger and L Oxelheim (eds.), *National Tax Policy in Europe: to Be or Not to Be?*, (Berlin, Heidelberg, New York: Springer, 2007), 85-119 at 98-99,

¹⁵⁰ L Kovács, Speech at the official dinner organised by the Chartered Tax Advisers in London, 28 September 2006, p.2, available at <http://old.tax.org.uk/showarticle.pl?id=4842>.

¹⁵¹ L Kovács, Keynote speech at the Congress of the International Fiscal Association, 31 August 2008, p. 3, available at http://ec.europa.eu/taxation_customs/resources/documents/common/about/speeches/2008/speech_kovacs_brussels_310808_en.pdf.

¹⁵² Commissioner McCreevy expressed his opposition to the CCCTB plan: <http://www.independent.ie/business/irish/mccreevy-slams-ec-hidden-tax-plan-655022.html>. Some Irish businesses were also against the CCCTB idea in the EU. See: More Irish Pressure against CCCTB, available at <http://www.charteredaccountants.ie/General/News-and-Events/News1/2007/April/More-Irish-Pressure-against-CCCTB-/>.

The idea of introducing a common tax base in the EU has recently been revived. The proposal for a Directive was tabled in March 2011. This is unsurprising given that the Taxation and Customs Union, Audit and Anti-Fraud Commissioner, Algirdas Šemeta, has always been in favour of a harmonised corporate tax base.¹⁵³ In accordance with the Treaty, the Commission proposed a legislative instrument for all Member States. The Commissioner noted that both academics and companies support the measure.¹⁵⁴ Despite the Commission's emphasis on the fact that the CCCTB project does not imply harmonisation of corporate tax rates, the proposal is controversial.¹⁵⁵ Concerns have been raised that a harmonised EU tax base would have to be followed by harmonisation of tax rates because harmonised tax bases would shift tax competition towards tax rates.¹⁵⁶ In particular, the Irish have long lobbied against the proposal. The UK has also consistently stated publicly that it would not join any CCCTB system as this would undermine its sovereignty in tax matters.¹⁵⁷

¹⁵³ Written reply by the Commissioner-designate, Algirdas Šemeta, to the European Parliament questionnaire, p. 5. The answers are available at http://www.europarl.europa.eu/hearings/static/commissioners/answers/semeta_replies_en.pdf.

¹⁵⁴ European Corporate Tax Base: Making Business Easier and Cheaper, 16 March 2011, available at http://ec.europa.eu/commission_2010-2014/semeta/multimedia/videos/index_en.htm.

¹⁵⁵ See a report from Ernst and Young prepared for the Irish Business and Employers Confederation. This study is critical of the CCCTB. It is claimed that a harmonised tax base would have an increasing effect on the level of effective corporate tax rates. Ernst and Young, *Common Consolidated Corporate Tax Base: a study on the impact of the Common Consolidated Corporate Tax Base proposals on European business taxpayers*, January 2011, available at [http://www.ibec.ie/IBEC/DFB.nsf/vPages/Economics_and_taxation~Key_issues~common-consolidated-corporate-tax-base-%28ccctb%29-08-06-2011/\\$file/E&Y%20CCCTB%20Report%20Jan%202011.pdf](http://www.ibec.ie/IBEC/DFB.nsf/vPages/Economics_and_taxation~Key_issues~common-consolidated-corporate-tax-base-%28ccctb%29-08-06-2011/$file/E&Y%20CCCTB%20Report%20Jan%202011.pdf) [http://www.ibec.ie/IBEC/DFB.nsf/vPages/Economics_and_taxation~Key_issues~common-consolidated-corporate-tax-base-\(ccctb\)-07-02-2011/\\$file/E&Y%20CCCTB%20Report%20Jan%202011.pdf](http://www.ibec.ie/IBEC/DFB.nsf/vPages/Economics_and_taxation~Key_issues~common-consolidated-corporate-tax-base-(ccctb)-07-02-2011/$file/E&Y%20CCCTB%20Report%20Jan%202011.pdf). On the other hand, two official studies prepared for the Commission by the PwC and Deloitte found that the CCCTB would translate into substantial savings in compliance time. Deloitte, *Expert study on the corporate tax compliance costs for businesses going EU cross border – comparison under the current regime, the CCTB and the CCCTB regime*, 13 November 2009, http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/ccctb/deloitte.pdf. PwC, *Impact of corporate income tax reforms at the EU level on European business taxpayers Report on the impact on taxable profits*, 9 July 2008, http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/ccctb/pwc_taxable.pdf.

¹⁵⁶ C Spengel, 'Common Corporate Consolidated Tax Base- Don't Forget the Tax Rates!', (2007) 16:3 *EC Tax Review* 118-120 at 118-119.

¹⁵⁷ See a negative opinion of the UK Government on the CCCTB directive proposal. Cover note from the Clerk of the UK House of Commons to the President of the Council of the European Union of 12 May 2011, 10247/11 FISC 61 INST 245 PARLNET 140.

The Directive proposal sets out a single system for determining the taxable profit of a group of companies on a consolidated basis. Companies will be free to opt in to the CCCTB regime but must do so for a minimum of five years and the option will apply to all their qualifying subsidiaries. Once profit has been determined, it will be apportioned to the Member States in which the particular group operates based on three factors: payroll (amount spent and number of employees), sales and assets employed.

It remains very unlikely that all Member States will vote in favour of the CCCTB. If the Council cannot reach unanimous agreement, Commissioner Šemeta commented that the Commission would consider presenting a proposal for a group of Member States under enhanced cooperation, the measure of last resort in assisting the CCCTB proposal. The possibility of using the enhanced cooperation mechanism in the process of adopting the CCCTB shows little faith that a uniform directive accepted by all Member States can be achieved but, as such, probably reflects a pragmatic perception of direct tax integration.

Traditional hard law directives for direct taxation may be a thing of the past if the unanimity requirement is maintained as it leads to deadlock in decision-making. The latest Directive proposal is supported by the opportunity to employ the enhanced cooperation mechanism. It indicates that lessons have started to be drawn from the disappointing history of direct tax integration. Regulation through directives has not been successful. Some amendments are needed in the structuring of these regulatory measures. It can be argued that enhanced cooperation is situated between traditional uniform hard law directives and soft law instruments. It combines aspects of both approaches.

On the one hand, enhanced cooperation is related to a directive, a regulatory instrument offering a standardised solution. However, cooperation established through enhanced cooperation provides regulation only for interested states. Similarly to soft law, enhanced cooperation supports the voluntary decisions of the states as to whether to participate in given regulation or not. It will be shown that the middle solution of enhanced cooperation does not constitute the only regulatory

option for the EU. Chapter 3 establishes that, partially, jurisprudence took over the role of regulating direct taxes in the EU. Moreover, soft law has been explored since 1997, as presented in Chapter 4. The regulatory arsenal of the EU has diversified.

2.4. Assessing the failure of the conventional hard law approach

2.4.1. Why hard law failed

One might ask why hard law solutions were unsuccessful in the context of direct tax regulation. A combination of the unanimity requirement in voting over direct tax proposals and the great diversity of national tax systems, paired with the Commission being imperious and not consulting the Member States, can be indicated as the major stumbling blocks. Regardless of how extensive or limited harmonisation proposals were, all Member States had to agree for (the elements of) national taxes to be aligned at EU level. The Community Method and hard law require uniform solutions to be adopted by all Member States. One Member State is sufficient to block a development seen by the Commission as necessary to reach Union goals and that the Parliament is ready to back. Taking into account the great diversity of national tax regimes,¹⁵⁸ it is difficult to decide which solution will be most keenly accepted by all Member States. Member States express various social and political traditions through choices in their tax systems. Unanimity can be problematic to attain.

Moreover, with the increasing number of Member States, reaching a unanimous decision has become even more challenging. The Commission realises that retaining unanimity for all taxation decisions will make it difficult to achieve any coordination necessary for Europe and has made proposals to move towards QMV in certain tax areas. The voting rules have not been modified.

¹⁵⁸ This was mentioned in reference to the changes in proposals for a common tax system since the 1960s. For a comprehensive examination of differences between national tax systems see: Structures of the Tax Systems in Poland, Hungary, the Czech Republic and Slovenia: Final Report, available at http://ec.europa.eu/taxation_customs/resources/documents/tax_sys_est_pol_hu_en.pdf; Taxation Trends 2011 in the European Union, available at http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_structures/2011/report_2011_en.pdf.

Difficulties in harmonising direct taxation through directives could also stem from the fact that the EU achieved a high level of harmonisation of indirect taxes. This process meant a serious change going beyond a simple alteration of features of existing tax systems. For the Member States, except for France, the adoption of VAT implied replacing turnover taxes with a new type of an indirect tax.¹⁵⁹ VAT entailed a transformation of national systems and a far-reaching transfer of powers. This development could have made Member States more cautious about harmonisation of direct taxes. When losing regulatory influence in one sphere, they could become more protective of their sovereignty in the direct taxes sphere.

2.4.2. The future of hard law regulation

At the current level of European integration, directives are bound to fail. What has been achieved so far is valuable because the abolition of double taxation of cross-border activities has been attempted and thus encourages inter-EU transactions. Member States agreed to these directives which were restricted in scope because they could see benefits for their economies and the sacrifice of tax sovereignty was not too extensive. They were also convinced by the Commission's assertions that the plans were necessary and within the requirements of subsidiarity.

Further progress in harmonising direct taxation through a pure hard law approach seems unlikely. After tackling double taxation of intranational transactions, the next step in the process of aligning national tax systems would be harmonising tax bases or tax rates. This does not appear possible because some Member States may perceive harmonised tax bases or tax rates as a step too far. Admittedly, the proposal for the CCCTB directive was published. However, although the proposal exists, not much hope is put into realising this project via the traditional route. It is already expected that unanimous agreement will not be reached. Enhanced cooperation is already being considered as an alternative to the uniform application of a CCCTB directive.

¹⁵⁹ It is unnecessary to explain thoroughly why cumulative turnover taxes were found harmful for the intra-EU trade. Suffice to say that VAT system was considered less distortive.

The enhanced cooperation mechanism positions collaboration on the CCCTB between a fully-fledged, homogenous solution of traditional directives and non-legally binding soft governance. The traditional way of regulation through directives means that a directive becomes a source of EU law for all Member States. It only leaves discretion as to how a directive is implemented. Non-implementation of a directive can result in state liability. Soft regulation, on the other hand, does not create legal obligations but only suggests certain behaviours. Enhanced cooperation allows for a directive not to become a source of law for all Member States but only for those that want to participate. Thus, enhanced cooperation alters the nature of the regulation by directive.

It is clear that the hard law approach to direct taxation, founded on unanimity, is at a standstill. A turn to other regulatory modes might be desirable or even necessary for any progress to be achieved. The EU seems to have started to come to terms with the fact that directives in the area of direct taxes might have run their course. Modifications in the regulatory approach are needed. Enhanced cooperation presents only one of the possibilities to modify hard law. As shown in Chapters 3 and 4, regulation via direct tax case law and the soft law approach also diversify the regulatory framework for direct taxation.

Conclusions

This chapter presented the EU direct tax directives. On the basis of the overview of these regulatory measures, two conclusions can be drawn. First, the number of adopted directives indicates a disappointing outcome for EU attempts to harmonise direct tax regimes. Second, these directives do not form a comprehensive framework.¹⁶⁰ The restricted substantive scope of the directives means that they tackle individual, separate problems and do not create a systematic solution. Bearing in mind the early ambitions of the Commission to introduce a harmonised corporate tax *system*, what has been achieved thus far looks like a failure of the hard law approach. In general, tax sovereignty has not been extensively restricted by traditional hard law measures.

¹⁶⁰ This framework is incomplete because, for example, the problem of losses has not been resolved through a directive. See Chapter 2, section 2.1.1.5.

Chapter 3 proceeds to examine the second element of hard law regulation. It focuses on influential direct tax case law. Effectively, Chapter 3 contrasts achievements in regulating direct tax through jurisprudence with the limited legislative framework presented in this chapter.

CHAPTER 3. COMPLETING THE HARD LAW REGULATORY PUZZLE: AN EXPLORATION OF THE ECJ'S CASE LAW ON DIRECT TAXATION AND THE FUNDAMENTAL FREEDOMS

Introduction

Perhaps as the first person to do so, Van Raad reached a conclusion that the Treaty provisions on free movement¹ could protect against domestic tax measures.² Since 1986,³ the ECJ has decided numerous cases involving various aspects of the Member States' direct tax systems.⁴ The Court has found that, as a rule, when no harmonising instruments are adopted, the regulatory power to allocate taxation rights rests with the Member States. They have the power to determine criteria to impose direct taxes.⁵ However, this freedom is not absolute. Restrictions are imposed by the scope of the fundamental freedoms.⁶ Moreover, the free movement provisions operating with regard to direct taxes have been generously interpreted by the Court.

¹ Articles 45, 49, 56, 63 TFEU. These were outlined in Chapter 1, section 1.4.2.3. An introduction to the issue of the internal market and the significance of the fundamental freedoms were laid out in Chapter 1, section 1.1.1.

² K Van Raad, 'Non-discrimination', (1981) 1 *British Tax Review* 43-48; K Van Raad, 'Revisiting a 1981 Perspective on EC Non-discrimination rules in Income Tax Matters', (2006) 2 *British Tax Review* 318-321 at 318.

³ In 1986, Case 270/83 *Commission of the European Communities v French Republic* [1986] ECR 273 was decided. It is considered to be the first direct tax case of the ECJ. Some authors draw attention to Case 6/60 *Humblet v Belgian State* [1960] ECR 559 as the first direct tax judgment, e.g. T O'Shea, 'Freedom of Establishment Tax Jurisprudence: *Avoir Fiscal* Re-visited', (2008) 17:6 *EC Tax Review* 259-275 at 260. In brief, Community officials' salaries were exempt from Member States' direct taxation. They were taxed by the Community and that charge constituted a part of the Community budget. Contrary to this arrangement, Belgian tax provisions amounted to tax imposition on the Community officials' salary. According to the ECJ, these rules were against the Protocol on the Privileges and Immunities of the ECSC Treaty. Thus, Belgium intruded upon the taxing powers of the Community. Direct tax jurisprudence decided on grounds of the fundamental freedoms, unlike *Humblet*, does not advance claims of EU competence to impose direct taxes. They attempt to reconcile the non-harmonised field of direct taxes with the principles underpinning the EU legal system. Hence, *Humblet* falls more comfortably within a group of cases dealing with problems of implementation and application of direct tax directives. As a result, *Humblet* is not of primary relevance for this chapter because the case did not discuss a relationship between national tax measures and the fundamental freedoms. Consequently, the *Avoir Fiscal* case is considered to be the case that opened a new chapter in EU direct tax law developments.

⁴ Its work has spurred considerable interest among scholars. For references see: note 196 in Chapter 1.

⁵ Case C-336/96 *Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas-Rhin* [1998] ECR I-2793, paragraph 53 states that allocation of taxation rights falls within the scope of national tax sovereignty.

⁶ Case C-279/93 *Finanzamt Köln-Altstadt v Roland Schumacker* [1995] ECR I -225, paragraph 21.

Interactions between national direct tax rules and the founding principles of the EU constitute a challenging area for the ECJ to deliver judgments because of high political sensitivity of the subject. These dilemmas amounted to the creation of a complex legal framework through which the ECJ demarcates the limits of national tax autonomy and EU interests.

The main objective of this chapter is to demonstrate how regulatory power over direct tax systems has been exerted. In order to achieve this goal, the chapter is structured as follows. Section 3.1. uncovers what principles guide the ECJ when striking a balance between the Member States' tax autonomy and the interests of the EU. Building on examples from case law, the discrimination approach and the market access approach are explained. Subsequently, the investigation centers on the question as to where tax sovereignty limits lie in an EU striving for the internal market. An assessment of the compromise found between national and EU interests regarding direct taxes is offered.

Section 3.2 places direct tax jurisprudence in the broader context of EU tax regulation. Interconnections with other regulatory measures are investigated. It is shown that direct tax jurisprudence is not a futile exercise. On the contrary, it plays a primary role in current developments within European tax regulation. Direct tax jurisprudence has been a source of inspiration for a range of activities within the Commission and is entwined with soft law regulatory instruments. With the help of some statistical evidence, section 3.3. highlights the considerable influence of the ECJ on national direct tax systems.

From a broad range of direct tax cases, this chapter concentrates only on a selection of cases. Attention is paid to cases relating to direct taxation and the fundamental freedoms of EU law. Thus, judgments of the Court concerned with harmonised aspects of national direct tax systems⁷ are disregarded.⁸

⁷ Examples of secondary tax law cases include the following: cases concerned with the Parent-Subsidiary Directive are: Joined Cases C-283/94, C-291/94 and C-292/94 *Denkavit International BV, VITIC Amsterdam BV and Voormeer BV v Bundesamt für Finanzen* [1996] ECR I-5063; Case C-58/01 *Océ Van der Grinten NV v Commissioners of Inland Revenue* [2003] ECR I-9809. Judgments based on the Parent-Subsidiary Directive and the fundamental freedoms are, for instance: Case C-284/06

3.1. In search of the balance between tax sovereignty and the internal market

What tax measures, creating obstacles to the internal market, are unacceptable under the Treaty? Are there tax obstacles that the Court excluded from its regulatory influence? To answer these questions of how the Court, on a case-by-case basis, demarcated a line between national tax sovereignty and internal market freedoms, it is essential to draw on examples from case law.

There are two key features that can be distilled from direct tax jurisprudence. First, it is commonly agreed that direct tax case law has developed in waves.⁹ These developments would seem to follow the pattern of the general internal market case law where the ECJ established two parallel meanings of the fundamental freedoms. It set out interpreting the fundamental freedoms using the pure discrimination approach¹⁰ and moved towards the non-discriminatory restriction principle.¹¹

A closer investigation of direct tax case law reveals that this division of developments is rather simplified. In the context of direct tax jurisprudence, it remains unclear whether the ECJ adopted both the non-discrimination and the obstacle approaches. The initial period of adjudicating in direct tax cases was dominated by the discrimination approach, already well-developed in non-tax jurisprudence. However, later, the ECJ did not go as far as in general cases where the

Finanzamt Hamburg-Am Tierpark v Burda GmbH [2008] ECR I-04571 or Case C-303/07 *Aberdeen Property Fininvest Alpha Oy* [2009] ECR I-5145. An example of a case on the Fiscal Mergers Directive is Case C-321/05 *Hans Markus Kofoed v Skatteministeriet* [2007] ECR I -5795. The Mutual Assistance Directive along with the fundamental freedoms was a legal basis for: Case C-451/05 *Européenne et Luxembourgeoise d'investissements SA (ELISA) v Directeur général des impôts and Ministère public* [2007] ECR I-8251; Case C-318/07 *Hein Persche v Finanzamt Lüdenscheid*, [2009] ECR I-359.

⁸ Cases concerning the interpretation of national tax laws in relation to secondary tax law are not as common as cases on the relationship of direct tax measures and the free movement principles. Nevertheless, these cases, lately, have become more frequently referred to the ECJ by national courts and tribunals.

⁹ Hinnekens spoke of two generations in the application of the Treaty principles to direct taxation. Discriminatory cases belong to the first generation of direct tax jurisprudence. The second generation of direct tax cases is related to non-discriminatory restrictions of the internal market See: L Hinnekens, 'The Search for the Framework Conditions of the Fundamental EC Treaty Principles as Applied by the European Court to Member State's Direct Taxation', (2002) 11:3 *EC Tax Review* 112-119 at 113-115.

¹⁰ This is occasionally referred to as the market equality test. G Bizoli, 'Balancing the Fundamental Freedoms and Tax Sovereignty: Some Thoughts on Recent ECJ Case Law on Direct Taxation', (2008) 40:3 *European Taxation* 133-140 at 133.

¹¹ This is also called the market access test. *Ibid.*, at 133.

concept of market access was adopted and applied to a greater extent than in direct tax jurisprudence.¹² In that respect, the recent approach of the ECJ to direct tax hindrances is less stringent from the Member State perspective than in other fields.¹³ The second characteristic of direct tax cases is the limited force of the invoked justifications of measures violating EU law. In the majority of cases in which the ECJ found that national tax rules had breached internal market principles, the Member State defences of these rules were not accepted by the Court. In an overwhelming majority of cases, the ECJ declared elements of national tax systems to have been non-compliant with EU law.

3.1.1. The discrimination approach: its legal foundation and meaning

Non-discrimination is a cornerstone of European integration that emanates from the Treaty. The prohibition of discrimination is not expressed in just one specific provision of the Treaty. Article 18 TFEU expresses the principle of non-discrimination on grounds of nationality.¹⁴ This provision is of a general nature and is not relevant in direct tax cases regarding discriminatory measures because of its residual character. It is applicable only when the Treaty does not set out more specific expressions of the non-discrimination principle.¹⁵ Subsequently, the provisions on the fundamental freedoms constitute *leges specialis* of the general principle of non-discrimination on grounds of nationality.

¹² The origins of the market access approach in general case law lie in the free movement of goods. See: Case 120/78 *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein* [1979] ECR 469, hereinafter the *Cassis de Dijon* case. This approach spilled over to other fundamental freedoms. With regards to the free movement of workers, see Case C-415/93 *Union royale belge des sociétés de football association ASBL v Jean-Marc Bosman, Royal club liégeois SA v Jean-Marc Bosman and others and Union des associations européennes de football (UEFA) v Jean-Marc Bosman* [1995] ECR I-4921. Case C-55/94 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165, concerns the freedom of establishment and Case C-76/90 *Manfred Säger v Dennemeyer & Co. Ltd* [1991] ECR I-422 is concerned with the free movement of services. Some argue that the ECJ applied the market access approach even as early as the *Dassonville* case (Case 8/74 *Procureur du Roi v Benoît and Gustave Dassonville* [1974] ECR 837). J Snell, 'The Notion of Market Access: a Concept or a Slogan?', (2010) 47:2 *Common Market Law Review* 437-472 at 446.

¹³ See Chapter 3, section 3.1.3.2. regarding this development.

¹⁴ The role of this provision was clarified in *Phil Collins* by AG Jacobs. Article 18 TFEU (previously, Article 12 TEC) serves not only as a tool for economic integration but is also a great symbol for the EU. Opinion of AG Jacobs in Joined Cases C-92/92 and C-326/92 *Phil Collins v Imtrat Handelsgesellschaft MbH and Patricia Im- und Export Verwaltungsgesellschaft mbH and Leif Emanuel Kraul v EMI Electrola GmbH* [1993] ECR I-5145, paragraph 11.

¹⁵ This follows from Article 18 TFEU. It states that 'without prejudice to any special provisions any discrimination on grounds of nationality shall be prohibited'.

It is necessary to consider what discrimination on grounds of nationality entails. Generally, measures that discriminate make a distinction between an internal and a foreign situation in which a free movement right is invoked.¹⁶ Discrimination was developed to mean treating similar situations differently or treating different situations in a similar way.¹⁷ The element of similarity and comparability of situations becomes imperative. The fact that two situations are treated differently does not settle the case and does not necessarily mean that discrimination is present. For discrimination to occur, these two situations have to be comparable.

Moreover, discrimination can be divided into two categories. The first category refers to discrimination that in an explicit fashion differentiates on grounds of nationality.¹⁸ In principle, this direct form of discrimination is unlawful unless it can be justified on one of very few grounds mentioned in the Treaty.¹⁹ Additionally, a discriminatory rule can be justified only under the condition that the national provision breaching EU law is proportionate.

The second form of discrimination, more common in direct tax cases, is indirect discrimination. In law, national and foreign products, investments, workers or the self-employed are treated in the same manner; in fact, however, a differentiation on grounds of nationality is achieved.²⁰ Indirectly discriminatory measures can be potentially justified on the basis of a broad non-exhaustive list of justifications, called ‘imperative requirements in the general interest’ or ‘overriding requirements of the public interest’, established by the ECJ on a case-by-case basis. These justifications are also subject to the requirement of proportionality.

3.1.1.1. *Discrimination and direct tax measures*

The category of indirect discrimination plays a greater role in direct tax cases because, usually, tax provisions do not create a differential treatment expressly on

¹⁶ D Weber, *Tax Avoidance and the EC Treaty Freedoms: a Study of the Limitations under European Law to the Prevention of Tax Avoidance*, (The Hague: Kluwer, 2005), p 83.

¹⁷ See, for example, Case 13/63 *Commission v Italy* [1963] ECR 165, paragraph 6; Case C-107/94 *P. H. Asscher v Staatssecretaris van Financiën* [1996] ECR I-3089, paragraph 42.

¹⁸ Case 152/73 *Giovanni Maria Sotgiu v Deutsche Bundespost* [1974] ECR 153, paragraph 3.

¹⁹ See: Articles 45(3), 52(1) and 65(1)(b) TFEU. The explicit derogations from these fundamental freedoms are: public policy, public health and public security.

²⁰ Case 152/73 *Sotgiu*, note 18 above, paragraph 3.

grounds of nationality.²¹ In national direct tax systems, differentiation is primarily made on the basis of residency.²² Residents of a Member State usually pay their income tax on their world-wide earnings and may be granted access to certain benefits fully to reflect their ability to pay. Non-residents operating in the same Member State are usually taxed on their income earned in that host state. They might be refused access to benefits and tax advantages.

When assessing a measure in the light of discrimination, the ECJ adopted a three-stage approach. It considered, first, whether internal and foreign situations were comparable.²³ If they were not similar, no examination of discrimination was carried out because when situations are not comparable, no discrimination occurs. If the situations were considered similar, the ECJ assessed whether there was a difference in treatment of the situations. If there was, the Court explored whether the different treatment was justified. The existence of different rules is not in itself a case of discrimination; only when situations can be shown to be comparable may discrimination occur. A discriminatory measure may nevertheless be still defended by a reference to a justification.

Bearing in mind the importance of the comparability of situations, the ECJ stated that, as a rule, residents and non-residents are not in a comparable situation.²⁴ However, the acceptance of tax differentiation based on residence is not unconditional. The situations of residents and non-residents can be comparable under

²¹ The concept of nationality is commonly related to natural persons. Nevertheless, Article 54 TFEU includes companies as beneficiaries of the provisions on the prohibition of discrimination on grounds of nationality. A company is regarded to have the nationality of a Member State where it has its registered office, central administration or principal place of business, provided that this company is formed in compliance with the law of the Member State.

²² Tax measures that differentiate on grounds of residency are likely to create a risk of disadvantaging nationals of other Member States. See: Case C-175/88 *Klaus Biehl v Administration des contributions du Grand-Duché Luxembourg* [1990] ECR I-779, paragraph 12.

²³ Mason criticised the comparability test applied by the ECJ. See: R Mason, 'Flunking the ECJ's Tax Discrimination Test', (2007) 46:1 *Columbia Journal of Transnational Law* 72-130. She claims that a highly formalistic comparability test does not allow the ECJ to fully recognise interactions between tax discrimination and harms caused by it with the benefits of the Member States retaining tax sovereignty. It also leads to encroaching on national tax sovereignty in cases of overlapping taxation that the ECJ tends to mistake for discrimination. Mason proposes the adoption of the approach developed by the U.S. Supreme Court to assessing discrimination. See: R Mason, 'Made in America for the European Tax', (2008) 49:4 *Boston College Law Review* 1277-1326.

²⁴ Case C-279/93 *Schumacker*, note 6 above, paragraph 31.

certain circumstances.²⁵ According to the *Schumacker* doctrine, personal and family circumstances of non-resident workers within the EU must be taken into account at least once for the purpose of calculating tax, preferably in the home state.²⁶ However, when this is not possible because the non-resident worker earns his income entirely or almost exclusively in the state of employment, his circumstances have to be considered in the host state. As a result, resident and non-resident workers need to be treated equally.²⁷

The prohibition of discrimination on the grounds of nationality of economic operators is founded on the belief that if the EU market is to be truly open, economic operators should be granted national treatment in all other Member States. Generally, the non-discrimination principle respects the fact that there are different tax systems and only interferes in the national tax regulation of one Member State. This principle is satisfied when foreigners are treated equally to a Member State's nationals within its borders. Tax discrimination does not result from tax disparities existing between Member States' tax systems. Consequently, the non-discrimination approach allows for differences between tax systems to exist. As such this approach respects tax sovereignty to a greater extent than the non-restriction approach. Non-discrimination developed in direct tax jurisprudence imposes only 'negligible limitations of the national power of taxation'.²⁸

3.1.1.2. *The first generation of direct tax cases*²⁹

The discrimination-based approach was dominant in direct tax jurisprudence up to the late 1990s.³⁰ That is not to say that the discrimination analysis was abandoned by

²⁵ In the context of the free movement of workers, residents and non-residents will be comparable in the case of the virtual resident. See: P J Wattel, 'The EC Court's Attempts to Reconcile the Treaty Freedoms with International Tax Law', (1996) 33:2 *Common Market Law Review* 223-254 at 226.

²⁶ For assessment of the *Schumacker* doctrine see, *inter alia*: A Cordewener, 'Personal Income Taxation of Non-Residents and the Increasing Impact of the EC Treaty Freedoms', in D Weber (ed.), *The Influence of European Law on Direct Taxation: Recent and Future Developments*, (Alphen aan den Rijn: Kluwer, 2007), at 35-73; P J Wattel, note 25 above, at 223-254.

²⁷ It stems from Case C-80/94 *G. H. E. J. Wielockx v Inspecteur der Directe Belastingen* [1995] ECR I-2493 that the same holds true for self-employed persons. In the light of the recent citizenship jurisprudence, this can be explained by the establishment of a real link with the economy and social environment of a host state.

²⁸ M Lehner, 'Limitation of the National Power of Taxation by the Fundamental Freedoms and Non-discrimination Clauses of the EC Treaty', (2000) 9:1 *EC Tax Review* 5-15 at 7.

²⁹ L Hinnekens, note 9 above, at 112-119.

the ECJ in later direct tax cases. The ECJ extended its case law to the sphere of direct taxation in 1986 in the *Avoir Fiscal* case.³¹ This case concerned a tax credit granted to shareholders receiving dividends from a French company, but the tax credit was refused when dividends were received by a branch or agency situated in France of a company having its registered office in a Member State other than France. The Commission brought the case before the ECJ under the infringement procedure and relied on two arguments. It claimed that the contested French tax provision violated the non-discrimination principle and that it also constituted a restriction on the freedom to set up secondary establishments in France.

France brought up for consideration a number of arguments defending its tax rules. The core arguments related to the risk of large scale tax avoidance if the tax credit was extended to branches/agencies of foreign companies and the fact that the lack of harmonisation in the area of direct taxation justified the tax provisions at issue. As a result of a lack of EU rules settling this problem, the French Government claimed that the issue could only be decided on a bilateral basis through a double tax convention. Moreover, France stated that any disadvantages suffered by a branch operating in France whose company had a registered office in another Member State were compensated for by other tax advantages. If that was not satisfactory, France put forward an argument that foreign companies could easily set up a subsidiary in France and thus qualify for the tax credit.

In delivering its landmark decision, the ECJ placed the case firmly on a discrimination footing and blended the restriction argument put forward by the Commission with a discrimination analysis. It held that:

*Article 59 [Article 52] is thus intended to ensure that all nationals of Member States who establish themselves in another Member State (...) receive the same treatment as nationals of that state and it prohibits, as a restriction on freedom of establishment, any discrimination on grounds of nationality resulting from the legislation of the Member State.*³²

³⁰ S Kingston, 'A Light in the Darkness: Recent Developments in the ECJ's Direct Tax Jurisprudence', (2007) 44:5 *Common Market Law Review* 1321-1359, at 1329. The discrimination approach was very strong in older direct tax cases, especially relating to the freedom of establishment.

³¹ Case 270/83 *Avoir Fiscal*, note 3 above.

³² *Ibid.*, paragraph 14.

In the following paragraph, the ECJ highlighted the close link between two submissions made by the Commission. These related to discrimination against branches and agencies of insurance companies established in other Member States vis-à-vis companies established in France, and the restriction on the freedom of foreign insurance companies to establish branches and agencies. The ECJ went on to deal with the Commission's submissions using language of non-discrimination and equal treatment.

The Court examined and rejected all justifications proposed by France. It also concurred with the Opinion of AG Mancini that the approximation of national laws is not a condition for applying tax laws in a non-discriminatory way. On the contrary, it was claimed that the principle of a unified market and its corollary, freedom of movement and the prohibition of discrimination that this entails, is always in force. This is especially so when there is a delay on the Communities part to adopt necessary legislation.³³ The ECJ found that the French tax credit provision was discriminatory.

One may ask how the ECJ identified discrimination in this case. The key argument of the French Government was a reference to the fact that situations of residents and non-residents were not comparable. In effect, there could have been no discrimination as this could only occur when situations were comparable. The ECJ admitted that, in general, residents and non-residents were not in a comparable position. Nevertheless, in the case in question, French law did not distinguish between residents and non-residents for the purpose of tax liability. Hence, France was not allowed to make a distinction for the purpose of granting the tax credit. Indeed, why would non-residents be denied the tax credit if their profits were taxable in France?

The *Royal Bank of Scotland* case³⁴ is another instance in which the ECJ grounded its decision firmly on discrimination reasoning. According to Greek law, a foreign bank (the RBS was a bank with a seat in the UK) conducting its activities in Greece

³³ *Ibid.*, paragraph 24.

³⁴ Case C-311/97 *Royal Bank of Scotland plc v Elliniko Dimosio (Greek State)* [1999] ECR I-2651.

through a branch (PE) established in Greece was charged 40 % tax on its profits whereas a branch of a bank having its seat in Greece (therefore a Greek bank) was subject to a 35 % tax rate.

The ECJ assessed whether a Greek bank and a Greek branch of a foreign bank (having its seat in another Member State) could be regarded as being in objectively comparable situations. In the case of a tax advantage denied to non-residents, a difference in treatment between the two categories of taxpayer would constitute discrimination where there was no objective difference such as to justify the different treatment. The ECJ effectively held that such differentiation in treating branches of Greek banks and foreign banks was not acceptable because it constituted a form of direct discrimination. The ECJ focused on the situation within the borders of one Member State and compared the situation of a resident with a non-resident whose positions were considered similar.³⁵

None of the grounds justifying discrimination authorised by the Treaty were relied upon by the Greek Government. Accordingly, the ECJ found that the Treaty precluded a Member State's legislation from giving local companies – as compared with local permanent establishments of companies established in other Member States – a lower rate of tax on profits where there was no objective difference between such companies.

3.1.2. The market access approach: its legal foundation and meaning³⁶

In non-tax cases,³⁷ the ECJ developed a new approach³⁸ to tackle the issue of restrictions on free movement in the internal market because non-discrimination

³⁵ Although Greek companies were subject to worldwide income taxation, whilst foreign companies carrying on business through a Greek permanent establishment were subject to Greek tax only on the establishment's profits, this was not sufficient to prevent the two categories of companies from being in a comparable situation.

³⁶ The development of the understanding of the fundamental freedoms as prohibiting non-discriminatory restrictions does not mean that discrimination disappears as a concept, or is replaced by obstacles to the internal market. This process should rather be seen as an enlargement of the meaning of the free movement principle. See: A Cordewener, 'The Prohibitions of Discrimination and Restriction within the Framework of the Fully Integrated Internal Market', in F Vanistendael (ed.), *EU Freedoms and Taxation: EATLP Congress, Paris 3-5 June 2004*, (Amsterdam: IBFD, 2006), 1-46, at 2.

³⁷ Examples of the application of the market access approach are not as common as the non-discrimination analysis in the ECJ's reasoning although they are increasing.

alone was not sufficient to secure true liberalisation in this regard. As expressed in *Gebhard*,³⁹ even a non-discriminatory measure might breach EU law when it is liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty. Certain restrictions can block effective access to domestic or foreign markets. The development of the market access approach in general case law was marked by a number of formative judgments which attempted to establish how expansive the influence of the prohibition of non-discriminatory measures should be in relation to the heterogeneity of national policy preferences. It has not been an unproblematic process and determination of what the concept of access to market imparts still remains unclear.

The market access test in direct tax case law can apply to two types of tax obstacles. First, it applies to obstacles which originate from tax disparities imposing double burdens on economic operators who wish to be active in more than one Member State. Notably, such restrictions are the result of tax sovereignty and a lack of harmonisation measures within the area of direct taxation. They take place not because of the existence of one particular tax system but derive from the simultaneous operation of various tax systems.

Second, market access can also apply to measures of one Member State which apply without distinction to national and foreign operators but result in hindering access to the markets of other Member States. Such restrictive measures are outbound orientated, making it unattractive to take advantage of free movement opportunities.

A classic example of the first category of restrictions can be found in *Cassis de Dijon*. The ECJ viewed the disadvantages arising from disparities between national

³⁸ That is not to say that the understanding of the concept of the market access is unproblematic and uniform among scholars. Developments in case law did not leave a clear picture. It appears that market access was initially linked with measures which have specific impact on cross-border situations. D Chalmers, 'Repackaging the Internal Market-the Ramifications of the *Keck* Judgement', (1994) 19: *European Law Review* 385-403; S Weatherill, 'After Keck: Some Thoughts on How to Clarify the Clarification', (1996) 33:5 *Common Market Law Review* 887-908. However, it appears that more recent cases seem to indicate that the ECJ includes also measures which reduce economic activity only generally. E Spaventa, 'Leaving Keck Behind? The Free Movement of Goods after the Rulings in *Commission v Italy* and *Mickelsson and Roos*', (2009) 35:6 *European Law Review* 914-932.

³⁹ Case C-55/94 *Gebhard*, note 12 above, paragraph 37.

regulations as a restriction on the free movement of goods. A dual burden on a cross-border transaction occurred because of the substantive differences between non-discriminatory legislation in two states: Germany and France.⁴⁰ The ECJ held that, under the principle of mutual recognition, the legislation of the state of origin had priority. Germany had to recognise regulation adopted in France. Measures without distinction which nevertheless restrict the exercise of fundamental freedoms will be accepted only if they pass the rule of reason test.⁴¹

An example of the second group of restrictive, even-handed measures is exit taxation. Case law in this field grants the right to free movement in outbound movements to citizens against their own Member State. Those measures effectively create restrictions on the exercise of the right of free movement. Exit taxes are taxes imposed on accrued but unrealised capital gains when a taxpayer (an individual or a company), regardless of nationality, transfers their residence or assets to another state. It was considered by the ECJ to constitute an infringement of free movement provisions.⁴² For instance, *Hughes de Lasteyrie du Saillant*⁴³ left France to work in Belgium, holding securities in a French company and was subject to French tax. On exit from France, he was subject to immediate taxation on the unrealised increase in value of the securities, applicable to taxpayers, both French nationals and foreigners, moving their residence for tax purposes. The ECJ held that the provision in question was likely to restrict the exercise of free movement, or at the very least have a dissuasive effect on taxpayers wishing to establish themselves in other Member States, because they are subjected, by the mere fact of transferring their residence outside France, to tax on income that has not yet been realised, and thus to

⁴⁰ To market an alcoholic drink in Germany as a liqueur, the alcoholic content of 25 % was required. In France, the strength of 15-20 % was sufficient to sell the product as a liqueur. The French product did not meet the requirements of German law; however, under French law it satisfied all conditions. Thus, a double burden was imposed on the French liqueur that would have to satisfy two varying regulations.

⁴¹ This test has its roots in jurisprudence regarding the free movement of goods. This rule was developed in the context of the *Cassis de Dijon* judgment. Under the rule of reason doctrine, not mentioned in the Treaty, a restrictive national measure is acceptable when it is necessary to protect a legitimate public interest, is proportionate and has a non-discriminatory character.

⁴² See e.g.: Case C-470/04 *N v Inspecteur van de Belastingdienst Oost/kantoor Almelo* [2006] ECR I-7409; Case C-9/02 *Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie* [2004] ECR I-2409.

⁴³ Case C-9/02 *de Lasteyrie du Saillant*, note 42 above, paragraphs 39, 45.

disadvantageous treatment by comparison with a person who decides not to leave France.⁴⁴

In the process of assessing whether a measure is non-discriminatory, yet prohibited, the ECJ applies a two-stage test. The first question is whether a provision restricts cross-border operation, i.e. if it hinders or is likely to hinder or make less attractive the exercise of the fundamental freedoms. If so, potential justifications for a breach of EU law are considered. A question of similarity of foreign and internal situations is not generally raised because the right to enter market of another Member State is independent from treatment of other situations.⁴⁵

The extension of the scope of the fundamental freedoms to encompass the prohibition of non-discriminatory obstacles had an important impact on national legislation. Not only does discrimination against foreign operators in national legislation work against the internal market, non-discriminatory rules that may restrict access of economic operators to the market of another Member State are also forbidden. In addition, the operation of different national regulations could have a restrictive impact on freedom of movement and in turn activate EU law protection. In non-tax jurisprudence, the ECJ developed a broad meaning of the fundamental freedoms. Has the process developed similarly in relation to taxes?

3.1.2.1. *The second generation of direct tax cases*⁴⁶

It remains clear that the potential reach of the *Gebhard* formula is far-reaching. Under the market access approach, any form of national regulation could trigger protection under the Treaty and has to be shown by the relevant Member State to be both justified and proportionate. The transposition of the market access approach to the sphere of direct taxation was not unproblematic. The broad concept of a market access restriction did not adapt well to taxation because this approach provokes questions about the influences of the EU and Member States in the area of direct

⁴⁴ Chapter 3, section 3.2. discusses potential inconsistencies between the ECJ case law on exit taxes and the Commission soft law measure on the same issue.

⁴⁵ A Cordewener, note 36 above, at 26.

⁴⁶ According to Hinnekens, this second generation of direct tax cases began in 1997. L Hinnekens, note 9 above, at 115.

taxes. After all, the market access approach assesses measures from a perspective of the internal market and looks beyond the regulation framework of one Member State.

Generally, *Futura Participations*⁴⁷ is considered to be a first example of the application of the prohibition of non-discriminatory restrictions to direct taxation. The dispute in this case took place between Singer (a Luxembourg branch of a French company, Futura Participations SA) and Luxembourg's tax authorities. Under Luxembourg law, both resident and non-resident taxpayers could carry losses forward if the losses were established on the basis of accounts duly kept and held in Luxembourg. In addition, non-resident taxpayers were subject to the condition that losses should be economically related to income received locally and that accounts should be kept within the country. Singer did not fulfil the requirement of keeping proper accounts in Luxembourg and relied on accounts that were held in France by Futura.⁴⁸ The requirement to keep accounts in Luxembourg constitutes an additional burden for non-resident taxpayers who already held accounts in their home countries.

Interestingly, AG Lenz declared that the disputed measure represented a discriminatory tax rule. In doing so, he followed the traditional approach of analysing the comparability of non-residents' and residents' situations.⁴⁹ He did not recognise that companies established in Luxembourg were subject to the same condition of keeping accounts in Luxembourg as non-residents. He identified discrimination grounded on nationality instead.⁵⁰ In his view, a French company operating in Luxembourg through a branch was in a comparable situation to a Luxembourg company operating in Luxembourg through a branch or a foreign company that founded a subsidiary in Luxembourg and then established branches.

⁴⁷ Case C-250/95 *Futura Participations SA and Singer v Administration des contributions* [1997] ECR I-2471.

⁴⁸ This seemed logical because Singer was a branch. Branches are not separate legal entities and are perceived as an emanation of the parent company. Hence, financial arrangements of branches are organised by their parent company. See: A Easson, *Tax Incentives For Foreign Direct Investment*, (The Hague: Kluwer, 2004), p. 37 on differences between a subsidiary and a branch.

⁴⁹ Opinion of AG Lenz in Case C-250/95 *Futura Participations SA and Singer v Administration des contributions* [1997] ECR I-2471, paragraph 11.

⁵⁰ For a company, nationality is determined by a reference to the place of its seat.

Only a non-resident company that had a branch in Luxembourg was required to keep additional accounts in Luxembourg.⁵¹

The ECJ did not follow the Opinion of AG Lenz with regard to legal reasoning and classification of the tax rule. The Court also found that the challenged tax rule breached EU law but it did not find discrimination. Thus, the Court decided in favour of the view of the British and Luxembourg Governments.⁵² According to the ECJ, the national tax measure was a non-discriminatory restriction because it did not create distinction. It resulted from disparities between the tax regulations of two Member States that created a double burden of tax accounting on Singer, which was expected to hold accounts both in Luxembourg and France where its parent company kept accounts in accordance with French law.

However, it is imperative to note that similarly to AG Lenz, the ECJ differentiated between the substantive aspect of Luxembourg law which required the existence of an economic link between losses to be carried forward and income earned in Luxembourg and the requirement to hold accounts in Luxembourg. The first aspect of the measure was found to be permissible under EU law. The condition that accounts had to be kept and held in Luxembourg was found to be restrictive⁵³ and disproportionate.⁵⁴ As Cordewener noted, the issue for *Futura Participations* was not the result of a substantive law but the double burden created by procedural law.⁵⁵

A finding of non-compliance with EU law of a procedural requirement, such as the accounting rules in the *Futura* case, poses an important question. Was the fact that it was a *procedural*, and not a substantive, rule decisive for the ECJ finding that a

⁵¹ Opinion of AG Lenz in Case C-250/95 *Futura*, note 49 above, paragraphs 30-31.

⁵² Both the UK and Luxembourg claimed that there was no difference in treatment between the branches of non-resident companies and Luxembourg resident companies. The Luxembourg tax rule constituted a restriction on freedom of establishment. Opinion of AG Lenz in Case C-250/95 *Futura*, note 49 above, paragraphs 32-33.

⁵³ Case C-250/95 *Futura*, note 47 above, paragraphs 24-25. Hatzopoulos describes this as 'evidential requirements'. See: V Hatzopoulos, 'Case C-250/95 *Futura Participations SA and Singer v Administration des contributions, Judgment of 15 May 1997*, [1997] ECR I-2471', (1998) 35:2 *Common Market Law Review* 493-518 at 498.

⁵⁴ Case C-250/95 *Futura*, note 47 above, paragraph 30. It can, therefore, be argued that the problem was more technical and did not touch upon limitations to national tax jurisdiction. The division/allocation of taxing powers between Luxembourg and France specified in its tax codes was not questioned before the ECJ.

⁵⁵ A Cordewener, note 26 above, at 29.

Luxembourg non-discriminatory tax measure violated the internal market? Would the ECJ come to the same conclusion if it dealt with a non-discriminatory substantive tax rule creating double burdens? These questions are revisited in section 3.1.3.2.

In the aftermath of *Futura Participations*, the expanded interpretation of free movement was then applied in fiscal case law like *Bosal*.⁵⁶ This led to a new, more comprehensive formulation of the two-track EU-compatibility test of tax measures under the converged freedom principles. Notably, *Bosal* is not an example of double burdens in the internal market but exemplifies a non-discriminatory tax measure which negatively influences the exercise of free of movement. Put differently, it was decided on the basis of a tax measure which may hinder outbound investments.

Bosal concerned the deductibility of interest expenses incurred to obtain shares in subsidiaries from other Member States. The ECJ found that a subsidiary's place of establishment is not important; rather it is the place where the profit is made that counts. Therefore, discrimination is not relevant in this case. Dutch legislation does not differentiate on grounds of nationality because it does not determine that only companies resident abroad do not have access to the deduction of holding costs. In determining who has access to costs deduction in relation to the taxable profit of the parent company depends solely on the question whether those costs are indirectly instrumental in making profit that is taxable in the Netherlands, without there being any requirement, however, that those profits be made by subsidiaries themselves established in that Member State or established abroad but having a stable establishment in the latter. Thus, it is a non-discriminatory measure that can hinder free movement because it may dissuade a parent company from carrying on its activities through a branch of a subsidiary established in another Member State as such subsidiaries do not usually generate profit taxable in the Netherlands.

Under the market access approach, the EU market is perceived as a whole. In effect, it is assumed that all economic operators should be able to move freely within the internal market. In consequence, especially in the case of double burdens, the prohibition of non-discriminatory restrictions sharply limits national power to tax.

⁵⁶ Case C-168/01 *Bosal Holding BV v Staatssecretaris van Financiën* [2003] ECR I-9409.

3.1.3. Towards legal certainty and clarity?

At first sight, it appears that the ECJ strongly pursued the imperatives of the internal market and integration through its case law. However, an in-depth analysis of direct tax case law reveals that the ECJ has struggled to send a coherent message about the role of jurisprudence in tax integration. At times, it was unclear in which approach the Court grounded its judgments⁵⁷ and there was a lack of certainty, exacerbated by the continuous discontent of national authorities, as to whether all direct tax obstacles to the internal market should fall in the scope of the Treaties. It was unclear whether the one country approach⁵⁸ or the overall approach⁵⁹ should be used.

Striking down tax measures that are independent from the legislation of other Member States is less invasive with regard to tax sovereignty than the evaluation of obstacles created by two differing systems. The former approach requires the ECJ to decide only whether or not a tax measure breaches fundamental freedoms. A Member State whose tax measure is held to violate the internal market must remove the measure or must reform it so that the rule is compatible with the Treaty. However, the ECJ does not advise Member States on the changes necessary to achieve compatibility with EU law.

When a Treaty breach results from the interaction of two non-harmonised tax systems, the potential for restricting national tax sovereignty by the ECJ is far greater. If the violation of free movement principles is recognised, the decision involves deciding which national tax rule takes priority. In general case law, the Court opted for the state of origin principle.⁶⁰ Landmark decisions explored in the next section are used to assess whether this was reflected in tax jurisprudence.

⁵⁷ In some cases, the ECJ applies the language of restrictions but in fact it conducts an analysis of discrimination, e.g. in Case C-324/00 *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* [2002] ECR I-11779.

⁵⁸ Dealing with direct tax obstacles which arise from the laws of a single Member State rather than from the interaction of laws of different states, discriminatory tax measures or even-handed restrictions on outbound movements in one Member State

⁵⁹ Assessing the compatibility of tax restrictions with fundamental freedoms in the light of rules of all involved states because the tax obstacles stem from disparities between laws of more than one Member State, e.g. double burdens.

⁶⁰ This principle was formulated in the *Cassis de Dijon* case.

3.1.3.1. The allocation of taxing rights

The ECJ finally delivered important verdicts providing more clarity with regard to the boundaries of national and EU interests interplaying in the internal market. The effort to provide clarification about which tax obstacles fall within the scope of the Treaty represents an important step in direct tax law development. This move towards more predictability about the role of jurisprudence was based on developing concepts of the allocation and the exercise of tax powers.

The first signs of the importance of a distinction between these two concepts in direct tax jurisprudence can be traced back to the *Gilly* case.⁶¹ This case raised a question of the compatibility of Article 45 TFEU with a double tax convention between France and Germany. It involved a husband who was German and held a teaching job in France and his wife, of French and German nationality, who was a teacher in Germany. The double tax treaty provided for taxation of income paid out from the public budget in the state where the income was paid. Exceptionally, where a person concerned was a national of another Member State, income would be taxable in the state of residence. In effect, the tax convention used nationality as a criterion of differentiation. However, the ECJ held that this distinction did not constitute discrimination on the grounds of nationality. The determination of tax jurisdiction did not in itself breach the Treaty because it merely determined which national tax system would apply. The allocation of tax powers came within the scope of national tax sovereignty.

Consequently, the Member States may decide about the nexus that will allocate fiscal power (nationality as in *Gilly*, but *a fortiori*, it could also be the residence criterion) and differentiation thus created will not constitute discrimination. Any negative consequences are not the result of the criteria used to delimit tax jurisdictions but of differences in tax systems between Member States.

The second issue in *Gilly* was the fact that under the double tax treaty, Mrs Gilly's German income was exempt in France but due to the fact that German tax was more progressive, the foreign tax credit that was granted to Mrs Gilly in France was lower

⁶¹ Case C-336/96 *Gilly*, note 5 above.

than the amount of the tax actually paid in Germany. It was argued that the tax credit mechanism penalised Mrs Gilly for exercising her freedom of movement because a degree of double taxation was still present. In addition, if Mrs Gilly had worked in France, she would have paid less tax.

The Court stated that, whilst the abolition of double taxation in the EU is one of the objectives of the Treaty, there were no EU measures that harmonised national laws with regards to the elimination of double taxation. Therefore, it was clear that, although such a system may impact negatively upon the free movement of workers, it was not incompatible with EU law. In the absence of EU rules, the Member States remain free to decide about their tax rates and how to remove, if at all, double taxation.⁶²

The interplay between allocation and exercise of tax powers was also an important aspect of the *D* case,⁶³ which concerned the assessment for net wealth tax. Dutch law granted a wealth tax allowance to Dutch residents and also to Belgian residents, on the basis of a double tax convention. The taxpayer D was German and a resident of Germany, holding 10% of his assets in the Netherlands. Hence, he was not entitled to the allowance. D presented two claims, however. First, he stated that not granting a tax allowance to a non-resident breached EU law because the allowance was granted to Dutch residents. The second standpoint was that difference in treatment between Belgian and German residents constituted prohibited discrimination. D demanded that the most favoured nation principle should be extended to all residents of the Member States. AG Colomer agreed with D's claims. However, the Court disagreed.⁶⁴ By referring to *Schumacker*,⁶⁵ it was decided that residents and non-

⁶² See F Vanistendael, 'Case C-336/96 *Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas-Rhin*, Judgement of the Court of Justice of 12 May 1998. Full Court. [1998] ECR I-2793', (2000) 37:1 *Common Market Law Review* 167-179 at 176-178 for a critique of this part of the judgment.

⁶³ Case C-376/03 *D. v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen* [2005] ECR I-5821.

⁶⁴ See: S Van Thiel, 'A Slip of the European Court in the *D* Case (C-376/03): Denial of the Most-Favoured Nation Treatment because of Absence of Similarity?', (2005) 33:10 *Intertax* 454-457; S Van Thiel, 'Why the European Court of Justice Should Interpret Directly Applicable Community Law as a Right to Most-Favoured Nation Treatment and a Prohibition of Double Taxation', in D Weber (ed.), *The Influence of European Law on Direct Taxation: Recent and Future Developments*, (Aalphen aan den Rijn: Kluwer, 2007) 75-138; D Weber, 'Most Favoured Nation Treatment under Tax Treaties Rejected in the European Community: Background and Analysis of the *D* Case: A

residents are not in a comparable situation when the non-resident taxpayers have most of their assets in the country of their residence.

As regards discrimination between two non-residents, the ECJ reasoned that the double tax convention between Belgium and the Netherlands belonged to the sphere of allocating taxing powers among these two states. In effect, the tax treaty allocated jurisdictions among two countries and created reciprocal rights and obligations between Belgium and the Netherlands. Hence, horizontal discrimination⁶⁶ originating from different provisions of bilateral tax conventions was acceptable.

Van Thiel rejected the ECJ's reasoning on the basis of a broad interpretation of discrimination. He claimed that under EU law, discrimination is prohibited irrespective of its source, national law or a bilateral tax convention. EU law has primacy over both.⁶⁷ He concluded that *D* allows the Member States to maintain divisions in the internal market by simply packaging distortive tax measures within a bilateral tax treaty.⁶⁸ Kingston, on the other hand, read the case as a positive expression of national tax sovereignty. According to her, the ECJ showed praiseworthy unwillingness to encroach onto national tax sovereignty.⁶⁹

Similarly to *D*, the autonomy of the Member States to conclude a bilateral tax treaty was recognised in the *Columbus Container Services* case.⁷⁰ The judgment in this case confirmed that if the problem of double taxation is tackled in a bilateral agreement, it remains beyond the scope of the ECJ's influence. Because EU law does not provide any criteria for the attribution of taxing rights among the Member States, any rules giving relief to double taxation adopted by the Member States in a tax treaty will be respected by the Court. The ECJ will not decide which tax system, credit or exemption, should be applied to eliminate double taxation.

Proposal to Include a Most Favoured Nation Clause in the EC Treaty', (2005) 33:10 *Intertax* 429-444 for negative comments on this judgment.

⁶⁵ Case C-279/93 *Schumacker*, note 6 above.

⁶⁶ G W Kofler and C P Schindler, 'Dancing with Mr D': the ECJ's Denial of Most-favoured-nation Treatment in the *D* Case', (2005) 45:12 *European Taxation* 530-540 at 534.

⁶⁷ S Van Thiel (2005), note 64 above, at 454-457.

⁶⁸ *Ibid.*, at 455.

⁶⁹ S Kingston, note 30 above, at 1336.

⁷⁰ Case C-298/05 *Columbus Container Services BVBA & Co. v Finanzamt Bielefeld-Innenstadt* [2007] ECR I-10451.

In the context of the ideals of the internal market, the ECJ decided the three cases incorrectly. It allowed international law agreements to take priority over the principles of EU law and, in effect, the internal market was compromised. The tax treaty became a barrier to pushing tax integration further. It can be recalled that in the first direct tax case, *Avoir Fiscal*, the understanding of the internal market conveyed in the judgment was broad. The Court clearly said that the approximation of national laws was not a condition for the applicability of the Treaty principles to national tax laws. On the contrary, it was claimed that the principle of a unified market was always valid, *especially* when there was a delay on the Community part to adopt necessary legislation.⁷¹ The lack of unanimous agreement among the Member States to harmonise direct taxes was not regarded as an exonerating circumstance allowing the internal market to be violated. However, between the *Avoir Fiscal* and *D* decisions, two decades passed. The Court had many opportunities to learn that what is valid and coherent from a legal viewpoint is not necessarily acceptable to the Member States in the political context. Traces that such lessons have been drawn are identifiable in later cases.

Another milestone in the process of delimiting the borderline between the imperatives of the internal market and national tax sovereignty is the *Marks and Spencer* case.⁷² It appears that *Marks and Spencer* attempts to balance both aims of the Treaty: the fundamental freedoms and the integrity of national tax systems. However, the result achieved is complicated. On the one hand, it can be argued that the ECJ impinges on national tax sovereignty because it gets involved in deciding for the United Kingdom where it should exercise its tax jurisdiction. Consequently, the ECJ does not respect the tax jurisdiction delimitation determined by the Member State. In effect, the ECJ lays down criteria for when a Member State has to extend its jurisdiction, irrespective of the fact that it did not provide for such tax jurisdiction itself. On the other hand, the ECJ does not admit a complete victory for taxpayers.

⁷¹ Case 270/83 *Avoir Fiscal*, note 3 above, paragraph 24.

⁷² Case C-446/03 *Marks & Spencer plc v David Halsey* [2005] ECR I -10837.

The facts of the case were as follows. Marks and Spencer was a company resident in the United Kingdom. It established subsidiaries in Belgium, France and Germany. These subsidiaries were making considerable losses throughout the 1990s. In effect, Marks and Spencer decided to sell the French subsidiary and liquidated the other two subsidiaries. This resulted in unrelieved losses. They could not be relieved in the Member States of the subsidiaries any longer. In addition, under British law, only losses incurred in the United Kingdom, either by a UK-resident company or by the permanent establishment of a foreign company, could be relieved. Moreover, it has to be noted that resident companies with domestic subsidiaries and resident companies operating via foreign subsidiaries were subject to tax in the United Kingdom on their worldwide income. The non-resident subsidiaries were taxable on their profit insofar as the profit was earned in the United Kingdom. A question was referred to the ECJ as to whether the national law, not allowing resident companies to offset the losses of their foreign subsidiaries (whereas this was possible in case of domestic subsidiaries), was compatible with Article 43 EC (currently, Article 49 TFEU).⁷³

The view of AG Maduro and the ECJ diverged. AG Maduro's Opinion⁷⁴ left commentators perplexed because of the very restrictive impact that the proposed solution could exert on the non-harmonised aspects of direct tax systems.⁷⁵ AG Maduro proposed a wide approach to the concept of restrictions, aiming at consistency with other areas of freedom of movement.⁷⁶ In principle, he considered the UK's loss relief rules incompatible with Article 43 EC. According to AG Maduro, the system of offsetting losses had to be extended also to the losses incurred by foreign subsidiaries of the company resident in the United Kingdom. This

⁷³ The potentially negative outcome of this case could have serious consequences for the Member States' budgets. The ECJ judgment declaring the violation of EU law in this case was estimated to cost approximately £30 million. See: A Cordewener and I Dörr, 'Case C-446/03, *Marks & Spencer plc v. David Hasley (HM Inspector of Taxes)*, Judgment of the Court of Justice (Grand Chamber) of 13 December 2005, nyr.', (2006) 43:3 *Common Market Law Review* 855-884 at 855.

⁷⁴ Opinion of AG Maduro in Case C-446/03 *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)* [2005] ECR I-10837.

⁷⁵ See: M Lang, 'Marks and Spencer- More Questions Than Answers: an Analysis of the Opinion Delivered by Advocate General Maduro', (2005) 14:2 *EC Tax Review* 95-100; G Meussen, 'Cross-border Loss Relief in the European Union Following the Advocate General's Opinion in the *Marks & Spencer Case*', (2005) 45:7 *European Taxation* 282-286.

⁷⁶ Opinion of AG Maduro in Case C-446/03 *Marks & Spencer*, note 74 above, paragraph 35.

interpretation had far-reaching consequences in the light of the allocation of tax powers expressed in national law that only income earned in the United Kingdom by a foreign subsidiary would be taxed in the United Kingdom. The UK decided to limit its power to tax. However, AG Maduro created a form of liability for the foreign losses to be offset in the UK despite not taxing the profits of subsidiaries that incurred these losses. In terms of national tax sovereignty, this solution was controversial. For the purpose of the cross-border relief of losses, AG Maduro looked at the case from a viewpoint of the internal market, not an individual Member State, as losses had to be relieved somewhere within the market. As a result, Member States could refuse to offset losses only when these losses received ‘equivalent treatment’⁷⁷ in the state where they arose.

The decision of the Court was in fact not as revolutionary as AG Maduro’s Opinion. The ECJ reversed the principles outlined by AG Maduro.⁷⁸ The Court reiterated, first, that, although direct taxation is within the competence of the Member States, the latter must exercise that competence with respect for EU law. By applying different treatment for tax purposes to losses incurred by a subsidiary resident in the UK and losses incurred by a subsidiary in another Member State, the UK rules may discourage undertakings from establishing subsidiaries in other Member States. As a consequence, such rules will act as a restriction on freedom of establishment.

A restriction compromising the internal market is permissible when it pursues a legitimate objective compatible with the Treaty and is justified by overriding reasons in the public interest. It must also be apt to ensure the attainment of the objective in question and not go beyond what is necessary to obtain that objective. The Court considered that there was a legitimate objective given the arguments put forward by the United Kingdom (supported by Germany, Greece, France, Ireland, the Netherlands, Finland and Sweden): namely, protecting a balanced allocation of the power to impose taxation between the Member States concerned, the need to avoid the risk of the double use of losses, and the desire to avoid the risk of tax

⁷⁷ *Ibid.*, paragraph 71.

⁷⁸ M Lang, ‘The *Marks & Spencer* Case: the Open Issues Following the ECJ’s Final Word’, (2006) 46:2 *European Taxation* 54-67 at 54.

avoidance.⁷⁹ For the first time, the ECJ presented a multi-bases justification for breaching EU law. These three grounds have to be taken together to constitute an overriding reason in the public interest.⁸⁰ Nevertheless, the ECJ considered that the second of the conditions was not satisfied i.e. the UK legislation did not observe the principle of proportionality.

Some scholars⁸¹ concluded that, in *Marks and Spencer*, the ECJ announced that allocation of tax powers is a matter of national sovereignty. Restrictions to the attainment of the internal market that arise because of the process of allocating tax powers are going to be accepted under case law. However, one exception was created to this acceptance of the allocation of tax powers. When disparities arise because one state decided to allocate its tax jurisdiction in a negative way and consequently not tax certain tax bases (the UK not taxing foreign subsidiaries' profits),⁸² obstacles to the internal market cannot be accepted and will be subject to assessment against freedom of movement. Losses need to be relieved somewhere; therefore, this aim takes priority over respecting the allocation of tax powers.

As mentioned in the context of the *D* case, the ECJ understood that an absolute approach to the internal market in direct tax cases may cause a political crisis. The complex solution found in *Marks and Spencer* is yet another example of the Court's attempt not to demarcate the boundaries of the internal market too far. An absolute vision of the internal market is more easily acceptable when measures internal to one Member State are involved (the one state approach). Changes necessary to bring such measures in line with EU law do not require a compromise between two separate tax jurisdictions. However, when the internal market is compromised because of the involvement of tax rights of two states, as in *Marks and Spencer*, these states need to decide how to resolve a potential conflict. They would need to agree whose tax claims take the precedence. In *D* and *Columbus Container Services*, the compromise

⁷⁹ Case C-446/03 *Marks & Spencer*, note 72 above, paragraphs 45-50.

⁸⁰ Kingston claimed that the three grounds did not have to be taken together in the light of later case law. See: S Kingston, note 30 above, at 1353. The allocation of tax powers was treated as a standalone justification in Case C-470/04 *N*, note 42 above, paragraph 42.

⁸¹ D Weber, 'In Search of a (New) Equilibrium between Tax Sovereignty and the Freedom of Movement within the EC', (2006) 34:12 *Intertax* 585-616.

⁸² The other Member State would tax profits and would also offset losses as long as subsidiaries exist.

reached between two Member States was transposed to the double tax treaty. The Court respected the international agreements and did not get involved in assessing the treaty. This enabled the Court not to decide about the allocation of taxing rights at EU level.

In *Marks and Spencer*, no agreement existed between the states involved. As the Court did not want to determine which state has the priority to exercise its taxing rights, it permitted the internal market to be compromised. Only when a state decides not to allocate its taxing rights, and this results in disparities between various tax systems, must the principles of the internal market be endorsed.

Overall, the approach presented in *Marks and Spencer* is difficult to reconcile with a vision of a pure internal market. The significance of cross-border loss compensation for the internal market was recognised many years before *Marks and Spencer*.⁸³ Had the directive proposal for intragroup loss relief been adopted, the problem tackled by the ECJ in *Marks and Spencer* would have been resolved under that measure. In this context, at least for a decade before the *Marks and Spencer* judgment, the Member States realised that the lack of EU regulation of cross-border loss relief distorts the internal market. Due to the inability of the Member States to agree unanimously on a legislative solution, the internal market was allowed to have been undermined. The ECJ had an opportunity to rectify that but it did not fully recognize this chance. It respected the frontiers of integration set by the Member States. The Court's behavior may be explicable by the political context in which direct taxation functions but it is unacceptable from a perspective of legal consistency because, in general case law, the Court promoted integration in a stronger manner.

3.1.3.2. *Permissible dual burdens in the internal market*

In a quest to secure greater predictability of direct tax jurisprudence and in recognition of the need to abandon a case-by case approach in tackling restrictions to the internal market, AG Geelhoed suggested a theory that would allow the Court to

⁸³ Chapter 2, section 2.1.1.5. summarises key legislative developments regarding losses relief.

decide which direct tax measures are within the scope of the free movement provisions.⁸⁴ He distinguished true restrictions from permissible quasi-restrictions.⁸⁵

In essence, the first category of direct tax barriers involves direct tax rules of only one Member State. Thus, these tax rules are a result of the *exercise* of taxing power by a Member State. Some national direct tax measures are discriminatory in the way they treat individuals or businesses based on their country of origin. The disadvantages to free movement resulting from the tax system of one Member State fall within the scope of the Treaty and can be assessed in the light of the fundamental freedoms. As expressed by the ECJ, in pursuing their national tax policies, the Member States are required to respect principles of the Treaty:

*Although, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law.*⁸⁶

This classic statement of the Court, reiterated regularly over years,⁸⁷ expresses an obligation on the Member States to exercise their sovereign rights in direct taxation consistently with EU law. As a result, the Member States are required to respect the principles of non-discrimination and market access because the Treaty has an overriding effect upon national tax provisions. Only exceptional circumstances are able to produce satisfactory justification for the violation of EU law.

The second type of obstacles to the internal market operates as a result of the coexistence of and interaction between two or more national regimes of direct taxation within the EU. It clearly involves more than one Member State. The fact that national direct tax systems are largely non-harmonised allows the Member States to

⁸⁴ Opinion of AG Geelhoed in Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue* [2006] ECR I-11673. Similarly, Opinion of AG Geelhoed in Case C-513/04 *Mark Kerckhaert and Bernadette Morres v Belgische Staat* [2006] ECR I-10967.

⁸⁵ Weber calls these differences among direct tax systems of the Member States 'disparities'. See: D Weber, note 81 above, at 587.

⁸⁶ Case C-279/93 *Schumacker*, note 6 above, paragraph 21.

⁸⁷ Among others, a statement expressing restriction of national freedom in direct taxation has also been included in Case C-446/03 *Marks & Spencer*, note 72 above, paragraph 29; Case C-196/04 *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] ECR I -7995, paragraph 40; Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I-11673, paragraph 36; and Case C-379/05 *Amurta* [2007] ECR I-9569, paragraph 16.

allocate tax jurisdiction among them as they wish. The Member States retain the power to decide about the connecting factors upon which their tax jurisdiction is based. They can also decide whether they want to levy tax or not, what they want to impose a tax on and at what rate.⁸⁸ Distorting effects that operate as a result of variations in national direct tax regimes have to be accepted. In *Schempp*,⁸⁹ the ECJ held that the Treaty offers no guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation. Given the disparities between the tax legislation of the Member States, a transfer may or not be to the citizen's advantage.⁹⁰

Acceptance of the classification proposed by AG Geelhoed is demonstrated in the *Kerckhaert-Morres* case.⁹¹ In this judgment, the ECJ stated that double taxation has to be accepted within the internal market because it originates from a parallel exercise of tax sovereignty by two Member States. It can only be eradicated by harmonisation. This decision acts greatly in favour of national tax sovereignty and simultaneously compromises the imperatives of the internal market.

The facts of the case were as follows. A married couple who were resident in Belgium received dividends from a company resident in France. France withheld tax at source following provisions of the Belgian-French double tax treaty. The couple claimed a tax credit in Belgium in accordance with the tax treaty. Dividends against which the couple claimed the tax credit were regarded to constitute *avoir fiscal*, hence they already came with a tax credit granted by the French Government. Under the Belgium-France tax treaty, *avoir fiscal* granted to Belgian residents constituted a dividend. The taxpayers reported French dividends as income in Belgium and claimed the use of the tax credit. Tax authorities rejected the couple's claim because, despite the treaty provisions, Belgian law changed after the treaty came into force and the credit for foreign withholding taxes was removed from Belgian legislation. In effect, taxpayers suffered from double taxation of the French dividends. However,

⁸⁸ For instance, one Member State may decide to introduce a low corporate tax rate, whereas another imposes a much higher tax rate.

⁸⁹ Case C-403/03 *Egon Schempp v Finanzamt München V* [2005] ECR I-06421.

⁹⁰ *Ibid.*, paragraph 45.

⁹¹ Case C-513/04 *Mark Kerckhaert and Bernadette Morres v Belgische Staat* [2006] ECR I-10967.

the Belgian courts found that the refusal to credit French withholding tax on inbound dividends did not breach the tax treaty. The treaty provided that Belgium would credit the French tax on dividends but the credit was conditional on its availability under Belgian domestic legislation.

According to the ECJ, there was no discrimination because domestic and foreign dividends were taxed in Belgium without a credit at the same tax rate. Negative consequences for the taxpayers arose from the simultaneous application by the Member States of their taxing rights. These adverse situations need to be addressed by double tax agreements because, apart from some specific rules e.g. the Parent-Subsidiary Directive, there are no harmonising measures eliminating double taxation in the EU. The Treaty does not impose an obligation on the Member States to relieve double taxation.⁹² The Belgian-French treaty was concluded in order to apportion fiscal sovereignty and it should deal with double tax avoidance.⁹³

Why was mutual recognition⁹⁴ not suggested by the ECJ? In cases such as *Cassis de Dijon*,⁹⁵ dual burdens existing in the internal market as a result of differing national regulations had to be removed. Under the principle of mutual recognition, even when harmonisation is not on the agenda, Member States have to admit goods, services or persons which are lawfully produced, offered or employed in their country of origin to their markets in order to avoid dual burdens. When diversity becomes a significant value to foster, mutual recognition offers a solution respecting the aim of the internal market without resorting to introducing EU law. It means that in case of a free movement conflict, dual regulation by the home and host states is replaced by the home state rules.

In direct tax jurisprudence, the Court diverged from its approach to double burdens developed in general jurisprudence on the fundamental freedoms. *Kerckhaert-Morres*

⁹² Article 293 TEC had encouraged the Member States to enter into double tax treaties but it did not create a legal obligation. It can be argued that the removal of Article 293 TEC under the Lisbon Treaty reforms confirms this interpretation.

⁹³ The line of reasoning presented in *Kerckhaert-Morres* was confirmed in Case C-128/08 *Jacques Damseaux v État belge* [2009] ECR I-6823.

⁹⁴ This principle was formulated in the *Cassis de Dijon* case. Case 120/78 *Cassis de Dijon*, note 12 above.

⁹⁵ *Ibid.*

is a disappointment from the internal market perspective. It adopts a narrower view of restrictions than in non-tax case law. This could be explained by the special position of direct taxation in the EU. The recommendation that in case of a conflict between two non-discriminatory tax regulations, the home state law should be respected can be interpreted as restricting the tax jurisdiction of the host state. Moreover, mutual recognition is possible only when objectives of the Member States are similar. As presented in Chapter 1, section 1.1.2., direct tax systems are often constructed on conflicting national priorities. Thus, direct tax barriers resulting from diversity of national tax systems remain within the scope of Article 115 TFEU and require unanimous agreement of the Member States. If such agreement fails, the tax obstacles remain and the internal market can be compromised. If the *Cassis de Dijon* reasoning were transposed to the sphere of direct taxation, it would mean that the ECJ would decide whether the source or home state had priority to tax. The ECJ would take decisions that can only be made by a legislator.

As regards clarity, direct tax jurisprudence has become more predictable and structured. When a tax measure is discriminatory or it creates restrictions on market access in outbound situations, it will most likely be struck down by the ECJ in accordance with the one state approach. However, an overall market access approach was not keenly adopted in direct tax cases. Double tax burdens which have their origins in unregulated tax systems will be acceptable, as shown in *Kerckhaert-Morres*. If an agreement on avoiding double taxation is reached by Member States concluding a bilateral tax treaty, it will be respected by the ECJ even if a tax treaty potentially could contain provisions distortive to the internal market.

Arguably, however, there is one exception to *Kerckhaert-Morres*. Procedural non-discriminatory tax measures, such as the accounting rules in *Futura*, created a double burden on a company and were condemned by the Court. It is submitted that the fact that it was a *procedural*, and not substantive, rule was decisive in the ECJ judgment. The ECJ did not accept the existence of a disparity in *Futura* because procedural rules were at stake. As such, they did not have a significant link with tax sovereignty.

As regards legal consistency and coherence from an EU law viewpoint, developments in the direct tax field bring an undesirable duality of standards depending on the regulatory field in which the ECJ adjudicates. In general jurisprudence, the promotion of the internal market is bolder and less susceptible to weakening this concept. Direct tax case law is more forgiving. From the legal clarity perspective of the whole case law, direct tax jurisprudence is an inexplicable exception. The fact that in direct tax case law the one state approach is acceptable, whereas the overall approach is permissible only to a limited degree (as established in *Marks and Spencer* and voiced in *Kerckhaert-Morres*) can be explained by the political realm in which direct tax jurisprudence evolves. But the argument that the political sensitivity of a regulatory field should be decisive in determining how far the internal market reaches is not convincing.

3.2. The relationship between hard law direct tax jurisprudence and soft law measures

With its significant impact on national tax laws and the extensive scope of the direct tax problems it addresses, ECJ case law is of considerable relevance to the Commission and has particular links to its soft law measures. Currently, the Commission follows a two-track path when dealing with direct tax problems in the internal market. As well as releasing general approach documents⁹⁶ outlining a grand design for the future of direct taxation in the EU, the Commission produces communications on specific issues. The origins of this approach can be traced back to a Communication from 2001.⁹⁷ Then, a need was recognised to develop a more general understanding of the impact of important rulings of the Court regarding Member States' company tax rules and double taxation treaties. The Commission decided to publish guidance in this area in order to clarify the meaning of tax decisions for the Member States, their judiciaries and businesses. According to the Commission, guidance was necessary to render non-harmonised direct tax regimes of

⁹⁶ Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee *Tax Policy in the European Union: Priorities for the Years ahead*, COM (2001) 260 final; Communication *An Internal Market without Company Tax Obstacles- Achievements, Ongoing Initiatives and Remaining Challenges*, note 40 above.

⁹⁷ Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee *Towards an Internal Market without Tax Obstacles: a Strategy for Providing Companies with a Consolidated Corporate Tax Case for their EU-wide Activities*, COM (2001) 582 final.

the Member States compatible with EU law and more specifically with case law of the Court of Justice. By strengthening compliance with the Treaty, the abolition of tax obstacles in the internal market would be facilitated.

In 2003, the Commission prepared a Communication developing guidance on and coordinating implementation of important ECJ rulings about dividend taxation of individuals.⁹⁸ It explained how to render national rules on taxing dividends received by individuals compliant with EU law. Additionally, the Communication encouraged the Member States to cooperate in order to deal with this matter quickly. It stated that if Member States could not agree on coordinated solutions, the Commission would initiate legal action against those Member States whose dividend tax rules breached the Treaty. The Court of Justice was already faced with the issue of dividend taxation. In principle, the ECJ ruled that a measure which provides for different tax treatment between domestic and inbound dividends was incompatible with the provisions on the free movement of capital. The Communication referred primarily to the judgments in: *Verkooijen*,⁹⁹ *Manninen*¹⁰⁰ and *Lenz*.¹⁰¹

In 2006, the European Commission adopted a Communication that announced a series of new initiatives to improve cooperation and to promote better coordination of national direct tax systems in order to remove fiscal barriers that hinder the internal market.¹⁰² Once again, a driving force behind this renewed concern about direct taxation within the EU was an increase in the volume and importance of litigation by taxpayers challenging national tax rules on grounds of their non-compliance with EU law. As a result of jurisprudence of the ECJ, three

⁹⁸ Communication of 19 December 2003 from the Commission to the Council, the European Parliament and the European Economic and Social Committee on *Dividend Taxation of Individuals in the Internal Market*, COM (2003) 810 final.

⁹⁹ Case C-35/98 *Staatssecretaris van Financiën v B.G.M. Verkooijen* [2000] ECR I-4071.

¹⁰⁰ Case C-319/02 *Petri Mikael Manninen* [2004] ECR I -7477.

¹⁰¹ Case C-315/02 *Anneliese Lenz v Finanzlandesdirektion für Tirol* [2004] ECR I-7063.

¹⁰² Communication of 19 December 2006 from the Commission to the Council, the European Parliament and the European Economic and Social Committee on *Co-ordinating Member States' Direct Tax Systems in the Internal Market*, COM (2006) 823 final.

Communications based on the case law related to the problems of exit taxation¹⁰³, anti-abuse measures¹⁰⁴ and cross-border losses¹⁰⁵ were issued.

With respect to the Communication on exit taxation of emigrating individuals and undertakings, the explicit sources of inspiration for the Commission were two tax judgments: *Lasteyrie du Saillant*¹⁰⁶ and *N.*¹⁰⁷ The Communication on the application of the rules preventing abuse of tax laws called on the Member States to review their national anti-abuse rules regarding, *inter alia*, thin capitalisation of companies and controlled foreign companies in the field of direct taxes in the light of the principles established by the ECJ in relevant case law, including *Lankhorst-Hohorst*,¹⁰⁸ *Thin Cap GLO*¹⁰⁹ and *Cadbury Schweppes*.¹¹⁰ Additionally, the Communication on cross-border loss relief was largely built upon case law of the ECJ, particularly the *Marks and Spencer* case.

Having as their main objective the coherent interaction of national laws within the EU and their compliance with EU principles, the three Communications produce examples of areas that require greater attention for coordination between EU Member States. In these soft law measures,¹¹¹ the Commission explains how the ECJ's judgments on exit taxation, cross-border loss offsetting and anti-abuse measures should be understood, inviting the Member States to accept that interpretation and to apply it within their tax systems. In that sense, soft law is used as a supplement to hard law regulation through case law.

¹⁰³ Communication of 19 December 2006 from the Commission to the Council, the European Parliament and the European Economic and Social Committee on *Exit Taxation and the Need for Coordination of Member States' Tax Policies*, COM (2006) 825 final.

¹⁰⁴ Communication of 10 December 2007 from the Commission to the Council, the European Parliament and the European Economic and Social Committee on the *Application of Anti-abuse Rules in the Area of Direct Taxation* COM (2007) 785 final.

¹⁰⁵ Communication of 19 December 2006 from the Commission to the Council, the European Parliament and the European Economic and Social Committee on *Tax Treatment of Losses in Cross-Border Situations* COM (2006) 824 final.

¹⁰⁶ Case C-9/02 *de Lasteyrie du Saillant*, note 42 above.

¹⁰⁷ Case C-470/04 *N*, note 42 above.

¹⁰⁸ Case C-324/00 *Lankhorst-Hohorst*, note 57 above.

¹⁰⁹ Case C-524/04 *Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* [2007] ECR I -2107.

¹¹⁰ Case C-196/04 *Cadbury Schweppes*, note 87 above.

¹¹¹ Under Senden's classification of soft law measures presented in Chapter 1, section 1.5.4., the Communications, *prima facie*, can be grouped as pure interpretative instruments.

As the guardian of the Treaties, the Commission has assumed the role of proposing a common response to the most significant issues in the internal market arising due to the lack of closer coordination of national tax rules.¹¹² Unsuccessful in pursuing traditional hard law, the Commission proposed instead to expand the range of regulatory instruments coordinating national direct tax systems.¹¹³

The use of a non-legislative approach becomes an additional means of making progress in the direct tax field. The Commission appears to attempt to achieve similar results as were achieved through peer pressure, which is the basis of the Code of Conduct. Other instruments, for example, recommendations, guidelines and interpretative notices, could also be considered. According to the Commission, the use of the soft law approach could be particularly effective where such soft law has a firm legal foundation, based on the Treaty and ECJ case law. In these cases, instruments such as communications, recommendations, guidelines and interpretative notices can provide guidance to Member States on the application of the Treaty principles and promote the rapid removal of obstacles to the internal market.

A somewhat reverse process took place in the personal tax field.¹¹⁴ Here, a soft law measure (a Recommendation of the Commission¹¹⁵) preceded the case law of the Court. However, tax jurisprudence became a primary source of regulation and developed the sphere of cross-border workers' taxation. Soft law, in this context, acted as a precursor to hard law. In its decisions, the Court applied components of the soft law measure but, with time, tax case law became a more comprehensive and influential source of regulation.

¹¹² In addition to the activities consisting of the release of soft law instruments described in this section, the Commission decided to initiate infringement proceedings more often against those Member States that violate EU law in the field of direct taxation. See Chapter 3, section 3.3. for some statistical evidence in this context.

¹¹³ Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee *Tax Policy in the European Union: Priorities for the Years ahead*, COM (2001) 260 final, p.22.

¹¹⁴ The process of coordination of personal taxation within the EU has not been of great interest to the EU. Among the most important initiatives in this regard, one has to point out the Directive on the taxation of savings income. See Chapter 2, section 2.2.5.

¹¹⁵ 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 1994 L 39/22.

The principles of this Recommendation were largely confirmed by the ECJ in the *Schumacker* case.¹¹⁶ The ECJ in this decision does not refer to the Recommendation and does not explicitly acknowledge that the ECJ deviates from the rules set out there. Unlike the soft law measure, which indicates that the earning of 75% of the relevant income in the host state is sufficient to be granted national treatment, the ECJ uses more ambiguous terminology without specifying a percentage level. The ECJ does not explain what earning income ‘entirely or almost exclusively’ income in the source state means. This rule allows for a degree of arbitrariness and legal uncertainty. The *Schumacker* rule has been further settled in later judgments such as *Gschwind*,¹¹⁷ *Gerritse*¹¹⁸ and *Wallentin*.¹¹⁹ It is worth noting that the *Gschwind* case indicates that the limit should be set higher than the 75 % suggested in the Commission Recommendation.

In general terms, the interaction between direct tax case law and other EU regulatory measures is evident. As shown, the Commission has started to undertake more non-binding initiatives and it sought inspiration from the jurisprudence of the ECJ in doing so. Thus, hard and soft law interplay and reinforce each other in removing obstacles to the internal market. In other words, it can be argued that the newly found interest of the Commission in direct taxation systems is, to a great extent, a result of negative integration carried out by the ECJ. As such, soft law measures in the form of various Commission communications are adopted in order to enhance and maximise the effects of the Court’s tax decisions.

In direct tax judgments, many tax obstacles to cross-border activities have been removed. Nonetheless, the ECJ cannot provide a Member State with positive guidance on what to do when a national tax rule is found to be non-compliant with EU law. The Court can merely point out what measures breach EU principles but it does not clarify how to change national tax systems. Thus, scope for the Commission to act appears. The Commission *can* offer explanations and positive guidance on the direct tax decisions.

¹¹⁶ Case C-279/93 *Schumacker*, note 6 above.

¹¹⁷ Case C-391/97 *Frans Gschwind v Finanzamt Aachen-Außenstadt* [1999] ECR I-5451.

¹¹⁸ Case C-234/01 *Arnoud Gerritse v Finanzamt Neukölln-Nord* [2003] ECR I-5933.

¹¹⁹ Case C-169/03 *Florian W. Wallentin v Riksskatteverket* [2004] ECR I-6443.

This positive guidance proves invaluable because, as the Commission correctly envisaged, even when a direct tax judgment forces a number of Member States to introduce new direct tax rules, the Member States may often do so in vastly differing ways.¹²⁰ When Member States put tax judgments into practice in different ways, national direct tax systems are still at risk of not operating coherently. Hence, uniform applicability of EU law principles is endangered if the process of implementing the Court's decisions is not consistent. The complexity of direct tax regulation may increase. The use of soft law instruments can address, at least to a certain extent, the problem of asymmetry in the legal approaches of Member States to implementing tax judgments. These measures can indicate potential legal problems and suggest ways of dealing with them to avoid legal conflicts or even litigation. Second, these instruments can contribute to the development of new tax rules when the Court has found the old ones to be unlawful.

In addition, by ensuring that ECJ rulings are respected and uniformly implemented by the Member States, the Commission attempts to solve the problems of the internal market and direct taxation at the political level before it decides to litigate against a Member State that might be in breach of EU law. In other words, the explanation of the consequences of direct tax decisions in interpretative non-binding instruments is expected to prevent infringement procedures where possible.¹²¹

It can also be argued that the establishment of an obvious link between direct tax case law and the Commission's activity constitutes a signal to the Member States. The message imparted is that both the ECJ and the Commission pursue similar agendas and express coinciding views as to the shape of national direct tax systems

¹²⁰ For instance, when a specific direct tax measure is declared to violate EU law, some Member States that apply such a measure may remove it from their tax systems. It is also possible that some of them may extend the measure also to their residents in order to escape the problem of a discriminatory nature of the measure.

¹²¹ A Member State may be referred to the Court of Justice for incorrect implementation of a judgment. As far as direct taxation is concerned, the most recent example of such a proceeding is from 8 October 2009. The European Commission decided to refer the United Kingdom to the ECJ for improper implementation of the ECJ ruling in *Marks & Spencer* on cross-border loss relief. See: IP/09/1461 available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1461&format=HTML&aged=0&language=en&guiLanguage=en>. The Commission's infringement case number is 2007/4026 Implementation of *Marks & Spencer* (tax compensation of fiscal losses). The decision of the Commission to go to the ECJ has not yet been carried out.

operating within the internal market. It could be claimed that in setting up the connection with direct tax jurisprudence by issuing related soft law instruments, the Commission endeavours indirectly to indicate two dominant, prospective and potentially successful paths for developing EU direct tax policy when the traditional legislative approach fails to succeed. As a result of the combination of these two integration roads, a solid basis for future legislative initiatives may be built. Achievements of the two combined approaches may become a signpost in harmonising systems of direct taxes when/if the Member States are ready to take a step further in bringing their tax systems together.

A question has to be asked whether the Commission offers a correct interpretation of direct tax jurisprudence in the three Communications. A discovery that the Communications do *not* offer the right interpretation of case law is important from two perspectives. First, the Communications, as examples of soft law, are not legally binding and cannot be subject to the ECJ enforcement. If a Member State follows the Commission's interpretation of the ECJ's jurisprudence, it will not be able to use this as a justification when the Commission does not interpret case law in a correct manner. A case against national law adopting an incompatible interpretation of case law, on the basis of soft law, can be referred to the ECJ. Alternatively, the ECJ can be requested to clarify its case law through the preliminary ruling procedure.

It has to be underline that the ECJ is not able directly to test compatibility of the interpretative communications (or any other soft law measure) with its decisions. Neither can the Commission or any other institution refer a question to the Court on the compatibility of soft law initiatives. Therefore, explicitly, it would not be a case of deciding about the content of a soft law measure. The Court would thus be given an opportunity to elucidate its jurisprudence. *Indirectly*, however, the judgment would reflect on the content of the soft law measure, formally outside the influence of the ECJ. The ECJ would only indirectly engage soft law in a case. By providing its interpretation of case law, the Court would reject incorrect interpretation of case law endorsed in the soft law measure. In other words, hard law would displace soft law.

Second, when the interpretation presented in the Communications deviates from the goals conveyed by the Court, the Communications become an expression of the ambitions of the Commission in this field and the future integration paths promoted by the Commission. When goals of tax integration expressed in case law and such goals expressed by the Commission in its soft law instruments differ, that may create a potential clash of priorities and lack of clarity about necessary developments in European integration.

As regards the Communication on exit taxation, it is developed by reference to two cases; *Lasteyrie du Saillant* and *N*, which prohibited taxes on emigration. These cases were concerned with exit taxation imposed on *natural persons* who wished to change their country of residence. With respect to companies, a body of case law existed before *Lasteyrie du Saillant* and *N*. Starting with the *Daily Mail* case¹²² which is thought to have permitted exit taxes when a company transfers its seat, it was indirectly confirmed in *Cartesio*¹²³ that exit restrictions on companies are acceptable. The distinction between natural and legal persons was drawn on the fact that legal persons exist only because of the law of the state in which they were incorporated. The Communication (in the introduction) states that it analyses the *Lasteyrie du Saillant* and *N* cases and considers how they affect exit taxes levied on individuals and *companies*.¹²⁴ Consequently, the Communication disregards the strand of case law on exit restrictions developed specifically in relation to companies. This clearly means that the Commission expands the scope of the cases on exit taxation regarding natural persons without explaining why the cases regarding companies are disregarded.

The view of the internal market conveyed by the 2006 exit tax Communication is wider than the view taken by the Court. In effect, the Communication articulates the discontent of the Commission with case law in the field of exit taxation. The Communication oversteps its role of providing guidance on the principles stemming

¹²² Case 81/87 *The Queen v H. M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc.* [1988] ECR 5483.

¹²³ Case C-210/06 *Cartesio Oktató és Szolgáltató bt* [2008] ECR I-9641.

¹²⁴ Communication *Exit Taxation and the Need for Co-ordination of Member States' Tax Policies*, note 103 above, at 3.

from this case law. It does not just offer guidance on the exit tax jurisprudence but departs dramatically from the understanding which the ECJ attempted to incorporate in its decisions. Of course, if the Commission is not satisfied with the outcome of jurisprudence, it can initiate a legislative process which would propose law compatible with the Commission's comprehension of exit taxation in the internal market.

Similarly, the Communication on offsetting cross-border losses is said to be built on case law, in particular, the *Marks and Spencer* decision. Once again, through the Communication, the Commission expresses its views on the problem of loss relief despite the fact that the Communication was supposed to explain loss relief case law to the Member States. The *Marks and Spencer* decision established that cross-border loss relief was obligatory only in specific situations i.e. when the losses of the foreign subsidiary could not have been offset in the source state. By no means has the Court supported an unconditional loss offsetting in intragroup situations. Examination of the Communication indicates that the Commission supports a wider availability of loss compensation both in cross-border and domestic situations than the ECJ. It urges the Member States to adopt a coordinated response to allowing companies loss relief.¹²⁵

As regards the Communication on anti-abuse measures, it cannot be considered to go against case law. The Communication, just as the ECJ, does not purport to say that all rules through which the Member States seek to protect their tax bases from erosion, such as controlled foreign company rules or thin cap rules, constitute a violation of the freedom of movement. The message underlying both the jurisprudence and the Communication can be recapitulated in a statement that the anti-abuse measures have limitations. They must not be constructed too expansively and must be targeted at wholly artificial arrangements. The Commission respects the principles established by the ECJ on a case-by-case basis but claims that the criteria which the ECJ laid down in specific cases must be applied to individual facts. The Communication manifests the Commission's willingness to explore the practical application of case law principles on anti-abuse measures to the national tax systems

¹²⁵ Communication *Tax Treatment of Losses in Cross-Border Situations*, note 105 above, at 10.

in a more general fashion. For instance, it calls for cooperation among the Member States in developing common definitions of abuse or wholly artificial arrangements.¹²⁶ It also suggests that Member States should not overreact to the anti-abuse direct tax case law by extending the scope of measures to purely internal situations where no risk of abuse exists.¹²⁷

Overall, according to Terra and Wattel,¹²⁸ the Communications were published in order to maximise negative integration by interpreting the case law of the ECJ to facilitate the adoption of the principles by the Member States. This author disagrees. The Communications undermine in fact the ECJ's jurisprudence by presenting an incompatible understanding of the relevant case law. This is undesirable when the case law is actually the most developed aspect of direct tax regulation.

If the Communications enhanced and supported case law, soft and hard law measures could be considered as working towards one goal, strengthening EU integration and showing a united front to the Member States. However, the Communications seem to exceed the role that they should play. Interpretative communications should not change the *acquis* and should not contain new normative elements. The Commission appears to have utilised the Communications to express *its* opinions on the requirements of the internal market and did not restrict itself to shedding light on the principles established by the Court. Of course, the Commission does not have to share the views of the Court; however, its critique of case law should be conducted more openly, not by 'interpreting' case law in a manner which the Commission approves. The lack of coherence between case law and the Communications may create unnecessary discord between soft law and hard law tax integration, and cause confusion among the Member States with regard to the direction of tax integration. If the Commission disagrees with the substance of the direct tax regulation achieved by the ECJ, a legislative action harmonising national tax systems at EU level should be initiated. Thus, the ECJ will be relieved from deciding, often highly controversial, direct tax cases.

¹²⁶ Communication *Application of Anti-abuse Rules in the Area of Direct Taxation*, note 104 above, at 9

¹²⁷ *Ibid.*, at 6.

¹²⁸ B J M Terra and P J Wattel, *European Tax Law*, (The Alphen aan den Rijn: Kluwer, 2008), at 92.

3.3. The ECJ as a driving force behind direct tax regulation within the internal market: statistical evidence

The previous sections of this chapter demonstrated the substantive influence exerted by the Court over national direct tax systems. This section serves a similar purpose. It establishes that the ECJ is the major force behind developments currently occurring within direct tax regulation. Presentation of some statistical evidence advocates a claim that the regulatory importance of the ECJ in direct taxation has been increasing. A quantitative overview of direct tax jurisprudence suggests that the ECJ has been actively contributing to the development of European direct tax law.

Five key characteristics of direct tax jurisprudence can be distinguished. First, the absolute number of direct tax cases lodged before the ECJ has increased enormously. 171¹²⁹ direct tax cases have been, so far, decided by the ECJ.¹³⁰ Analysis carried out across the years proves that direct tax cases were initially very infrequent. Having delivered its first direct tax judgment in 1986, the ECJ was not again occupied by direct tax problems until the late 1990s.

Until then, direct tax cases were irregularly brought before the ECJ. In some years, the ECJ did not decide any cases concerned with direct tax problems.¹³¹ One can also notice that, since 1992, the ECJ was annually presented with at least one direct tax case. With time, however, the number of cases has grown remarkably. To compare,

¹²⁹ This calculation is valid as of 29 August 2011. It is based on information provided in a table of ECJ and CFI cases in the field of, or of particular interest for, direct taxation (capital duty inclusive), available at http://ec.europa.eu/taxation_customs/resources/documents/common/infringements/case_law/court_cases_direct_taxation_en.pdf. It covers individual and corporate tax cases. For the purpose of this chapter, the focus has been on direct taxation cases, with the exclusion of capital duty cases. Judgments delivered in the last six months, not yet reported, are: Case C-155/09 *European Commission v Hellenic Republic* of 20 January 2011; Joined Cases C-436/08 and C-4367/08 *Haribo Lakritzen Hans Riegel BetriebsgmbH, Österreichische Salinen AG v Finanzamt Linz* of 10 February 2011; Case C-25/10 *Missionswerk Werner Heukelbach eV v État belge* of 10 February 2011; Case C-450/09 *Ulrich Schröder v Finanzamt Hameln* of 31 March 2011; Case C-20/09 *European Commission v Portuguese Republic* of 7 April 2011; Case C-267/09 *European Commission v Portuguese Republic* of 5 May 2011; Case C-384/09 *Prunus SARL, Polonium SA v Directeur des services fiscaux* of 5 May 2011.

¹³⁰ For clarification, the calculation of direct tax cases may be somewhat different when one takes into consideration that some cases were joined.

¹³¹ For instance, in 1987, 1989 and 1991, no record of direct tax judgments exists. On the other hand, 1986, 1988, 1990 and 1994 witnessed only one decision within the field of direct taxes in each year. See: http://ec.europa.eu/taxation_customs/resources/documents/common/infringements/case_law/court_cases_direct_taxation_en.pdf.

in 1988, the ECJ decided one direct tax case. In 1998, there were four rulings, whereas in 2008 the ECJ decided on 21 direct tax cases.

Secondly, the vast majority of cases decided by the ECJ in the context of direct taxes were based on the procedure of Article 267 TFEU establishing preliminary ruling references.¹³² According to Kingston, by April 2007, the ECJ handed down 75 judgments on the compatibility of national tax provisions with the fundamental freedom provisions protected by the Treaty. Among these judgments, only eight cases were grounded on Article 258 TFEU.¹³³ It can be shown that the trend of dominance of preliminary ruling references¹³⁴ leading to the ECJ's decisions has remained reasonably stable to date.¹³⁵

It is worth mentioning, nevertheless, that as far as infringement procedures initiated by the Commission in the field of company taxation and personal taxation are concerned, the Commission appears to have started to pursue a more proactive infringement policy in general. It has also concentrated on a consistent policy of follow-up and monitoring of the implementation of the judgments of the ECJ in Member States.¹³⁶ A comprehensive survey of information about infringement proceedings in the context of direct taxes from the last four years suggests that the number of proceedings against a Member State¹³⁷ initiated by the Commission is on the increase. In the first 20 years of the direct tax jurisprudence, the ECJ delivered rulings in ten cases pursued under Article 258 TFEU whereas over the last two

¹³² S Kingston, note 30 above, at 1322.

¹³³ *Ibid.*, at 1322, footnote 4. For completeness, the first ruling of the ECJ in a direct tax case was initiated in an infringement procedure. See: Case 270/83 *Avoir Fiscal*, note 3 above. The first judgment resulting from a request of a national court for a preliminary ruling was the decision in Case 81/87 *Daily Mail*, note 122 above.

¹³⁴ Among national courts and tribunals that refer a request to the ECJ to give a preliminary ruling most frequently, one can include Belgian, German, Dutch and British courts.

¹³⁵ For instance, in 2008, the ECJ delivered 21 judgments in direct tax cases. 18 of these proceedings were initiated on grounds of the preliminary ruling procedure. In 2009, the trend of the dominance of preliminary ruling references remained consistent. 13 out of 19 direct tax cases were decided as preliminary ruling references. In 2010, 13 out of 15 were based on Article 267 TFEU.

¹³⁶ Monitoring Application of Community Law:

http://ec.europa.eu/taxation_customs/common/infringements/commission_policy/index_en.htm. This new approach of the Commission was discussed in more detail in Chapter 4, section 4.3.

¹³⁷ An overview of direct tax cases brought before the ECJ on the basis of the infringement procedure suggests that initially, France and Belgium were most often referred to the Court of Justice for breaching EU law. Since 2007, Portugal, Germany and Spain are most frequently brought before the ECJ in infringement direct tax proceedings.

years,¹³⁸ the ECJ has already decided eleven cases regarding direct tax which were lodged on the basis of Article 258 TFEU. That demonstrates greater activity and involvement of the Commission in issues regarding direct taxes. It can also be noted that, since 2006, the ECJ has been delivering infringement decisions on a yearly basis.¹³⁹

The altered approach of the Commission with regard to taking legal action against Member States whose national tax rules do not comply with the Treaty is expressed in the 2001 Commission Communication.¹⁴⁰ The Commission recognises the potential in actions against the Member States on the basis of Article 258 TFEU as a way of enhancing the functioning of the internal market. The Commission's hitherto prevailing lack of influence as far as infringement proceedings in relation to direct taxation are concerned is clearly admitted in the 2001 Communication.¹⁴¹ Subsequently, the Commission announces that it is going to become more proactive in undertaking steps against those Member States that do not respect EU principles and breach them through direct tax measures or practices.

This document marks an attempt on the Commission's part to try alternative routes within the context of direct tax issues in the EU to enable smoother operation of the internal market. The aim of the Communication in question is to ensure that the tax systems of the Member States comply with EU law and interact with each other in a coherent manner. The comprehensive strategy of the Commission to promote tax coordination among the EU Member States complements the ongoing legislative initiatives within the field of direct taxation. It can be argued that the fresh approach to direct tax cases carried out under the infringement procedures constitutes an element of the new proactive policy supported by the Commission.

¹³⁸ Period from January 2008 to December 2010.

¹³⁹ Among the recent judgments in direct tax cases initiated on grounds of Article 258 TFEU are: C-155/09 *European Commission v Hellenic Republic* of 20 January 2011, not yet reported; Case C-20/09 *European Commission v Portuguese Republic* of 7 April 2011, not yet reported; Case C-267/09 *European Commission v Portuguese Republic* of 5 May 2011, not yet reported.

¹⁴⁰ Communication of 23 May 2001 from the Commission to the Council, the European Parliament and the European Economic and Social Committee on *Tax Policy in the European Union - Priorities for the Years Ahead*, COM (2001) 260.

¹⁴¹ *Ibid.*, page 21.

Simultaneously, even though the Commission appears to be more active under Article 258 TFEU in relation to direct tax issues, many more proceedings are resolved before reaching the litigation phase.¹⁴² The Commission can decide not to direct a case to the ECJ because either a Member State whose legislation was suspected to be in breach of EU law decided to implement necessary changes to make its rules compatible with EU law or, on a closer inspection, national tax measures were not found to breach EU law. All but two infringement procedures regarding company taxation that have been in progress since September 2008 are at the stage of a request or a formal request of the Commission to the Member State to end discriminatory tax practices. Nine referrals of a Member State to the ECJ for its discriminatory direct tax rules (personal and company taxation) took place 2009¹⁴³ and eight in 2010/2011.¹⁴⁴

The third characteristic of direct tax jurisprudence is that most cases judged by the ECJ concern the issue of compatibility of national tax rules with the primary Treaty provisions. This should not come as a surprise. Due to the limited legislative framework within the area of direct taxes, the ECJ applies provisions set out by the EC Treaty when it deals with direct taxation issues. On a few occasions, however, cases regarding interpretation of national tax laws in relation to secondary tax law were subject to an ECJ decision; as was the case in *Denkavit*¹⁴⁵ and *Burda*.¹⁴⁶

Additionally, the material scope of tax cases appears to expand. Put differently, the number of areas covered by the jurisprudence has risen. Initially, tax cases lodged

¹⁴² P Schonewille, 'Eliminating Tax Barriers via the Infringement Procedure of Article 226 of the EC Treaty', (2006) 15:3 *EC Tax Review* 147-150 at 148.

¹⁴³ For example: on 19 February Hungary was referred to the Court of Justice over discriminatory tax provisions concerning the duty levied on the purchase of residential property. See IP/09/290 available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/290&format=HTML&aged=0&language=en&guiLanguage=en>. Portugal was referred to the European Court of Justice over discriminatory taxation of non-resident taxpayers. See IP/09/288 available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/288&format=HTML&aged=0&language=en&guiLanguage=en>.

¹⁴⁴ See for example: <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/662&format=HTML&aged=0&language=en&guiLanguage=en>. On 3 June 2010 the Commission referred Austria, Germany and Portugal to the ECJ. Portugal changed its legislation and the proceedings against it closed on 14 March 2011.

¹⁴⁵ Joined Cases C-283/94, C-291/94 and C-292/94 *Denkavit International BV*, note 7 above.

¹⁴⁶ Case C-284/06 *Burda*, note 7 above.

before the ECJ concerned exclusively VAT/indirect taxes; however, since the 1980s direct taxes have also started to be considered by the ECJ. With regard to the material scope of direct tax cases, various areas of taxation are covered. Corporation taxes, individual income taxes and inheritance taxes are some of the examples.

Lastly, in all but a few direct tax cases, the ECJ has ruled in favour of a taxpayer. In other words, in the majority of the decided cases, the Court found that national tax regulation violated the Treaty fundamental freedoms. Furthermore, justifications of the incompatible national tax measures offered by national governments were very rarely accepted by the ECJ. This might be one of the reasons for the rising number of direct tax cases that the ECJ is requested to hear. Positive results of litigation for taxpayers may give others encouragement to challenge national tax restrictions on cross-border activities.

The statistical data supports a conclusion that the Court has become the leading institution in promoting the interests of the internal market and exerting regulatory power over national direct tax systems. Examination of direct tax jurisprudence shows that the volume of the cases has increased dramatically over years. Direct tax cases have become an opportunity to fill in gaps operating due to the lack of direct tax directives.

The statistical evidence suggests the roads to integration that are currently being taken within the EU and touches upon a broad problem for the future of European tax regulation. Taxpayers see sources of desirable European tax regulation in the jurisprudence and the impetus to coordinate national tax systems currently comes from the ECJ. It is anticipated that the influence of the ECJ within the field of direct taxation will be maintained and direct tax jurisprudence will remain a source of important developments.

Conclusions

Within the context of this thesis, this chapter belongs to the group of chapters that present hard law measures. Chapter 3 demonstrates importance and great complexity of the regulatory structure created by the ECJ. In effect, this chapter plays an

important role in showing the contrast between the achievements of direct tax jurisprudence when compared with the scope of the relatively unimpressive legislative framework on direct taxes.

This chapter testifies that the ECJ has exerted considerable influence on direct tax systems. It is a sign that hard law regulation still develops. In other words, hard law regulation of direct taxes in the EU is not overpowered by other governance modes. As traditional hard law regulation is not successful because of the EU political inability to respond to common concerns regarding direct taxes, litigation increases and taxpayers indirectly reshape the direct tax landscape.

Currently, the ECJ's jurisprudence is the most dynamic area of regulatory achievements. Many direct tax barriers to the internal market were abolished. The ECJ has corrected the power to regulate taxes by pointing out that, even in the field of exclusive competence, EU legal principles must be respected. The position of the ECJ, as described by the Treaty, has enabled the Court to take leadership in targeting these tax areas in need of clarification and reform. In direct tax cases, as in all other cases, the ECJ pursued its task to ensure that in the interpretation and application of the Treaty, the law is observed. Therefore, the primary role of the Court is to interpret provisions of the Treaty and determine their limits. The ECJ has not shied away from setting out foundations for the EU legal order and stepping in where the Treaty rules were unclear about relations between the EU and the Member States. It should not shy away from that task in direct tax cases either.

Tax constitutes a context and what is brought to the forefront in ECJ litigation is EU law. The Court does not act as a tax court and nor should it.¹⁴⁷ Tax technicalities are not of primary importance to the ECJ and questions touching upon the division of tax jurisdictions should not be of concern to the Court. What really matters is the behaviour of Member States with respect to EU law when carrying out their tax activities. No exception should be made in the field of direct taxation with regard to

¹⁴⁷ Some academics suggested that the ECJ should be given guidance on how to decide tax cases. It was also proposed that the ECJ could consult national tax experts or set up a specialist tax division. See: J F Avery Jones, 'Carry on Discriminating', (1995) 6, *British Tax Review* 528; W Vermeend, 'The Court of Justice of the European Communities and Direct Taxes: Est-ce que la justice est de ce monde?', (1996) 6:2 *EC Tax Review* 55.

the application of EU law principles. Differences have been created, however. The duality of standards in the internal market, uncovered throughout this chapter, is undesirable and it disturbs the legal clarity and certainty of the case law as a whole.

Good understanding of the developments in direct tax case law gains special importance in the context of unwillingness to develop European legislation on direct taxation and the inability of the EU to respond to common concerns. It is likely that the elimination of obstacles to the internal market will still be left for the ECJ to pursue on the basis of the fundamental freedoms. The increasing significance and volume of direct tax cases lodged before the ECJ makes it a laboratory revealing the most pressing tax problems. Case law on direct taxation may become an important source of inspiration for regulatory initiatives in the EU and solutions proposed by the ECJ may be taken on in legislative measures if/when political will allows it.

On the other hand, the dominance of case law over directives is not ideal. The ECJ cannot create a positive, coherent tax *system*. It only has ‘the power to destroy’¹⁴⁸ because the Court can merely indicate whether or not certain provisions comply with EU law. Judicial integration is a negative process because, under Article 267 TFEU, the ECJ can only provide guidance on the interpretation of EU law so that national courts can assess the compatibility of national rules with it. Moreover, the ECJ answers the issues which are raised only to the extent necessary to deal with a case. This entails solely case-by-case progress. In this context, the connection between hard law jurisprudence and the interpretative soft law instruments published by the Commission could play an important role. The Commission could help the Member States to overcome difficulties with fuller implementation of direct tax judgments. However, such Communications were employed to date in order to undermine case law instead of enhancing negative integration.

¹⁴⁸ Expression used by D. Williams in: ‘*Asscher, the European Court of Justice and the Power to Destroy*’, (1997) 6:1 *EC Tax Review* 4-10. To the power to destroy, one can add the power to maintain the existing situation.

A remedy to the abovementioned drawbacks of case law lies in the Member States' hands. So far, this has not been fully realised and its importance may be underappreciated by national authorities. If a true internal market is to be established, the next step has to be taken by the Member States.

CHAPTER 4. DISCOVERING NEW LANDS: THE SOFT LAW APPROACH TO DIRECT TAX REGULATION

Introduction

Chapters 2 and 3 explored two components of hard law regulation. In this chapter, soft law regulation is investigated. The focal point becomes an instrument formally presented and generally regarded as an example of EU soft law,¹ namely, the Code of Conduct for Business Taxation (hereinafter the Code or Code of Conduct).² On the basis of this regulatory measure, a two-fold debate is conducted throughout this chapter.

First, the analysis concentrates on the soft law features of the Code. It is explored how the Code meets the criteria of a soft law measure. In this context, this chapter reminds us that soft law is not exclusive to the EU. It was also employed by the OECD in order to resolve international tax issues. Second, the examination in this chapter is carried out from a broader perspective. It is evaluated how the Code is embedded in the wider environment of direct tax regulation. Consequently, the chapter attempts to establish why soft law governance was applied in the sphere of corporate tax regulation. Thus, situated among chapters discussing the traditional hard law approach to direct tax regulation,³ this chapter demonstrates the novelty of the soft law approach to regulation of direct taxation in the EU.

¹ The Code was classified as a soft law measure by, for example: H Gribnau, 'Soft Law and Taxation: EU and International Aspects', (2008) 2:2 *Legisprudence* 67-117, at 1; A Fantozzi, 'The Applicability of State Aid Rules to Tax Competition Measures: a Process of 'De Facto' Harmonisation in the Tax Field?', in W Schoen (ed.), *Tax Competition in Europe*, (Amsterdam: IBFD, 2003), 121-132 at 123; R H C Lujta, *Assessment and Recovery of Tax Incentives in the EC and WTO: a View on State Aids, Trade Subsidies and Direct Taxation*, (Antwerp, Oxford, New York: Intersentia, 2003), p. 106; C Radaelli, *The Code of Conduct against Harmful Tax Competition: Open Method of Coordination in Disguise*, EUI Working Papers RSC No. 2002/43, available at http://cadmus.eui.eu/dspace/bitstream/1814/1801/1/02_43.pdf, p.9.

² Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy, OJ 1998 C 2/1.

³ See Chapters 2 and 3 for details of hard law regulation in direct taxation.

The Code of Conduct has attracted little interest among scholars.⁴ In addition, the existing literature has been largely restricted to describing the material side of the Code. Little is known about the reasons underpinning the formulation of the Code as a soft law instrument. Unfortunately, the question about the motivation behind the choice of the regulatory form of the Code is difficult to explore due to limited access to (or lack of) documentation from the time when the Code was created. It was prepared in the era preceding the openness and transparency now guaranteeing easier access for the public to EU documents. Nevertheless, on the basis of circumstances surrounding the adoption of the Code, it can be argued that there are compelling arguments in favour of the soft law provenance scenario.

Additionally, irrespective of the fact whether the soft law approach was purposefully introduced to the area of direct taxation in recognition of its regulatory potential or as the result of a compromise in the light of political inability to adopt a directive, the introduction of soft law added a new dimension to EU direct tax regulation. The soft law aspects of the Code thus offered positive values that may continue to influence the future of EU corporate tax regulation. They should not be overlooked.

Finally, this chapter supports an argument that EU corporate tax cooperation has not evolved in a linear fashion from traditional hard law regulation to the softer approach. The hard law approach has not been abandoned and replaced by soft law. On the contrary, both approaches coexist within the same field but their presence is unequal. The regulatory environment of direct taxation is still dominated by hard law instruments. Despite the disappointing framework of direct tax directives, the hard law approach has a strong regulatory influence, primarily because of expanding case law of the ECJ.

⁴ The Code is usually mentioned in relation to the problem of (harmful) tax competition but the available literature dedicated to the Code itself is not extensive. The most important are: C Radaelli, note 1 above; W M Bratton and J A McCahery, 'Tax Coordination and Tax Competition in the European Union: Evaluating the Code of Conduct on Business Taxation', (2001) 38:3 *Common Market Law Review* 677-718. There was also a special issue of *European Taxation* in September 2000, fully devoted to the Code of Conduct.

In effect, this chapter plays a role in explaining the need to re-evaluate different ways of regulating direct tax matters by the EU. The choice of regulatory measures in the field of direct taxation is not restricted to hard law instruments. Regulation of direct taxation within the EU has now gained a new dimension and a complex structure, consisting of interconnected soft law and hard law elements. These two types of governance do not operate in a parallel, unrelated fashion. They can work together, complement each other and reinforce each other. Hard and soft law measures are not mutually exclusive and they do not need to be perceived as complete opposites when regulating a specific field. My thesis presents the regulation of direct taxation as a dynamic area where governance modes are subject to change and evolution.

This chapter is composed of four main sections. The first section provides a brief account of the history of the tax package introduced to tackle harmful tax competition,⁵ with special emphasis on developments regarding the Code. The second section focuses on procedural aspects set out by the Code. This knowledge of the substantive provisions of the Code enables us to reflect in Chapter 5 on whether the implementation of the Code of Conduct occurred within the given mandate or exceeded its boundaries. The third section is devoted to an exploration of the soft features of the Code. Here, an explanation as to why soft law was introduced to direct tax regulation is also suggested.

Through a comparative study, the fourth part of the chapter shows that the soft law approach is not exclusive to the EU but has also been employed at the international level by the OECD in tackling harmful tax competition. Lessons learned in that context will help to flesh out the problems and advantages associated with transnational regulation of direct tax through soft law means. This section finds that the soft law initiative of the OECD evolved towards hard law. Soft law did not seem to have been sufficient to achieve regulatory goals. This finding provokes a question as to whether the same issue can be related to the Code. Can it be regarded as a pure

⁵ The tax package encompasses three elements. These are: the Code of Conduct for Business Taxation; Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ 2003 L 157/49; and Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, OJ 2003 L 157/38.

soft law measure or is the nature of this Code not as clear-cut as it appears at first sight? This issue is signalled in this chapter. It is subject to a comprehensive discussion in Chapter 5.

4.1. The road to the tax package

4.1.1. Monti's initiative: from Verona to Mondorf-les-Bains

After years of non-achievement regarding direct taxation,⁶ the 1990s can be characterised as a time of increased activity and interesting transformations. A key figure determined to stimulate progress in direct tax regulation was the Commissioner responsible for the Internal Market, Financial Services and Financial Integration, Customs, and Taxation, Mario Monti.⁷ The impetus to pursue changes in the sphere of direct tax regulation was provided by focusing on the issue of harmful tax competition, which was placed high on the political agenda.⁸ After years of stagnation, Monti gave new momentum to the direct tax field through the establishment of a dialogue about taxation between the Commission, the Council and the Member States. He emphasised principles of subsidiarity and sovereignty of the Member States. This entailed that any package that would be proposed had to balance the interests of different Member States.

As a result of a proposal from Commissioner Monti, the Council of Ministers for Economic Affairs and Finance (ECOFIN) met in Verona in April 1996 to discuss his paper, *Taxation in the European Union*.⁹ In terms of content, the Verona Council initiated EU tax strategy based on a comprehensive approach, engaging in the simultaneous and linked discussion about a number of important tax issues. For that reason, the text of the document was not restricted only to business taxation but referred also to VAT, social security contributions and personal income taxation. The

⁶ Chapter 2 provides an overview of direct tax harmonisation proposals since the 1960s.

⁷ Monti was in charge of tax policy in the period 1995-1999. Frits Bolkestein was Monti's successor between 1999 and 2004.

⁸ The Ruding Committee had already warned the EU Member States about harmful forms of tax competition in 1992. See Chapter 2.

⁹ *Taxation in the European Union: Discussion Paper for the Informal Meeting of ECOFIN Ministers*, SEC (96) 487 final. This document is known as the Verona Memorandum, Monti Memorandum or the First Monti Report. See: A J Martín Jiménez, *Towards Corporate Tax Harmonization in the European Community: an Institutional and Procedural Analysis*, (London, The Hague and Boston: Kluwer, 1999), p. 143.

Verona Memorandum was submitted as a reflection and a basis for debate on taxation within the EU. It drew attention to the negative consequences of the lack of a coordinated approach to this regulatory sphere.

The Monti Memorandum identified three key interwoven challenges for tax policy in the EU. These were: stabilisation of Member States' tax revenues, smooth functioning of the single market and promoting employment. Harmful tax competition was believed to have a negative result on national tax revenues by leading to the erosion of the tax base. That process was interlinked to the increasing mobility of production factors. As capital was more mobile than labour, the taxation of capital decreased whilst taxes on labour grew. Increased pressure on labour resulted in a structural change in tax systems. Closer tax coordination at the EU level was perceived as the solution to these risks. The Verona Memorandum announced the Commission's intention to examine and put forward solutions for the challenges described in the Memorandum.

As a result of discussions that followed the publication of the Verona Memorandum, a High Level Group was formed. It consisted of personal representatives of the ECOFIN ministers. Its goal was to encourage the Member States to discuss tax policy and issues arising within this context. The Group prepared a report on the development of tax systems within the EU. This report¹⁰ was a response to the Commission's comprehensive view of taxation policy set out in the Verona Memorandum. The key points of the report were as follows. First, it asserted that there was a general recognition among the members of the High Level Group that tax rules were an important element of the fully attained single market. There was, however, a wide range of opinions with regard to the urgency of or need for EU action in this context.¹¹

Second, the report stressed the need to tackle harmful tax competition and to find common principles to identify harmful tax measures. However, the report also expressed the reluctance of many of the finance ministers to pursue a harmonisation

¹⁰ *Taxation in the European Union: Report on the Development of Tax Systems*, COM (96) 546 final. This Report is also known as the Second Monti Report.

¹¹ *Ibid.*, paragraph 3.5.

initiative for income taxation and lack of support for the idea of minimum corporate tax bases and rates.¹² Third, there was a broad consensus regarding the need to reduce taxes on labour but varying views were expressed on how to achieve this goal.¹³ Overall, the report manifested a lack of unanimous opinion among the Member States about the future of the EU tax policy.¹⁴

Fourth, the final part of the Second Monti Report presented conclusions drawn by the Commission from the meetings of the High Level Group, drawing also upon the paper prepared for the Verona meeting in 1996. The Commission emphasised that any proposal for EU action in the field of taxation had to respect the principles of proportionality and subsidiarity. The Commission could not propose harmonisation of taxation for the sake of harmonisation; rather, this process should be designed in order to provide an effective protection of national tax sovereignty. As explained in Chapter 1, section 1.1.3., a common action would protect sovereignty because it would restrict tax competition, which deprives states of the ability to decide independently about taxation. The Commission also announced that it would take forward a number of initiatives, one of which was that common criteria were expected to be transposed to a ‘code of good conduct’ in terms of tax competition.¹⁵

After the Second Monti Report and the ECOFIN informal meeting in Mondorf-les-Bains in September 1997, where it was announced that the Council would consider taking forward issues raised by the Second Monti Report, the Commission published a Communication.¹⁶ Once again, it recognised a great need to develop coordination of national tax systems. A package of measures tackling harmful tax competition was then set out. The Communication envisaged that the package to tackle harmful tax competition would be composed of four possible components.

With regard to direct taxation, three measures needed to be adopted: measures to eliminate distortions in taxation of interest on savings, measures to eliminate

¹² *Ibid.*, paragraph 3.14.

¹³ *Ibid.*, paragraphs 4.1-4.8.

¹⁴ See Chapter 1, section 1.1.2. for a broader reflection on tax sovereignty.

¹⁵ Second Monti Report, note 10 above, p. 10.

¹⁶ Communication from the Commission to the Council of 1 October 1997: *Towards Tax Co-ordination in the European Union: a Package to Tackle Harmful Tax Competition*, COM (97) 495 final.

withholding taxes on cross-border payments of interest and royalties between companies,¹⁷ and a non-binding Code of Conduct for Business Taxation to tackle harmful tax competition.¹⁸ The fourth element of the proposed package was composed of measures designed to eliminate significant distortions in the area of indirect taxation.¹⁹ An annex to this Communication included a first draft of the Code of Conduct.

The Code was described as the key element of the package. Its role was to prevent economic distortions and an erosion of tax bases in the Member States. Its draft was developed through the work of the Taxation Policy Group. Despite being authored by the Commission, cooperative efforts of the Member States were acknowledged.²⁰ According to the Communication, there was wide support for the Code to be adopted as a non-legally binding instrument. However, the Communication further specified that if the Code was to be effective, it had to be supported by a *strong* political commitment on the part of the Member States.²¹ The wording ‘a strong political commitment’ could testify to the view that the Commission from the outset wanted the Code to be regarded as a regulatory instrument in a harder form, requiring from the Member States a commitment closer to a legally-binding obligation than a purely political commitment. Admittedly, in the final text of the Code, the preamble does not mention the need for a strong political commitment; it solely refers to the Code being ‘a political commitment’. Nevertheless, bearing in mind the former wording of, the Member States could have become uncertain as to what nature the Code is actually designed to have.

As a matching commitment to the Code, many Member States urged the Commission to re-examine its policy in the field of fiscal state aid and to make full use of its powers under the Treaty to tackle the problem of harmful tax competition. The Commission answered that it would respond positively to this call.²² The linkage

¹⁷ Chapter 2 presents the two directives.

¹⁸ A substantive analysis of the Code of Conduct is provided in Chapter 4, section 4.2.

¹⁹ Communication *Towards Tax Co-ordination in the European Union: a Package to Tackle Harmful Tax Competition*, note 16 above, paragraph 13.

²⁰ *Ibid.*, paragraph 15.

²¹ *Ibid.*, paragraph 16.

²² *Ibid.*, paragraph 17.

between State aid prohibition and the problem of tax competition is investigated in Chapter 5.

4.1.2. The adoption of the Code of Conduct

On the basis of the Second Monti Report, a meeting of the ECOFIN Council was convened. The Commission was invited to present modified proposals for the tax package. Aspects of the ongoing discourse were incorporated into the Communication issued on 5 November 1997.²³ This document was expected to form the basis of a political agreement to be reached in December 1997 at the ECOFIN Council meeting. It was not explained why the Commission was requested to refine its proposals. Nevertheless, an amended draft of the Code of Conduct was attached to the Communication.

It can be suggested that the request for an improved proposal from the Commission stemmed from the fact that the Commission was accused of impinging on national tax competencies through the way in which its first tax package was drafted. The first draft of the tax package was considered by some of the Member States as too restrictive as far as their tax sovereignty was concerned. This can be concluded from paragraph 6 of the November Communication, which stated that the Commission recognised the need to avoid any suggestions of disturbing national competencies. The revised package was prepared solely on the authority of the Commission but it drew extensively on cooperation with the Member States. It was also added that some of the Member States had hoped for a more ambitious tax package, but that proved politically impossible. The fourth element of the package referring to indirect taxation was abandoned.²⁴

²³ Communication from the Commission to the Council and the European Parliament: *A Package to Tackle Harmful Tax Competition in the European Union*, COM (97) 564 final, paragraph 1.

²⁴ Reasons for this decision are not explained. One can speculate that an initiative focused purely on direct taxation competition was regarded as more urgent and necessary. According to Kiekebeld, although differences in implementation of the VAT system by the Member States could create harmful tax competition in the context of indirect taxation, the Member States failed to reach an agreement on this point. Hence, the tax package was restricted solely to direct taxation. B J Kiekebeld, *Harmful Tax Competition in the European Union: Code of Conduct, Countermeasures and EU law*, (The Netherlands: Kluwer, 2004), at 28.

In this context, the *package* nature of the pursued initiative is worthy of reflection. The Code of Conduct was embedded within the broader context of a tax package. In addition to the soft law instrument, the package also contained two directives. The existence of the Code of Conduct was dependent on the acceptance of these directives. Simultaneously, the Code influenced their existence. The existence and operation of all components of the tax package were interrelated and entwined, and the package could not operate without the acceptance of all its components.

The decision to apply hard and soft law instruments within the setting of a package deal and the act of fusing together varying tax problems allowed an agreement to be reached. This solution made the process of balancing various interests of different actors possible. It can therefore be concluded that acceptance of the tax package comprising a variety of measures (as far as their legal status was concerned) was important. From a diplomatic perspective, it mattered because all involved parties had to demonstrate the ability to reach a compromise. Because everybody had to sacrifice something, everybody also gained from the package concept. This multi-dimensional strategy of dealing with tax problems by using different regulatory measures and correlating various tax problems was new and more feasible than proposing a purely hard law package, encouraging the Member States to be able to reach compromises.

The work carried out by the Commission in association with the High Level Group after the Verona Council culminated in the adoption of the tax package at the Council meeting on 1 December 1997. An examination of the related discussions shows that development within the context of the tax package was foreseen as incremental: different parts of the tax package required different timescales and negotiations to be completed. The discussions that culminated in the Verona Council were followed, as of 1 December 1997, by separate discussions on each of the three areas of the tax package. Specific procedures and negotiating bodies were also set up for each of the three areas. The treatment of each area in isolation showed its limitations at the Helsinki European Council of 1999, where the problem of savings taxation held back the process of adopting the package. Without an agreement on the taxation of savings, the whole package would fail. That European Council was

therefore followed by a period uncertainty while all political attempts were centered on resolving the deadlock.

Finally, at the Santa Maria da Feira European Council in 2000, a solution was reached in the form of a political compromise on savings. This unblocked the tax package, resulting in an intermediate agreement at the ECOFIN meeting in November 2000. The content of the tax package was agreed upon at the end of 2000, but the savings taxation initiative still had to be accepted by a number of dependent or associated territories and equivalent measures had to be agreed in non-member countries. Between 2000 and 2004, these negotiations were completed with Switzerland, Andorra, Liechtenstein, Monaco and San Marino.

The described processes leading to the adoption of the tax package can be characterised by the multiplicity of perspectives among the Member States, the Council and the Commission about the direction that EU tax policy ought to take. In terms of its scope and legal form, the package can be summarised as capturing the spirit of a compromise and preparing a foundation for agreement which could satisfy various ambitions.

When discussing the adoption of the Code of Conduct, it is also necessary briefly to consider other codes of conduct or practice which exist in the EU. Thus, a background for the operation of the Code of Conduct for Business Taxation is created. As their name suggests, codes of conduct or practice are prepared to influence the behaviour of their addressees. By establishing preferred standards or principles of behaviour, these instruments explain which actions are desirable and which are not. Codes of conduct or practice can be divided into measures of an internal character, relating to behaviour of EU institutions, and those aiming at guiding the behaviour of Member States (external codes). The first group of codes include, for example, the Code of Conduct concerning Public Access to Council and Commission Documents²⁵ or the Code of Conduct for Commissioners.²⁶ Among the

²⁵ Code of Conduct 93/730/EC concerning Public Access to Council and Commission Documents, OJ 1993 L 340/41.

²⁶ Code of Conduct for Commissioners, C (2011) 2904, available at http://ec.europa.eu/commission_2010-2014/pdf/code_conduct_en.pdf.

codes falling in the second category, one can mention the Code of Conduct on Arms Export²⁷ and the Code of Conduct for Business Taxation. These examples show that, generally, the Code in the direct tax field was not the first or the only code of behaviour prepared in the EU. Other codes were adopted, often under the name of other soft law instruments such as resolutions. Despite not being the first code of behaviour in the EU, the Code of Conduct for Business Taxation was the first code regarding taxes. It was soon followed by two codes of conduct concerned with transfer pricing.²⁸ That reveals the shift to soft law regulation in the field of direct taxes.

This section identified three key factors determining the creation of the Code. First, it was adopted because of the conviction of Commissioner Monti who promoted the unique idea of a tax package stimulating cooperation. Second, the Code was dictated by the needs of the internal market, which were undermined by the negative consequences of tax competition. Third, the aim of tackling tax competition was a force behind the measure.

4.2. The Code of Conduct for Business Taxation

This section explores the key substantive aspects of the Code, explaining how it deals with tax competition. In Chapter 1, it was stated that there is no universal legal definition of tax competition. The criteria set out in the Code to recognise tax rules that fall under the category of harmful tax measures are outlined here. Attention is also paid to the rollback and standstill commitments undertaken by the Member States under the Code.

4.2.1. Harmful tax competition under the Code of Conduct

The preamble to the Code acknowledges the positive effects of fair tax competition. Nevertheless, it also notes that some forms of tax competition may lead to harmful results. These developments are targeted by the Code. With regards to the scope of

²⁷ European Union Code of Conduct on Arms Exports adopted on 8 June 1998, 8675/2/98 REV 2, PESC 137, COARM 13 COMER 62.

²⁸ Code of Conduct for the Effective Implementation of the Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, OJ 2006 C176/8; Resolution on the Code of Conduct on Transfer Pricing Documentation for Associated Enterprises in the European Union, OJ 2006 C 176/1.

the Code of Conduct, this act concerns ‘those measures which affect, or may affect, in a significant way the location of business in the Community’.²⁹ Tax measures falling within the scope of the Code include laws, regulations and administrative practices.³⁰ More specifically, the Code stipulates that tax measures can be regarded as potentially harmful when they ‘provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question’.³¹ This level of taxation can operate by virtue of the nominal tax rate, the tax base or any other relevant factor. In other words, the Code is not aimed at the overall rate or level of corporate taxation in an individual Member State. The Code is rather directed at targeted measures that reduce the level of tax paid below the usual level.³² It can therefore be concluded that just one of these two types of tax competition is caught by the Code.³³

Moreover, it is essential to add that, according to the Code, business tax measures will be considered in terms of their harmful character only when it is first established that they (may) have a considerable and significant effect on the location of business activities within the EU. Consequently, the impact of potentially harmful business tax measures on the decision about the location of investment cannot be of a minimal nature. When the tax measure influences the decision only in a minor fashion or does not have any impact at all, then such a measure will not fall within the scope of the Code of Conduct. The problematic issue that remains is how one establishes the extent to which the location decision was affected by the tax measure. This was not clarified within the Code.

²⁹ Code of Conduct, note 2 above, paragraph A.

³⁰ *Ibid.*, paragraph A.

³¹ *Ibid.*, paragraph B.

³² B J Kiegebeld, note 24 above, at 22.

³³ The second draft of the Code anticipated that the initial evaluation of the Code should take place two years after it had been in operation. The review was expected to assess whether general tax measures could also be regarded as harmful and whether there was a need to extend the scope of the Code. Due to political pressure, this idea was abandoned but that does not mean that tax competition carried out through general tax measures does not cause harmful effects. See: Communication *Towards Tax Co-ordination in the European Union: a Package to Tackle Harmful Tax Competition*, note 16 above, paragraph P.

The scope proposed in both the first and second drafts of the Code was wider.³⁴ According to the drafts, the Code was also expected to cover, as well as business tax measures, special tax regimes for employees which had a similar effect on the location of business activity. Therefore, the drafts recognised that it is not only business taxation that may influence decisions about the location of investment. The Council Conclusions of 1 December 1997 contain a suggestion that special tax arrangements for employees could have come under the scope of the Code in the process of its revision.³⁵ So far, this has not taken place and the material scope of the Code has not been extended.³⁶

4.2.2. The criteria for establishing harmful tax regimes

The Code of Conduct does not explicitly declare which specific measures fall into the category of harmful tax regimes. It can be argued that, under the Code, the process of establishing harmful tax measures is composed of two steps. The first assessment enables the demarcation of a group of tax measures that are *potentially* harmful. The analysis that has to be carried out is whether, as already indicated, a tax measure ‘affects, or may affect, in a significant way the location of business in the Community’.³⁷ In addition, it is checked if the tax measure results in ‘a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question’.³⁸ When this condition is met, such

³⁴ Paragraph C of the Annex to Communication *Towards Tax Co-ordination in the European Union: a Package to Tackle Harmful Tax Competition*, note 16 above; Paragraph C of the Annex to Communication *A Package to Tackle Harmful Tax Competition in the European Union*, note 23 above, respectively.

³⁵ Paragraph N of the Code provides for the process of monitoring and review of its and invites the Council and the Member States to review the content of the Code two years after its adoption.

³⁶ The conditions regarding special tax regimes for employees were less restrictive under the first draft than under the second draft. Under the first draft, special tax regimes for employees would have been covered by the Code when they had a real effect on the location of business. Under the second draft, it was sufficient that a special tax regime for employees only potentially exerted influence on the location of business activity to ascertain that this regime was harmful. This condition is compatible with the approach displayed in the final version of the Code. The harmful nature of business tax measures can be signalled both when the tax measures have real influence on and also when they may only potentially affect, in a significant way, the location of business activity.

³⁷ Code of Conduct, note 2 above, paragraph A.

³⁸ *Ibid.*, paragraph B. When assessing the harmful nature of a tax measure, this criterion can raise a problem in the autonomous regions in the EU. Should the tax measure be considered in relation to taxation applicable in the territory of a Member State as a whole or should the reference framework be the autonomous territory? The Primarolo Report does not provide an unambiguous answer to this problem. It appears that, for example, measure A005 (Navarra coordination centres) was analysed in relation to the standard corporate tax rate in Spain. However, measure B012 (exempt offshore

tax measures should be further evaluated in the light of additional requirements in order to identify *actually* harmful measures.

Paragraph B of the Code establishes five criteria which should be taken into consideration when determining whether a tax measure is harmful or not. It states that ‘when assessing whether measures are harmful, account should be taken of, *inter alia*.’ The wording *inter alia* is crucial because it signals that the list of criteria provided in the Code is not exhaustive. Other characteristics, which are not expressly listed by the Code, may also be applied in the process of establishing harmful tax measures. Thus, it is possible that even measures which do not meet any of the factors described below can still be found to be harmful. The characteristics of harmfulness of tax measures enumerated by the Code of Conduct are as follows.

1. An indication that a tax measure is harmful might be given when it is established that tax advantages are accorded only to non-resident taxpayers or with regards to transactions carried out with non-residents. It is claimed that, in that respect, tax measures are created solely for the purpose of attracting foreign tax bases at the expense of other tax jurisdictions.
2. Tax measures are regarded as harmful when the advantages guaranteed by them are ring-fenced from the domestic economy. Thus, such tax measures do not have a negative influence on the domestic tax base.
3. The Code of Conduct also lays down a requirement to examine whether tax advantages are granted irrespective of conducting real economic activity or substantial economic presence in the Member State offering tax advantages. The provision of tax benefits to businesses that are not economically active or present in a Member State indicates that a country consciously pursues tax policies designed to attract mobile tax bases from other Member States.

companies and captive insurance regime in Gibraltar) was examined in the context of the normal corporate tax rate in Gibraltar, not the whole UK. This issue occurred with regard to the State aid conditions. See Chapter 5, section, 5.3.1.

4. It is also important to establish whether the rules for profit determination in respect of activities within a multinational group of companies depart from internationally accepted principles, particularly the rules set up by the OECD.

5. Tax measures lacking transparency are also an indication of a harmful tax practice, due to the fact that non-transparent tax measures are difficult to detect and can be protected by the discretion of national tax authorities. The lack of transparency of a tax measure enables the conducting of negotiations between taxpayers and tax authorities.

According to Kiegebeld, a decision about the harmfulness of a tax measure cannot be made exclusively on the grounds of the lack of transparency. Hence, it can only become an indication of a harmful tax measure. The material effect of a tax measure should be decisive in the assessment of the tax rule.³⁹ Formally, however, the Code of Conduct does not grant priority to any of the five criteria. It appears to me that all five of the criteria should have equal status and be treated as capable of determining the harmful nature of a tax measure to the same degree.

In addition to the five indicators of harmful tax competition, in paragraph G,⁴⁰ the Code of Conduct mentions two further economic factors that should be considered in the evaluation of the harmful character of a tax measure. First, an impact assessment of the tax measure on other Member States' economies, *inter alia*, in the light of how the activities concerned are taxed effectively throughout the EU, should be carried out.⁴¹ In the literature, the meaning of this criterion has caused debate. It was claimed that, in contrast to the initial impression created by paragraph B of the Code of Conduct, tax measures suspected of being harmful should not be compared merely with the level of taxation in the Member State which provides the tax measure. A broader interpretation can be supported. The tax burden on specific activities should be judged against the tax burden in various Member States. I cannot, however, agree with such an understanding of paragraph G of the Code of Conduct. As levels of

³⁹ B J Kiegebeld, note 24 above, at 26.

⁴⁰ This paragraph is included in the section of the Code explaining the review process.

⁴¹ This is the so-called spillover effect. C Pinto, 'EU and OECD to Fight Harmful Tax Competition: Has the Right Path Been Undertaken?', (1998) 26:12 *Intertax* 386-410 at 389.

direct taxation have not been harmonised, they are still to be decided upon by the Member States. Tax measures should not be declared harmful if they are at variance with the tax structure of another Member State. They can only be assessed against the level of taxation within the same Member State.⁴²

The second economic criterion specified in paragraph G asserts that insofar as a tax measure is applied to support the economic development of particular regions, an assessment should be made as to whether the measure is proportionate to and targeted at the aims sought. This provision shows that, under the Code of Conduct, some tax measures, even if harmful, will occasionally be accepted provided that they are utilised to improve the position of disadvantaged regions.⁴³

4.2.3. The rollback and standstill arrangements under the Code of Conduct

By adopting the Code, the Member States politically committed themselves not to introduce new tax measures which are harmful⁴⁴ and they also made a commitment to an internal review and re-examination of their existing tax laws and practices in the light of the principles expressed by the Code. The Member States agreed to repeal or amend any laws or practices as necessary, with a view to eliminating any harmful measures as soon as possible.⁴⁵ The standstill commitment took immediate effect. On the other hand, the rollback provision had to be implemented by the Member States by January 2002.⁴⁶ In addition, in exceptional circumstances and on a

⁴² Similarly, B J Kiekebeld, note 24 above, at 24-25.

⁴³ For example, the Madeira Free Zone was established to secure the development of Madeira. P Noiret Cunha, *Tax Competition in Europe: Portuguese Report*, available at http://www.eatlp.org/uploads/Members/Portuguese_report02.pdf, p. 5. It was found harmful under the Code of Conduct. However, the regime was granted an extension until 31 December 2011. It was also regarded as an acceptable State aid. See Chapter 5 for a discussion on State aid in the context of the Code of Conduct.

⁴⁴ This is the standstill provision expressed in paragraph C of the Code.

⁴⁵ The rollback provision is included in paragraph D of the Code.

⁴⁶ This timeline for the implementation of the rollback commitment is tighter than in the Code of Conduct. The Code envisaged the completion of rollback by January 2003. The new deadline was established in an interim agreement on the rollback of tax measures with harmful features. The agreement is not publicly available. Information about it has its source in an article by Nijkamp. See: H Nijkamp, 'EU Stands up to Harmful Regimes', (2001) 12:3 *International Tax Review* 35-39.

case-by-case basis, permission for the continuation of certain harmful tax measures beyond 2005 was able to be granted.⁴⁷

The Code of Conduct laid down rules for the review process that was expected to follow after the adoption of the Code. The Member States pledged to inform each other about proposed or operating tax measures which could potentially fall within the meaning of harmful tax measures. Information on any tax measure which appeared to have fallen within the scope of the Code was expected to be provided at the request of another Member State. Thus, principles of transparency and openness were to be respected in interstate relations.⁴⁸ Moreover, the review process envisaged that any Member State was allowed to request an opportunity to deliberate on a tax measure of another Member State when that measure could fall within the scope of Code of Conduct interest. In order to facilitate the review process, the Code of Conduct Group of high level representatives appointed by each Member State and by the Commission was established in March 1998.⁴⁹ The Group was established to review tax measures that may fall within the scope of the Code and it was decided that the Group shall meet at least twice a year. The work of the Group has been confidential.⁵⁰

The Code of Conduct Group set a deadline of 31 January 1999 for the Member States to submit reports identifying potentially harmful tax measures and practices. On the basis of the criteria described in section 4.2.2.,⁵¹ the Group conducted an examination of potentially harmful tax measures. Before the final report on harmful

⁴⁷ This concession was allowed in return for a shorter deadline for the rollback procedure. The Council agreed that, at the final adoption of the tax package and in the context of agreement on the assessment of the results reached on the rollback of harmful measures, extensions beyond the end of 2005 for the following measures were granted: Belgium: Co-ordination Centres extension to 31 December 2010, Ireland: Foreign Income extension to 31 December 2010, Luxembourg: 1929 Holding Companies extension to 31 December 2010, Netherlands: International Financing extension to 31 December 2010, Portugal: Madeira's Free Economic Zone extension to 31 December 2011. See: Report from the Code of Conduct Group (Business Taxation) to ECOFIN Council on 7 March 2003 on the Code of Conduct (Business Taxation), 7018/1/03 REV 1 (en) LIMITE FISC 31, paragraph 10.

⁴⁸ Code of Conduct, note 2 above, paragraph E.

⁴⁹ Council Conclusions of 9 March 1998 concerning the Establishment of the Code of Conduct Group (Business Taxation), OJ 1998 C 99/1. The basis for the creation of the Group, also known as the Primarolo Group, is paragraph H of the Code of Conduct.

⁵⁰ Council Conclusions of 9 March 1998, note 49 above, paragraph 13.

⁵¹ However, as will be discussed in Chapter 5, some Member States raised questions about the actual criteria applied in the process of reviewing national tax regimes.

tax measures was submitted to the ECOFIN Council on 29 November 1999,⁵² two interim reports were issued.⁵³ Unsurprisingly, that indicates difficulties with reaching agreement as to which tax practices and regimes should be treated as harmful and which should not be encompassed by the report.

The voluminous Primarolo Report was prepared after over 200 potentially harmful tax measures had been considered.⁵⁴ It contains description of all of the measures that were examined.⁵⁵ Out of more than 200 assessed measures, a list of 66⁵⁶ harmful tax measures was created. They were expected to be amended or abolished within the prescribed timescale. To facilitate the process of assessing tax measures, the Code of Conduct Group divided them into six main groups. The first group of measures covered activities related to the provision of financial services to third parties, intra group financing and the provision or licensing of intangible property in return for royalty payments.⁵⁷ The second group considered a number of measures relating to the taxation of insurance activities.⁵⁸ The third group encompassed a number of measures relating to the transfer pricing of intra group services.⁵⁹ Measures relating to holding companies constituted the fourth group of tax measures.⁶⁰ The fifth group considered a range of measures which provided for the partial or complete exemption from tax of corporate profits or certain categories of profits including those arising

⁵² Report of 29 November 1999 from the Code of Conduct Group to the ECOFIN Council, SN 4901/99. This Report is also called the Primarolo Report. Occasionally, the Report is referred to as the November Report. See: Council of the European Union, Outcome of the Proceedings of the Code of Conduct Group on 22 February 2000, 6523/00 FISC 23, p. 3.

⁵³ Report of 1 December 1998 from the Code of Conduct Group to the ECOFIN Council, 12530/98 FISC 164; Report of 25 May 1999 from the Code of Conduct Group to the ECOFIN Council, 8231/99 FISC 119.

⁵⁴ B J Kiekebeld, note 24 above, at 48, H Nijkamp, 'Landmark Agreement on EU Tax Package: New Guidelines Stretch Scope of EU Code of Conduct', (2001) 10:3 *EC Tax Review* 147-153 at 148.

⁵⁵ The work proceeded by classifying these measures into five categories: intra-group services, financial services and offshore companies, other sectoral regimes, regional measures and other measures. See Primarolo Report, note 52 above, paragraph 10.

⁵⁶ According to the Primarolo Report, 40 out of 66 harmful tax measures were found in the Member States and 26 in dependent and associated territories.

⁵⁷ Measures classed as harmful within this group included: the international financial services centre in Dublin, Shannon airport zone, intra-group finance activities in the Netherlands and the Dutch finance branch.

⁵⁸ Among the harmful tax measures in this group were the Åland islands captive insurance regime and Guernsey offshore insurance companies.

⁵⁹ The intra-group services measures classified as harmful included Belgian coordination centres, French headquarters and logistics centres and the Dutch regime for the US foreign sales companies ruling.

⁶⁰ Examples of measures considered harmful in the holding companies group included the 1929 holding companies regime in Luxembourg and the Irish regulation of foreign income.

from offshore activities.⁶¹ A number of other measures were considered by the Primarolo Group as meeting the criteria of harmful tax measures but they did not fit into the broad groups described above.⁶²

4.2.4. The geographical scope of the Code of Conduct

Considering the geographical outreach of the Code, the EU, as a polity of a regional character, addressed its initiative to the Member States but also called for the promotion of the Code's values in third countries. Paragraph M of the Code confers an obligation on the Member States to promote the adoption of the Code in third countries. The Council believes that the underlying goals of the Code are worthy of adoption on as broad a geographical basis as possible.

Paragraph M provides only for the commitment of the Member States to raise awareness in third countries and encourage them to adopt Code's principles. No suggestions of making the Code mandatory in third countries will be tolerable, as suggested by the Switzerland case. The bold position of Switzerland was motivated by a unilateral decision of the Commission in 2007 that certain cantonal company tax practices breached the Free Trade Agreement.⁶³ Switzerland could have interpreted this decision as impinging on its tax sovereignty. Switzerland clearly stated that no international agreement exists between Switzerland and the EU requiring Switzerland to harmonise its corporate taxation with the EU. It was added that the Code constitutes an obligation for the Member States, and as Switzerland is not an EU Member State, the Code does not apply to Switzerland.⁶⁴ The unequivocal approach of Switzerland advances a conclusion that any discussions about adopting the values of the Code by third countries will be conducted between equal partners and third countries will not allow the EU to impose any pressure to accept unwanted

⁶¹ Exempt (offshore) companies and captive insurance in Gibraltar and the free zones regulation in Aruba.

⁶² For example: the regime of informal capital rulings in Belgium.

⁶³ Commission Decision of 13 February 2007 on the incompatibility of certain Swiss company tax regimes with the Agreement between the European Economic Community and the Swiss Confederation of 22 July 1972, C(2007) 411 final, available at http://eeas.europa.eu/switzerland/docs/c_2007-411_en.pdf.

⁶⁴ Corporate taxation: tax controversy Switzerland-EU, available at <http://www.efd.admin.ch/dokumentation/zahlen/00579/00608/01473/index.html?lang=en>.

solutions. Negotiations between the EU and third countries operate in a different environment, however, with states that wish to join the EU.⁶⁵

During the Luxembourg Council meeting on 8 June 2010, it was emphasised that the EU would seek to apply the Code and its principles to third countries. In the first instance, the Council invited the Commission to initiate a dialogue with Switzerland and Lichtenstein about the application of the Code in these two states.⁶⁶ Progress concerning the promotion of the Code in third countries has been slow. The Commission was due to report back before the end of 2010.⁶⁷ In Council Conclusions on EU relations with EFTA countries published in December 2010, it was noted that discussions were still ongoing. The Council encouraged Switzerland and Liechtenstein to continue talks about the application of the principles and criteria of the Code.⁶⁸ If the principles of the Code were incorporated and followed by third countries, this would constitute a significant development in the soft law trajectory. A regional soft law measure would cease to operate as an EU instrument. The external facet of the Code would make it more powerful because of the geographical expansion of its principles.

Additionally, as regards the geographical scope of the Code, Member States with dependent or associated territories committed themselves, within the framework of their constitutional arrangements, to ensuring that the Code's principles are applied in these territories.⁶⁹ EU dependent and associated territories have been included in the reviews of the Code of Conduct Group and thus became a focal point of interest earlier than third countries.

⁶⁵ This is relevant when Chapter 5 indicates the hard side of the Code in the negotiations with acceding states.

⁶⁶ Presumably, the reason for promoting the Code first in Switzerland and Liechtenstein is the considerable economic integration of Switzerland and Liechtenstein with the EU.

⁶⁷ See: Press release 3020th Council meeting, Economic and Financial Affairs, Luxembourg, 8 June 2010, 10689/10 PRESSE 162 PR CO 7.

⁶⁸ Council Conclusions on EU relations with EFTA countries, 17423/1/10 REV 1 (en) LIMITE, paragraphs 24 and 25.

⁶⁹ For instance, the Dutch delegation stated in the final Report that although it is committed to ensuring that the principles of the Code are applied in its dependent or associated territories (in particular, the Netherlands Antilles and Aruba), it is not possible that the Netherlands can constitutionally force Aruba and the Netherlands Antilles to apply the principles on which the Group agreed. See: Primarolo Report, note 52 above, footnote 3.

4.3. The Code of Conduct as a soft law instrument

This section concentrates on showing that the Code can be regarded primarily as a soft law measure situated within an environment that was dominated by hard law regulation. This statement can be interpreted in two ways. First, the Code is a soft law measure embedded within the tax package. This package included two other components of a legally binding nature. Second, in a broader context, the Code can be considered as a soft law measure integrated within EU direct tax regulation. This regulation comprises various directives, recommendations and jurisprudence, therefore predominantly hard law instruments.⁷⁰

Before the soft law features of the Code become subject to closer examination, it is first analysed whether the choice of a non-binding instrument to tackle harmful tax competition was dictated by the conviction that a soft law measure was a more advantageous solution than a hard law instrument in the circumstances or if, instead, it was regarded as settling for a second best option on the basis that hard law was unachievable.

4.3.1. A first choice or a second best compromise?

Fundamentally, the origins of the Code as a non-binding measure can be linked to a failure of the hard law approach consistently supported by the Commission in the earlier decades of European integration.⁷¹ The approval and implementation of the Code should be then perceived within the wider context of a series of time consuming proposals put forward by the Commission since the early 1960s. It can be argued that the exploration of new regulatory lands was a result of pragmatism and political compromise rather than a strong belief that soft law can provide a more valuable answer to direct tax regulatory dilemmas.

The Code of Conduct thus tends to be characterised as a soft law measure situated within the regulatory environment of taxation that for years had been dominated by hard law instruments. Other regulatory instruments of a ‘softer’ nature had not been considered earlier as a potential way of achieving greater fiscal integration. The

⁷⁰ See Chapters 2 and 3.

⁷¹ Chapter 2 examines why the hard law integration path was problematic for the EU.

choice of the soft law form to influence direct taxation was a negative one. It was supported because of what could not have been achieved by hard law measures. In other words, the choice of implementing the soft law instrument was not positive because it did not underline the values of and relative strengths of soft law itself. Soft law was perceived as a workable but compensatory reaction to what hard law was incapable of achieving. On the other hand, the shift of approach from hard law towards soft law or governance falls comfortably in the general turn towards ‘softer’ forms of governance, less focused on achieving uniform results, which occurred in the EU.⁷² However, in the field of direct tax regulation, the shift was not definitive: the Code was embedded within the broader context of the tax package comprising directives.

Another development that could explain the adoption of a soft law instrument was the modified approach of the Commission, with Commissioner Monti responsible for issues of taxation, which contributed to reaching that compromise and thus to the adoption of the tax package. The new multidimensional strategy allowed various problems to be combined and measures of both a hard and soft law nature to be considered. Thus, interests of different Member States and institutions were balanced. Tax coordination at EU level was presented as strengthening the internal market, but also improving the fiscal powers of national governments. Commissioner Monti drew conclusions from the unsuccessful past of EU direct tax harmonisation attempts. He put forward a new, more sophisticated strategy for dealing with direct tax issues. In order to secure progress with regards to regulation of direct taxation, shifting the direction and character of the regulatory strategy was required. A suggestion of such reasoning can be traced in these words:

Some Member States have made it clear that they looked for a more ambitious package, but extensive debate within the Council and the TPG has shown that, at present, this is not attainable given the initial reluctance of others to consider any move towards tax co-ordination. Against this background, the Commission considers that the package now proposed would be a major step forward towards greater co-ordination and in the effort to combat harmful tax competition in the Union. Moreover, the Commission believes that the package offers the real prospect of agreement between Member States (...).⁷³

⁷² See Chapter 1, section 1.5.3 for an outline of new forms of EU governance.

⁷³ Communication *A Package to Tackle Harmful Tax Competition in the European Union*, note 23 above, paragraph 6.

Due to limitations in terms of accessing background materials, it is difficult to assess whether the (partial) shift from hard law to soft law solutions was contemplated by the Commission from the outset of its work on the tax package or whether this change was coerced by political constraints. None of the available documents contains an analysis as to why the Code should have the form of a non-binding resolution. There is no published debate on the advantages of a soft solution or potential problems it may cause as opposed to hard law regulation in the sphere of direct taxation. Bearing in mind that the application of a soft law instrument constituted a serious shift in the EU's approach within the context of direct taxation, one would expect an explanation of the reasons behind it. On the other hand, the lack of explicit explanation for the selection of the soft nature of the Code may not be so surprising when one realises that, as claimed earlier, the EU, generally, experienced a transition towards softer forms of governance at this time. Nevertheless, because the Code was such a novel solution for the field of direct taxation, the lack of explanation as to why it took the form of a soft law measure was a mistake.

In the light of the absence of formal justification as to the choice of a soft law instrument and on the basis of the above-mentioned arguments, it can be suggested that, most likely, the choice of the soft law measure was a choice of necessity and a compromise dictated by existing political circumstances. I have not been able to find any information in primary sources confirming that, initially, the Commission had planned to adopt a directive instead of a code of conduct. However, such suggestions have arisen in the literature.⁷⁴ Nevertheless, none of the authors of such claims provides a source for this suggestion or a reference to materials that could confirm their claim.

In relation to overall EU tax regulation, it is clear that the approval of the Code by the EU Member States marked an important day for tax regulation. A new, alternative way of approaching tax issues had been applied. It was discovered that the harmonisation approach to the tax field does not have to be the only method of European integration. Soft and hard law measures can co-regulate the same field.

⁷⁴ See for instance: H Gribnau, note 1 above, at 93; C M Radaelli, note 1 above, at 11.

Critically, however, as discussed in detail in Chapter 5, the EU did not fully recognise the full potential that soft law offers and relied on harder edges of the Code in order to secure its effectiveness.

4.3.2. The soft side revealed in the Code's name

Undoubtedly, the Code of Conduct displays a range of soft law features.⁷⁵ The first and most apparent indication of the soft nature of the Code can be discovered in the formal name. It has the form of a Council resolution. The full name of the instrument is *Resolution of the Council and the Representatives of the Governments of the Member States, Meeting within the Council of 1 December 1997 on a Code of Conduct on Business Taxation*. As explained in Chapter 1, section 1.2.2, the EU has a law-making competence but it differs from the power to introduce laws that national legislatures have because it is not of a general and inherent nature. This means that the EU can make laws only in those areas in which the Member States, through the Treaties, give it powers to do so. What are the sources of EU law (in a traditional, hard sense)? This enquiry is of great relevance to the establishment of the soft, non-legally binding character of resolutions. When a measure is *not* legally binding, it will not be classified as a source of EU law.. As we saw in Chapter 1, section 1.2.3., under Article 288 TFEU, EU law can be created through directives, regulations and decisions.

Among the three law-making instruments, Article 288 TFEU does not enumerate resolutions. *A contrario*, resolutions do not constitute hard law and do not create legal obligations on the Member States. Article 288 TFEU makes clear that the drafters of the Treaties decided that instruments other than directives, regulations and decisions should play a role different from law-making. The name under which the Code of Conduct was adopted therefore indicates that this regulatory measure is not a source of law, as resolutions fall within the same group of instruments serving to develop EU policy as recommendations and opinions, which are singled out in the final sentence of Article 288 TFEU. Recommendations and opinions, and many other instruments, unnamed by Article 288 TFEU, fall into the general category of 'soft

⁷⁵ See Chapter 1, section 1.5.1. for an exploration of the concept of soft law.

law' because they have no binding force. As the list of non-legally binding instruments is not exhaustive, other measures, such as guidelines, codes of conduct or resolutions have also been used to develop policies through the soft law approach. It is worth remembering that the fact that soft law measures do not have a legally binding nature does not mean that this type of measure is irrelevant. There are many channels through which soft law measures can exert influence and affect, and change, behaviour despite the lack of their legally-binding nature.⁷⁶

4.3.3. The Code of Conduct as a political commitment

The preamble to the Code is another argument in favour its soft character. The preamble overtly describes the official legal character of the measure, and explicitly emphasises that the Code of Conduct is:

a political commitment and does not affect the Member States' rights and obligations or the respective spheres of competence of the Member States and the Community resulting from the Treaty.

This means that, formally, principles set out in the Code do not restrict national tax sovereignty because the commitment established under the Code is only undertaken by the Member States at the political level. This conclusion is a logical consequence of what was argued in the previous section. Legally binding obligations can only be imposed through EU legal acts and an instrument is legally binding only when it is capable of influencing the sphere of legal rights and obligations of the Member States or their nationals.⁷⁷

Any EU action aiming at approximating national laws has to be anchored in the provisions of the Treaty. Regulation of direct taxation is not an exception. Under the Treaty, harmonisation of direct taxes depends on the general competence included in Article 115 TFEU.⁷⁸ When no instruments harmonising direct taxation are adopted, the regulatory power to structure tax systems rests with the Member States. As long as no positive integration has been brought about, the Member States are, in general,

⁷⁶ See Chapter 1, section 1.5.1.

⁷⁷ L Senden, *Soft Law in European Community Law*, (Oxford: Hart Publishing, 2004), p. 240.

⁷⁸ Article 94 TEC, pre-Lisbon reforms.

free to regulate the sphere of direct taxation as they see fit.⁷⁹ The Member States have the power to determine criteria to impose direct taxes and, thus, decide who and what is subject to direct taxation or whether a direct tax is imposed at all.

It follows that the operation of the Code cannot be founded on the creation of a legal commitment by the Member States. It is in force because of peer pressure to follow the goals expressed in it. The self-destructive nature of tax competition⁸⁰ explains the self-policing role of the Code. All Member States gain from respecting the Code because they avoid mutual damage. However, when a Member State does not act in compliance with Code's principles, no formal action can be taken against that State. The Code does not provide for any enforcement procedure. It can therefore be argued that the process of reviewing national tax measures against the criteria of the Code, which was carried out by the Code of Conduct Group, and the subsequent publication of the progress reports on national measures considered to be harmful should be interpreted as a sign of voluntary cooperation between the Member States.⁸¹ The soft nature of the commitment undertaken under the Code was expressed by AG Léger in the *Cadbury Schweppes* case.⁸² He stated that the adoption of the Code and the reference to the tax measure at issue as a harmful measure cannot limit or restrict the rights conferred by the Treaty on all companies to move freely in the internal market, including establishing in a state in which the tax system is viewed as harmful to the internal market.

Similarly, AG Mazák in the *ELISA* case⁸³ claimed that a finding of harmfulness under the Code cannot influence the rights conferred on economic operators by the fundamental Treaty freedoms. In this case, *ELISA* was a holding company incorporated under Luxembourg law. It owned immovable assets in France and, in effect, was subject to the provisions of the French tax code imposing a 3% tax on the commercial value of immovable property. This tax was supposed to discourage

⁷⁹ This statement was qualified by the ECJ. See Chapter 3 for details.

⁸⁰ Chapter 1, section 1.1.2.2. explored the problem of the race to the bottom debate in tax competition.

⁸¹ This statement is qualified in Chapter 5 discussing the harder edges of the Code.

⁸² Opinion of AG Léger in Case C-196/04 *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue* [2006] ECR I-7995, paragraph 57.

⁸³ Opinion of AG Mazák in Case C-451/05 *Européenne et Luxembourgeoise d'investissements SA (ELISA) v Directeur général des impôts and Ministère public* [2007] ECR I-8251, paragraphs 114-115.

French residents from transferring their properties to foreign entities to exclude these properties from the tax base for the French wealth tax. French-resident legal persons were exempt from the 3% tax if they complied with certain conditions about the provision of information, particularly in regard to their shareholders. Non-resident in France legal persons could also claim this exemption, provided they were resident in a country that had concluded an administrative assistance treaty with France or a treaty containing a relevant non-discrimination provision. This exemption applied if the French tax authorities could verify the accuracy and completeness of the information provided. The treaty concluded between France and Luxembourg excluded the 1929 holding companies from its scope; hence ELISA was excluded from claiming the exemption under French law as France was unable to receive the relevant information. ELISA thus claimed that resident and non-resident companies were treated unequally and that the restriction was not proportionate, even though France was unable to obtain the required information from Luxembourg about the 1929 holding companies.

France assumed that it could use the classification of this aspect of the Luxembourg 1929 holding companies tax regime as harmful under the Code to its advantage. The French argument was based on the reasoning that it would be justified to exclude the 1929 holding companies from the exemption because the Luxembourg legislation was found to be harmful under the Code of Conduct. According to AG Mazák, the national legislation at issue appeared to proceed from the assumption that all of those countries with which France has not concluded a bilateral tax treaty containing either a clause providing for administrative assistance or for non-discrimination on tax matters are likely to host legal persons used as a vehicle to avoid the payment of wealth tax by natural persons. The same assumption applied to those corporate entities, such as 1929 holdings, which had been excluded from the scope of the bilateral tax treaties. AG Mazák observed that due to the fact that the Code is a political commitment, listing the Luxembourg 1929 holding regime among harmful tax measures cannot restrict freedom of movement:

*The reference to 1929 holdings among those tax measures which are harmful to the single market cannot limit the right conferred on an investor by the Treaty under Article 56 EC to make investments in a particular Member State while having its effective centre of management in another Member State, even if that investor has a corporate structure subject to a tax system that is viewed as harmful to the single market.*⁸⁴

AGs Léger and Mazák, in contrast to the wording in the preamble of the Code emphasising the rights of the Member States, recognised that the political nature of the Code cannot restrict the rights of economic operators within the internal market.

It has to be added that a political commitment may, with time, transform into a legal obligation. The transformation would take place if the political circumstances mature and the political actors become ready to take on a new legal commitment. Hence, values expressed initially at the political level could be transposed to a legally binding measure. Nevertheless, at times, a political commitment remains the first *and* final step in exercising regulatory powers. It is not always converted into a hard law obligation.

To sum up, the fact that the Code expressed the political commitment of the Member States to tackle the problem of harmful tax competition means that the Code simply constituted a promise on their part to deal with the issue in question at the political level. Should this promise be broken, there would be no *legal* consequences.

4.3.4. The procedure leading to the adoption of the Code

A further argument supporting the claim about the soft nature of the Code is the non-legislative procedure which led to its adoption in the first place. As regards the applied working method, the fact that the Code is a political commitment and does not affect the Member States' rights and obligations, or the respective spheres of competence of the Member States and the EU under the Treaties, makes it apparent that the Council, representing the interests of the Member States, intended to keep control of the work relating to the Code. The applied working method did not follow any of the legislative procedures set out in the Treaty.⁸⁵ Those procedures establish

⁸⁴ *Ibid.*, paragraph 117.

⁸⁵ Generally, there are two principal groups of EU legislative procedure. First, Article 294 TFEU outlines the ordinary legislative procedure. Second, non-ordinary legislative procedures (the consent and the consultation procedures) are referred to in various provisions of the Treaty, e.g. Article 218

that the Commission has a virtual monopoly upon the initiation of legislation. The Commission, by submitting a legislative draft to the Council, begins the process of adopting EU law. The Council and, almost always, the European Parliament are then significantly engaged in the making of EU law. I have not tracked down any detailed discussions about the Code in the Parliament. That would indicate that, formally, the Code was established outside the Community Method.

As far as the adoption of the Code of Conduct is concerned, the key role in the negotiations was played by the High Level Group founded after the informal meeting of the ECOFIN Council in April 1996. It comprised personal representatives of the finance ministers and was chaired by the competent member of the Commission. The Council's Secretariat General was also present at the meetings of the High Level Group. The Group became a forum for debate and sharing information about tax challenges that the Member States and the EU may face. Admittedly, the Commission had an important role via supporting the Group and through its participation in the Group's discussions – indeed it had drawn up almost all of the Group's key working papers – but the working environment, to a large extent, remained intergovernmental.

In the method of operation of the High Level Group, a willingness to consult different actors was clearly visible.⁸⁶ As stated, this High Level Group was set up to facilitate direct, less bureaucratic and less formal contacts between the finance ministers' personal representatives in order to exchange knowledge on national tax systems. The meetings provided an invaluable chance to exchange views on the problems of taxation and discuss solutions to existing challenges. Although the impetus to discuss closer tax coordination among the EU Member States came from the Commission, this institution did not dominate the negotiation process that had led to the adoption of the tax package. The Commission was involved in the debates of

(6)(a) TFEU requiring the consent of the Parliament to conclude an association agreement or an agreement with financial consequences for the EU; Article 311 TFEU, which requires the consent of the Parliament when the Council adopts a decision implementing measures for the Union's own resources system.

⁸⁶ On the Commission's proposal, in December 1996, the High Level Group became a permanent Taxation Policy Group. See: M Monti, 'The Single Market and Beyond: Challenges for Tax Policy in the European Union', (1997) 6:1 *EC Tax Review* 2-3 at 2. The core function of this new Group was to overview EU tax policy. http://ec.europa.eu/internal_market/smn/smn08/s8mn09.htm.

the forum; however, the Member States did not give up agenda-setting powers. The tax policy process became ‘more similar to a co-operative problem-solving forum than to a conflictual arena’.⁸⁷

During its work, the High Level Group actively sought opinions from the European Trade Union Confederation, the Union of Industrial and Employers’ Confederations of Europe and also from Dr Onno Ruding.⁸⁸ The European Parliament was regularly updated on the topics presented by the Commission to be discussed by the High Level Group.⁸⁹ The effort made in order to include a variety of actors throughout the decisional process and the recognition of the need to incorporate various views in the decision-making process are closely linked with the objectives of soft law governance. As explained in Chapter 1, soft law governance is based on the inclusion of all relevant stakeholders in order to enable them to voice their opinions. It appears that the inclusion of a number of bodies in the discourse leading to the adoption of the tax package and the establishment of a constructive dialogue with them revealed another significant feature of the Monti approach. The multi-dimensional strategy of the EU based on the engagement of a variety of actors enabled the process of balancing interests of various forces and led to compromise.⁹⁰ It can be argued that the tax policy makers working at the Commission have learned the lesson that no progress can be made if power relations are too unbalanced towards the interests of one of the key actors.

4.3.5. Built-in soft channels of influence and control

The final aspect of the soft nature of the Code considered here lies in the soft law methods of operation manifested both at the stage of its preparation and also later, in the process of securing its effectiveness. In Chapter 1, section 1.5.1., it was explained that there are certain channels through which soft law measures exert influence over (and change) behaviour despite the lack of their legally-binding nature and

⁸⁷ C. M Radaelli, ‘Harmful Tax Competition in the EU: Policy Narratives and Advocacy Coalitions’, (1999) 37:4 *Journal of Common Market Studies* 661-682 at 672.

⁸⁸ Ruding, the former Dutch Minister for Finance, chaired a committee of independent experts on company taxation, which in 1992 prepared the Report of the Committee of Independent Experts on Company Taxation.

⁸⁹ Second Monti Report, note 10 above, paragraph 1.1-1.3.

⁹⁰ Communication *Towards Tax Co-ordination in the European Union: a Package to Tackle Harmful Tax Competition*, note 16 above, paragraph 12.

enforceability.⁹¹ Although the Code is not legally binding, the Member States would be reluctant to disregard it because if any Member State breaches the Code, all will suffer.⁹²

First, the process of developing the Code was, as shown in the previous section, based on discourse and debates among different interested parties. Discourse can lead to the acceptance of a common approach to a problem among the Member States. Development of a common vocabulary can help the process of regulation through soft law means to become more influential. Networking facilitates the process of learning among the EU Member States. Exchange of policy knowledge and deliberation allow actors to learn about each other's governing systems and, thus, a common identity through interaction is promoted. The learning process and exchange of experiences underpinning the existence of the High Level Group leading to the adoption of the Code indicated an important aspect of the soft law approach being present in the Code.⁹³

Second, soft law elements were incorporated into the work of the Code of Conduct Group. The soft approach is uncovered at the stage of the preparation of the list of harmful tax measures included in the Primarolo Report. This process appears to have attempted the enabling of an exchange of views and the involvement of various parties in the decision as to which measures would be placed on the list of harmful tax measures.⁹⁴ Moreover, where unanimity was not reached, the decision reflected a broad consensus and alternative views were shown in the footnotes of the reports as appropriate.

⁹¹ D Trubek, P Cottrell and M Nance, 'Soft Law, Hard Law and EU Integration', in G De Búrca and J Scott (eds.), *Law and New Governance in the EU and the US*, (Oxford: Hart Publishing, 2006) 65-94 at 78-79.

⁹² Kiekebeld shares this view. See: B J Kiekebeld, note 24 above, at 51.

⁹³ According to Radaelli, mutual learning may bring convergence in terms of applied concepts and vocabulary. Convergence of terminology and concepts does not, however, necessarily result in convergence of practice and behaviour. C M Radaelli, note 1 above, at 5, 12-13.

⁹⁴ Due to the fact that the work of the Code of Conduct Group was decided to be confidential, information on the practicalities of its operation are grounded in the available reports analysing the progress of its work. These reports are available when a search is carried out in the search engine on the Council of the European Union website.

<http://register.consilium.europa.eu/servlet/driver?typ=&page=Simple&lang=EN&cmsid=638>.

In July 1998, the Commission submitted to the Code of Conduct Group an initial list of measures that had fallen foul of the Code of Conduct principles. A description of each measure was also added. In addition, the Commission Services produced a background paper⁹⁵ overviewing the typical features of a harmful tax measure. The list of harmful tax measures was drawn up on the basis of information the Commission received from the Member States, publicly available information and material gathered during earlier discussions within the Taxation Policy Group. In the process of preparing the list, Member State delegations were also involved in suggesting whether other measures should be included in the list or not. It was a time consuming, complex process, which caused political controversies.

Third, in order to enhance the effectiveness of the Code, a typically soft mechanism was employed. Naming and shaming can deter the Member States from non-compliance with a soft law measure, in order to avoid criticism. In this context, a reputation mechanism and the avoidance of negative publicity play a part. This channel of exerting influence on the behaviour of the Member States is clearly visible in the fact of creating the ‘blacklist’ of harmful tax measures annexed by the Code of Conduct Group to the Primarolo Report. However, being singled out as a non-compliant state can also invite retaliation and further breaches of Code’s principles because the state is already negatively singled out.

Finally, from the moment when a tax measure was included in the harmful tax measures list to the acceptance that the measure was successfully abolished or amended in order to meet Code standards, the process of supervising compliance with the rollback and standstill commitments was inspired by the soft law values of discourse. When a measure was placed on the list or, under the standstill commitment, was later notified to the Commission and the Code of Conduct Group, and designated as harmful, the Member States were invited to report to the Code of Conduct Group on the administrative and legislative processes which would be needed to remove the harmful features of their measures.

⁹⁵ I was unable to find an official reference for or a copy of the background paper. It is mentioned in the Primarolo Report, paragraph 12.

The Member States had to prepare a description of a revised regime or a regime that would replace the harmful measure. Just as we saw in relation to the summary of harmful tax measures, the description of the planned regime was also subject to a bilateral discussion and an agreement between the Commission and the Member States.⁹⁶ When a compromise regarding the intended regime could not be reached, time was taken and a further exploration of opportunities between the Commission and the Member States carried out until an agreement was attained.⁹⁷ Thus, the system of surveillance of progress built upon consultation and constant dialogue allowed common solutions to be worked out by the interaction of national and European forces. Shared understanding of what constitutes harmful tax competition is then developed. Moreover, such an approach to the problem enables the variety of national tax systems to be preserved. Various solutions can be accepted for different Member States, taking into consideration circumstances specific to a given Member State.

4.4. Soft law in the context of international tax issues

This section establishes that, in order to resolve transnational tax problems, soft law has not been applied exclusively by the EU. The OECD also employed the soft law approach to confront the issue of international tax competition. Similarly to the EU, the OECD project was motivated by fears of the damage that tax competition may cause. However, the scope of the OECD action is narrower than the action taken by the EU. The former is concerned with the illegality of tax havens whereas the EU soft law initiative was placed in the broader context of the internal market.

⁹⁶ Report from the Code of Conduct Group (Business Taxation) to the ECOFIN Council on 3 December 2002, 14812/02 LIMITE FISC 299, paragraph 10.

⁹⁷ For example, according to the 2002 progress report, in relation to the following measures, there were no agreed descriptions of rollback proposals: the exempt companies regime and the free zones regime in Aruba and, with regard to the Netherlands Antilles, the free zones regime. See: Report 14812/02 note 96 above, paragraph 11. However, the 2003 progress report notes that agreement on the rollback proposals regarding these three measures was finally achieved. See: Report 7018/1/03 REV 1 (en), note 47 above, paragraph 10.

The purpose of this section lies not in a comparison of the material aspects of the EU and the OECD anti-tax competition projects.⁹⁸ Principally, the analysis of the OECD project is conducted through the thesis lens of soft law and hard law interactions. This section closes with a conclusion that the OECD soft law approach to the problem of tax competition evolved towards a more sophisticated solution. The current framework of the OECD initiative combines more recent, restricted-in-scope hard law measures, in the form of tax information exchange agreements, with the soft law mechanisms traditionally applied by the OECD.

4.4.1. The regulatory structure of the OECD

According to the preamble to the Convention establishing the OECD,⁹⁹ the Organisation is founded on the tradition of co-operation that has evolved among the Members.¹⁰⁰ The OECD guides national governments by ‘producing globally accepted standards’ and ‘acceptable ground rules’.¹⁰¹ The OECD tax competition project was one of the attempts to set up an international soft law regime¹⁰² in order to create a group of principles governing what is acceptable and forbidden in the international tax competition game.

⁹⁸ This comparison has already been carried out. See for example: A Easson, ‘Harmful Tax Competition: the EU and OECD Responses Compared’, (1998) 3:1 *EC Tax Journal* 1-15; C Pinto, note 41 above; E Osterweil, ‘OECD Report on Harmful Tax Competition and European Union Code of Conduct Compared’, (1999) 39:6 *European Taxation* 198-202; E Osterweil, ‘The OECD and the EU: Two Approaches to Harmful Tax Competition’, (1999) 3:2 *EC Tax Journal* 89-100.

⁹⁹ OECD, Convention on the Organisation for Economic Co-operation and Development, 1960, available at http://www.oecd.org/document/7/0,3746,en_2649_201185_1915847_1_1_1_1,00.html.

¹⁰⁰ The list of the OECD Members has expanded over the years and today there are 34 Members: Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States. There is a possibility of an enlargement of the OECD since in 2007 Russia was invited to open discussions for membership. The Members also agreed to offer an enhanced engagement, with a view to possible membership, to Brazil, China, India, Indonesia and South Africa. Hence, the idea of the OECD as a truly global organisation, at least in a geographic sense, comes closer to the ideal.

¹⁰¹ R M Hammer and J Owens, *Promoting Tax Competition*, 2008, available at www.oecd.org/dataoecd/63/11/1915964.pdf.

¹⁰² For Krasner, regimes are ‘sets of implicit or explicit principles, norms, rules, decision-making procedures around which actors’ expectations converge in a given area of international relations’. S D Krasner, ‘Structural Causes and Regime Consequences: Regimes as Intervening Variables’, (1982) 36:2 *International Organization* 185-205 at 186. Haas underlines that regimes grow out of the increasing interdependence between self-interested states and the possibility of a conflict between them. E B Haas, ‘Words Can Hurt You; or Who Said to Whom about Regimes’, (1982) 36:2 *International Organization* 207-243 at 210.

The fact that the OECD was designed principally as a ‘meeting place enabling dialogue among equals’¹⁰³ is reflected in its regulatory framework. The OECD Council¹⁰⁴ has a number of instruments available when carrying out its activities but the activity of the OECD ordinarily takes the form of non-binding soft law which is enforced through surveillance and peer review.¹⁰⁵ In other words, the OECD is an international organisation that governs through deliberation and soft influence. Within the context of regulatory governance, the following instruments can be distinguished: decisions; international agreements with Members, non-members and international bodies; recommendations and declarations; and others.¹⁰⁶

Decisions shall be, except as otherwise provided, binding on all the Members and must be implemented by them in conformity with the Convention, after following an appropriate national constitutional procedure. Unless the Council of the OECD otherwise agrees unanimously for special cases, decisions shall be taken and recommendations shall be made by mutual agreement of all the Members. If a Member abstains from voting on a decision, such abstention does not invalidate the decision, which shall be applicable to the other Members and may be implemented by the other Members, but not to the abstaining member. International treaties and conventions concluded within the OECD Council are also legally binding on the parties to the agreement; nevertheless, the rate of production of OECD hard law acts is relatively low.¹⁰⁷ OECD decisions and international agreements are not directly effective in the legal orders of the OECD Members. Consequently, these measures

¹⁰³ M Marcussen, ‘OECD Governance through Soft Law’ in U Mörth (ed.), *Soft Law in Governance and Regulation: an Interdisciplinary Analysis*, (Cheltenham: Edward Elgar, 2004), 103-128 at 103.

¹⁰⁴ Council is vested with decision making power. It is composed of one representative per Member State and a representative of the European Commission. The Council holds regular meetings where it sets out priorities for the OECD and establishes a strategic direction for the OECD’s activities.

¹⁰⁵ R Woodward, *The Organisation for Economic Co-operation and Development (OECD)*, (New York: Routledge, 2009), p. 6, 63.

¹⁰⁶ *Ibid.*, p.70-75.

¹⁰⁷ According to Woodward, agreements and conventions account for approximately 20% of legal governance of the OECD. Over 80% is composed of recommendations and decisions. See: R Woodward, note 105 above, p. 71. Marcussen states that only 36 of the OECD legal acts are legally binding and, predominantly, they are concerned with the area of environmental regulation. In comparison to other organisations with law-making powers, this number appears to be modest. See: M Marcussen, note 103 above, 103-128 at 107.

have to be formally transposed into national law. Only when these hard law instruments are ratified as they become enforceable before national courts.¹⁰⁸

Recommendations, the most common instruments used in OECD activity, are not legally binding but practice accords them great moral influence.¹⁰⁹ It is expected that the Members would do their utmost to implement recommendations because they express the political will of the OECD Members. If a Member abstains from voting on a recommendation, such abstention does not invalidate the recommendation, which shall be applicable to the other Members and may be implemented by the other Members, but not to the abstaining member. Similarly, declarations are not intended to be legally binding. They set out policy commitments undertaken by the governments of the OECD Members. Despite not being legally binding, declarations are noted by the OECD and their application is monitored by the responsible OECD body.¹¹⁰

Generally, the OECD creates an international regime that is not legally binding or enforceable through legal mechanisms. The goal of the OECD is to ‘promote policies designed to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy (...)’; however, the OECD was not granted extensive law-making competence in that respect.¹¹¹ The OECD is a forum for discussion between Members seeking to tackle shared problems. In general, the OECD’s task is to serve as a catalyst for collaboration between states and clarification of national policies. It is a space where cooperation between the Members is driven by peer pressure and political influences because the OECD was not set up as a body endowed with supranational powers. Cooperation

¹⁰⁸ M Marcussen, note 103 above, p. 106.

¹⁰⁹ N Bonucci, *Legal Status of an OECD Act and the Procedure for its Adoption*, the note is available at <http://www.oecd.org/dataoecd/26/29/31691605.pdf>; R Woodward, note 105 above, p. 70.

¹¹⁰ N Bonucci, note 109 above.

¹¹¹ The nature of the OECD is aptly summarised in the passage from its information brochure: ‘The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and co-ordinate domestic and international policies. It is a forum where peer pressure can act as a powerful incentive to improve policy and which produces internationally-agreed instruments, decisions and recommendations in areas where multilateral agreement is necessary for individual countries to make progress in a globalised economy.’ *The OECD: Organisation for Economic Co-operation and Development*, available at <http://www.oecd.org/dataoecd/15/33/34011915.pdf>, p. 7.

between the Members is based on keeping each other informed, providing the OECD with the information necessary for the accomplishment of its tasks, and on continuous consultations and studies.¹¹²

4.4.2. The OECD project against harmful tax competition

As established, the core of the OECD's work constitutes the process of consultation and knowledge-creation. Generating hard law is not of prime concern for this international organisation. Therefore, the OECD choice of approach to harmful tax competition was founded on soft law. The story of the OECD anti-tax competition initiative has its roots in 1996, when the OECD was called upon to develop measures that counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998. In 1998, the OECD Committee on Fiscal Affairs launched a continuing project against tax competition. The scope of the action, possible risks and advanced measures against non-beneficial tax competition were discussed in five published reports.¹¹³ These reports establish standards of behaviour for both OECD Members and third countries.

The 1998 Report identified two problem areas facing international taxation of geographically mobile activities:¹¹⁴ tax havens and harmful preferential tax regimes. One term, 'harmful tax practices', is applicable to both activities. The 1998 Report stated that it was intended to develop a better understanding of how tax havens and harmful preferential tax regimes operate, and to initiate activities to eliminate both

¹¹² Article 3 of the Convention on the OECD.

¹¹³ *Harmful Tax Competition: an Emerging Global Issue* (the 1998 Report), available at <http://www.oecd.org/dataoecd/33/0/1904176.pdf>; *Towards Global Tax Co-operation: Report To the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs. Progress in Identifying and Eliminating Harmful Tax Practices* (the 2000 Report), available at <http://www.oecd.org/dataoecd/9/61/2090192.pdf>; *The OECD's Project on Harmful Tax Practices: the 2001 Progress Report* (the 2001 Report), available at <http://www.oecd.org/dataoecd/60/28/2664438.pdf>; *The OECD's Project on Harmful Tax Practices: the 2004 Progress Report* (the 2004 Report), available at <http://www.oecd.org/dataoecd/60/33/30901115.pdf>; *The OECD's Project on Harmful Tax Practices: the 2006 Update on Progress in Member Countries* (the 2006 Report), available at <http://www.oecd.org/dataoecd/1/17/37446434.pdf>.

¹¹⁴ It does not focus on either tax incentives designed to attract investment in plant, building and equipment or on the tax treatment of interest on cross-border saving instruments, particularly bank deposits. 1998 Report, note 113 above, paragraphs 6, 12.

problems.¹¹⁵ Territorially, the 1998 Report covered OECD Members and non-Members as well as their dependencies.¹¹⁶

The 1998 Report provided guidance on how to identify tax havens and how to distinguish them from harmful preferential tax regimes. Accordingly, the 1998 Report established four criteria for identifying harmful tax practices, as the OECD did not attempt to indicate specific states as tax havens or preferential tax regimes. The four factors characterising tax havens and preferential tax regimes identified in the 1998 Report were: no or nominal taxes, in the case of tax havens, and no or low taxation, in the case of the OECD Member State preferential tax regimes; lack of transparency; lack of effective exchange of information; and no substantial activities,¹¹⁷ in the case of tax havens, and ring-fencing,¹¹⁸ in the case of Member State preferential tax regimes. No or nominal taxation is a key factor for both tax havens and preferential tax regimes. However, it is solely an opening criterion. In the process of establishing whether a jurisdiction might be a tax haven or preferential tax regime, the characteristics shared by tax havens and preferential tax regimes refer to the lack of transparency of the regime and lack of effective exchange of information. Currently, these two factors attract most attention in the battle against harmful tax practices.

4.4.3. Soft law character of the anti-harmful tax competition action

The OECD adopted an approach of a distinctly soft nature. To increase discipline and to enhance the goodwill of states to cooperate in the area of tackling harmful tax competition, certain mechanisms, discussed in this section, were put in place. First, the OECD produced recommendations and guidelines for actions to be taken at the level of domestic legislation, in bilateral tax treaties and concerning the intensification of international cooperation. Second, the Forum on Harmful Tax Practices was created to monitor the implementation of the OECD guidelines. The Forum was also responsible for a 'blacklisting' procedure.

¹¹⁵ 1998 Report, note 113 above, p. 8.

¹¹⁶ *Ibid.*, p. 3.

¹¹⁷ The absence of a requirement that the activity be substantial suggests that the jurisdiction aims at attracting investments that are purely tax driven.

¹¹⁸ A regime is said to be ring-fenced when it is isolated from the domestic economy. Thus, a state offering this regime bears little or none of the financial burden of its own preferential tax legislation.

4.4.3.1. Recommendations and guidelines

An important section of the 1998 Report constituted a number of recommendations for possible action at the level of national legislation, in tax treaties, and with regard to international cooperation, in order to deal with various aspects of harmful tax competition. The 1998 Report recommended 19 detailed, mutually reinforcing measures.¹¹⁹ Among the OECD Recommendations were: a proposal to adopt controlled foreign corporation (CFC) rules; a recommendation to adopt foreign investment fund regulations, to review transfer pricing rules and follow the OECD Guidelines on Transfer Pricing; a recommendation to consider terminating or not entering into new tax treaties with jurisdictions declared to be tax havens; a recommendation regarding intensification of exchange of information between national tax administrations; and a recommendation on associating non-member countries with the recommendations set out in the 1998 Report, including the guidelines.

As the name hints, recommendations about what steps could be taken on the national and international levels with regard to fighting harmful tax practices only have the power of advice and suggestion. If an OECD Member did not follow the recommendation, there was no enforcement procedure because recommendations did not create a legal obligation.¹²⁰ Recommendations are given for consideration and may be implemented when the Members find them helpful. Thus, recommendations prefer that flexibility is left to the states over aiming at a uniform set of rules. This is not altered by the nature of the OECD decision-making process. Recommendations can only be made when mutual agreement of all the Members is reached. When one state votes against, there are no recommendations. When one state abstains, recommendations will not be applicable to the abstaining state but they will be applicable to the Members who voted in favour of them.¹²¹

¹¹⁹ 1998 Report, note 113 above, paragraphs 97-171.

¹²⁰ N Blokker, 'Skating on Thin Ice? On the Law of International Organizations and the Legal Nature of the Commentaries on the OECD Model Tax Convention' in S Douma and F Engelen (eds.), *The Legal Status of the OECD Commentaries*, (Amsterdam: IBFD, 2008), 13-27 at 18.

¹²¹ Luxembourg and Switzerland both abstained from the 1998 Report and refused to commit to the recommendations it included.

A question could be posed as to why, if not legally binding, recommendations are adopted at all? Blokker proposes a few explanations.¹²² First, recommendations appear to be easier to adopt. Usually, the adoption of a legally binding instrument entails a formal and time-consuming procedure before a final agreement is reached. A non-binding document offers a faster path to attaining regulation. Second, there might be an urgent need for a rule in order to confront new developments. Thus, a regulatory vacuum will be filled more promptly and soft law becomes a solution to pressing unregulated problems. Third, recommendations may be able to express important regulatory messages that are not yet ready to be transposed into legal instruments. Although not legally binding, recommendations are not legally irrelevant.

The 1998 Report ends with a set of guidelines to enable the OECD Members to identify and report their own harmful preferential tax regimes. It promotes 3Rs: the states have to *refrain* from adopting new or strengthening existing harmful measures. They should *review* the existing laws and *remove* from their regimes those measures which constitute harmful tax practices within a provided timeframe. As stated in the 1998 Report, the guidelines outlined a general framework within which Members can implement a common approach to restraining harmful tax competition. However, they are non-binding.¹²³

4.4.3.2. *Self-review, peer review and blacklisting mechanisms*

In the context of soft law regulation to tackle tax competition, the Forum on Harmful Tax Practices (hereinafter the Forum) is worth mentioning. The Forum was proposed in the 1998 Report and established under the auspices of the Committee on Fiscal Affairs. Its objective was to administer the OECD guidelines on tax practices. The Forum also monitored the implementation of the standstill and rollback clauses contained in the guidelines. Consequently, the Forum was also responsible for the identification and elimination of harmful tax practices, both in the OECD Members and in non-members.

¹²² N Blokker, note 120 above, 13-27 at 19-20.

¹²³ 1998 Report, note 113 above, paragraph 140.

At the initial stage of its existence, between 1998 and 2000, the Forum engaged in a series of reviews providing overviews of states' tax regimes in order to identify tax havens and harmful tax regimes. The Forum could also carry out a review on the request of a Member if this state suspected that another state's tax measures constituted harmful tax practice. The opinions of the Forum were not binding. However, the fact that an opinion of an international body existed and concluded that tax measures were breaching political commitments undertaken by the Member could have an impact and exert pressure to comply.¹²⁴

The OECD Members were expected to self-review their tax systems in order to detect and eliminate harmful preferential regimes. This process of self-review could present the states with a prisoner's dilemma. Each state had to decide whether they would be better off cooperating or not. Simultaneously, the Forum conducted cross-country reviews. There was also another mechanism which was expected to strengthen discipline on the part of the Members, namely peer review consisting of extensive questionnaires. It entailed that Members could request the Forum to examine measures in another Member State in the light of the harmful preferential regimes criteria. On the basis of the answers received from a Member, the Forum evaluated national tax regimes against the criteria.

The reports following the 1998 Report presented a review of achievements and changes made so far in the battle against harmful tax practices. With regard to preferential tax regimes, the 2000 Report identified 47 *potentially* harmful preferential tax regimes in the OECD Members. The 2006 Report indicated that 18 potentially harmful preferential tax regimes have been abolished, 14 amended to remove potentially harmful features and 13 were found not harmful after further scrutiny.¹²⁵ Until 31 December 2010, one regime, the Luxembourg 1929 holding company regulation, was perceived as displaying harmful features, despite adopted amendments. The Luxembourg 1929 holding company regime was abolished by legislation enacted in December 2006, with transitional rules for certain existing

¹²⁴ J M Weiner and H J Ault, 'The OECD's Report on Harmful Tax Competition', (1998) 51:3 *National Tax Journal* 601-608 at 606.

¹²⁵ 2006 Report, note 113 above, paragraph 9.

beneficiaries up to 31 December 2010.¹²⁶ After that date, the Luxembourg holding companies were automatically converted to and became fully taxable companies unless they were liquidated or converted to adopt another tax regime before 31 December 2010.

The situation of jurisdictions that potentially met the criteria of tax havens was different. When a jurisdiction fulfilled the tax haven criteria, it was subject to external assessment by the OECD and not to self-review. The OECD scrutinised the potential tax haven's tax system and a list of tax havens was created by the Forum. Further, OECD Members were given the mandate to create a blacklist of jurisdictions meeting tax haven criteria and to set out a framework for defensive measures against uncooperative tax havens¹²⁷. This, in fact, meant a threat of economic counter-action against them and questions the voluntary nature of the OECD initiative, taking into consideration the economic disparity between OECD Members and non-members.

Interestingly, the Report did not explain what would happen if the OECD Members did not remove existing or would adopt new measures of a harmful nature. When non-members did not comply with the OECD initiative, the defensive measures against them were an option. It appears that this threat did not apply to the Members. Thus, the potential defensive measures would apply only to tax havens. Along with a changing approach towards harmful tax practices, the OECD abandoned the idea of suggesting the implementation of counter-measures as a way of dealing with uncooperative tax havens. The OECD admitted that these had always been an option of last resort, within the sovereign competence of each Member.¹²⁸

¹²⁶ Similar limitations on this measure operated in the EU. Hence, the success of abolishing Luxembourg's 1929 holding company regime can be attributed to both EU and OECD efforts.

¹²⁷ The list of possible defensive measures includes: a disallowance of deductions, exemptions and credits related to transactions with uncooperative tax havens, an imposition of withholding taxes on certain payments to residents of uncooperative tax havens, and an imposition of transactional charges onto transactions with uncooperative tax havens. See: 2000 Report, note 113 above, paragraph 35

¹²⁸ Sharman analyses from the political science perspective why the OECD did not use military force or apply economic sanctions, and why the OECD settled on the rhetorical strategy. See: J Sharman, *Havens in a Storm: the Struggle for Global Tax Regulation*, (Ithaca and London: Cornell University Press, 2006).

The 2000 Report identified 35 jurisdictions that met tax haven criteria. A small number of the jurisdictions reviewed by the Forum on Fiscal Affairs had, in advance of the 2000 Report, made a public political commitment at the highest level (an ‘advance commitment’) to eliminate their harmful tax practices and to comply with the principles of the 1998 Report. Alternatively, countries which did not undertake advance commitments could still demonstrate their interest in cooperating with the OECD by making scheduled commitments, after the publication of the preliminary list of tax havens. Since the 2000 Report, other jurisdictions have committed themselves to the 1998 Report principles to avoid being included in the list of uncooperative tax havens, which was supposed to result in a coordinated application of defensive measures by the OECD members. Those who did not commit themselves were listed as uncooperative tax havens. Until May 2009, there were three jurisdictions on the list of uncooperative tax havens (Andorra, Liechtenstein and Monaco). These three countries were removed by the Committee on Fiscal Affairs from the list of uncooperative tax havens after they had committed to implement the OECD standards of effective information exchange and transparency. In effect, currently, there are no jurisdictions classed as uncooperative tax havens.¹²⁹

To sum up, it can be argued that the OECD wanted to become an international forum for cooperation of those states that were in opposition to tax competition. To achieve this goal, at the early stage of its initiative, the OECD operated on the basis of values and principles of soft law. The work of the OECD was embedded in a soft law structure built upon non-legally binding reports, recommendations, peer pressure and blacklisting. The latter mechanism is a traditional soft law mechanism that is founded on the threat to damage reputation of a jurisdiction as a reliable and secure destination for investment. According to Sharman, blacklisting generates compliance by one of two related causal mechanisms. First, decision makers in targeted jurisdictions observe and then react to material economic losses resulting from the reputational damage caused by blacklisting (reactive compliance), or, secondly, they anticipate material economic losses from being blacklisted and thus comply to pre-

¹²⁹ List of uncooperative tax havens, available at http://www.oecd.org/document/57/0,3746,en_2649_33745_30578809_1_1_1_1,00.html.

empt this damage (pre-emptive compliance).¹³⁰ The procedure of blacklisting can therefore be an effective soft law vehicle in influencing the behaviour of national governments.

4.4.4. A new approach in the OECD initiative

So far, the OECD approach to the problem of tax competition has been characterised as a soft law project. However, when two substantial changes occurred in the OECD approach, in 2001, that resulted in an alteration of the legal character of the project. This section focuses on the substantial changes that materialised in the OECD initiative. First, the Report issued in 2001 declared that due to concerns expressed about the criteria used to identify tax havens, changes were necessary.¹³¹ The OECD abandoned the 'substantial activities' and ring-fencing tests.¹³² The official reason was that those factors had been difficult to establish. In practice, the OECD yielded to political pressure.

Second, a change concerning timing took place. The 2001 Report extended the deadlines prescribed in the 2000 Report for listed tax havens to undertake a commitment of compliance with the OECD principles. These two changes are regarded to be the result of a political decision taken by the United States and, to some extent, the stronger position of tax havens on the international arena. The change in United States support for the OECD initiative was the turning point. The new administration, with the statement made in May 2001 by Paul O'Neill, the Secretary of US Treasury, expressed its opposition to the OECD programme.¹³³ O'Neill announced that the OECD should refocus on the core issues for tackling

¹³⁰ J C Sharman, 'The Bark is the Bite: International Organizations and Blacklisting', (2009) 16:4 *Review of International Political Economy* 573-596 at 573.

¹³¹ 2001 Report, note 113 above, paragraphs 26 and 28.

¹³² See section 4.4.2., footnotes 117 and 118.

¹³³ "Although the OECD has accomplished many great things over the years, I share many of the serious concerns that have been expressed recently about the direction of the OECD initiative. I am troubled by the underlying premise that low tax rates are somehow suspect and by the notion that any country, or group of countries, should interfere in any other country's decision about how to structure its own tax system. I also am concerned about the potentially unfair treatment of some non-OECD countries. The United States does not support efforts to dictate to any country what its own tax rates or tax system should be, and will not participate in any initiative to harmonize world tax systems. The United States simply has no interest in stifling the competition that forces governments - like businesses - to create efficiencies". See:

<http://faculty.law.wayne.edu/tad/Documents/Country/Statement%20of%20Treasury%20SecretaryO%27Neill-5-10-2001.pdf>.

harmful tax practices, that is, on transparency and obtaining access to information between jurisdictions. Without backing from this major economy, the OECD initiative lost its strength. In order to secure continued American cooperation, the OECD decided to follow O'Neill's suggestions and put emphasis merely on transparency and on requests for exchange of information.

The second reason for the altered OECD position was the strong opposition on the part of tax havens themselves. At the initial stage of the action, jurisdictions that met tax haven criteria set by the OECD did not have much influence on their situation. They were not represented within the OECD and could have been subject to evaluation by an organisation with which they did not have direct dealings. Potential tax havens were anxious that they had not been consulted over the standards to which they were expected to conform. Hence, in March 2001 tax havens formed the International *Tax* and Investment Organization (ITIO, later known as the International *Trade* and Investment Organization) to further their anti-OECD efforts. The American declaration, as well as support from various libertarian, pro free-market organisations and institutionalised objections to OECD activities, greatly enhanced the position of tax havens.

Specific controversies were raised by tax havens in opposition to the OECD action. First, many of the potential tax havens simply insisted that the OECD had no right or authority to force changes in their domestic laws. Of course, this is true, but it ignores the fact that the OECD did not have power to dictate changes as such, but rather requested changes with the threat of sanctions against those states that did not comply. Second, harsher counter-measures were planned to be imposed on uncooperative tax havens than on those OECD Members who did not abolish or amend their harmful preferential tax regimes. This was considered to be unfair.

Third, tax havens expressed concerns that the OECD expects them to comply with standards that the OECD Members are not ready to respect. This turbulence was caused by Belgium and Portugal who abstained from approving the 2000 Report. Then, Luxembourg and Switzerland also sustained their abstention from the 1998 Report. Such a situation caused controversies. On the one hand, it upset non-OECD

states that were required to comply with principles not necessarily fully accepted by the OECD Members themselves. That is why the 'Isle of Man clause' was born. Under this proviso, tax havens could make a commitment to the OECD principles but no reforms were required until every OECD Member had fully complied with the OECD principles. It also became problematic for other OECD Members complying with the OECD standards, since they might be disadvantaged in comparison to the states that abstained from reports. How would, in this case, the aim of creating a level playing field be realised?

The substantial changes in the OECD project thus stemmed from a shift in the philosophy behind OECD action. The focal point of the OECD initiative became implementation of the principles of transparency and effective exchange of information. This way, the OECD downsized the official goals of its campaign. Transparency and information exchange on request were combined with the attempt to establish an international level playing field. The methods now used by the OECD involved more cooperation with tax havens, which had reached the status of participating partners with whom the OECD members enter into bilateral agreements on the exchange of information on tax matters. Section 4.4.5 explores how the modifications in the material aspect of the OECD anti-tax competition project influenced the legal character of this initiative.

4.4.5. The mixed stage: tax information exchange agreements and soft control

As stated earlier, when the nature of the OECD's tax competition project shifted towards establishing effective exchange of information on tax matters between tax authorities of the participating partners, the legal structure of the conducted action changed as well. Cooperation in building a network of agreements¹³⁴ securing the exchange of information on tax matters rests in bilateral tax information agreements concluded between the OECD Members and non-members. It can be argued that this network of tax information exchange agreements forms the hard law segment of the project. Nevertheless, it has to be underlined that the evolving legal structure of the

¹³⁴ For a list of the agreements see:

http://www.oecd.org/document/7/0,3746,en_2649_33767_38312839_1_1_1_1,00.html.

OECD project, even now, is not devoid of soft law elements. The hard law component is connected with soft law aspects, mirroring EU developments in this field.

4.4.5.1. *International hard law: tax information exchange agreements*

The core hard law feature of the revived OECD's tax competition project is the fact that it is grounded in tax information exchange agreements (hereinafter TIEAs), which have the form of treaties falling within the realm of public international law. A treaty is an agreement between parties on the international scene¹³⁵ which is concluded between states in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation.¹³⁶

Treaties¹³⁷ are just one of the ways of creating legally binding rules on two or more states. The participating states accept a commitment to certain behaviour that would not be legally expected of them if the treaty did not exist. The obligatory nature of treaties is founded on the well-established customary international law principle that agreements are binding (*pacta sunt servanda*) and shall be performed in good faith.¹³⁸ Therefore, they are legally binding for the parties to the treaties but, at the same time, are not a source of rights and obligations for third parties.

Treaties are always a product of negotiations and their power depends entirely on the consent of the parties. Therefore, the power to create law by concluding or amending bilateral treaties rests with the OECD Members and non-member partners who decide whether or not to sign an agreement and what provisions to include in a treaty. The modification of the legal structure of the tax competition action put the initiative in the hands of states, both OECD Members and non-members, who can decide about the content of the legal obligation and its extent. Paradoxically, a legally binding measure restores equality between different actors on the

¹³⁵ M N Shaw, *International Law*, (Cambridge: Cambridge University Press, 2008), p. 93.

¹³⁶ Article 2 of the International Convention on the Law of Treaties, 1969 (Vienna Convention).

¹³⁷ Treaties are known under many names: international agreements, pacts, conventions. See: M N Shaw, note 135 above, p. 93.

¹³⁸ Article 26 of the Vienna Convention.

international arena. The purely soft law approach pursued at the initial phase of the OECD project appeared to have allowed for ‘bullying’ of non-members.

4.4.5.2. *Soft law elements of the mixed tax regulation*

It was established that after 2001, the OECD’s tax competition project has been, primarily, built on the hard law treaties establishing principles for tax information exchange. However, even with the hard law regulation growing out of the OECD soft law initiative, the soft way of controlling things was not completely abandoned. The first soft law feature of the information exchange initiative is the fact that TIEAs can be structured in accordance with the Model Agreement on Exchange of Information on Tax Matters, prepared by the OECD Global Forum Working Group on Effective Exchange of Information in 2002.¹³⁹ The Working Group on Effective Exchange of Information represented the interests of the OECD Members but also attempted to give voice to countries that are not members of the OECD. The Working Group consisted of representatives from OECD Member countries as well as delegates from Aruba, Bermuda, Bahrain, the Cayman Islands, Cyprus, the Isle of Man, Malta, Mauritius, the Netherlands Antilles, the Seychelles and San Marino.¹⁴⁰

The Model Agreement on Exchange of Information on Tax Matters has a non-legally binding nature.¹⁴¹ The goal of this Model Agreement is to establish desirable international standards of effective tax information exchange and to stimulate dialogue about it.¹⁴² The creation of shared practices among involved shareholders is linked with soft modes of governing, as was shown in Chapter 1, section 1.5.1. When two states decide to conclude a TIEA, in drafting their treaty on information exchange, they can shape their treaty in accordance with the provisions of the Model Agreement on Exchange of Information on Tax Matters.¹⁴³ The acceptance of the

¹³⁹ Model Agreement on the Exchange of Information on Tax Matters, available at <http://www.oecd.org/dataoecd/15/43/2082215.pdf>.

¹⁴⁰ Tax Information Exchange Agreements (TIEAs): http://www.oecd.org/document/37/0,3746,en_21571361_43854757_44270949_1_1_1_1,00.html.

¹⁴¹ , Model Agreement on the Exchange of Information on Tax Matters, paragraph 4.

¹⁴² *Ibid.*, paragraph 6.

¹⁴³ To tackle double taxation, the OECD adopted the Model Convention for the Avoidance of Double Taxation on Income and Capital and states model their bilateral tax treaties on the avoidance of double taxation in line with this Model Convention. With regard to the exchange of information on tax matters, the OECD undertook a similar attempt. The Model Agreement on Exchange of Information on Tax Matters was prepared to act as a template for treaties on tax information exchange.

principles of the Model Agreement contributes to generation of shared practices and their proliferation. The soft law nature of the Model Agreement on Exchange of Information on Tax Matters is also evident in the fact that its application by states as a template for their agreement is not obligatory but depends on a voluntary decision of the interested states.

When the pattern of the Model Agreement on Exchange of Information on Tax Matters is used in a treaty on information exchange, the soft law measure gains significance and is transformed into a hard law measure, which adapts soft law principles to the regulatory requirements of the treaty parties. If the parties to the exchange of information agreement follow the text of the Model Agreement on Exchange of Information on Tax Matters, it can be presumed that they want their treaty provisions to convey the meaning which the OECD wanted the Model Agreement to express.¹⁴⁴ Consequently, a non-legally binding can become a relevant source to determine rights and obligations of the parties of a hard law measure.

The second soft law feature of the information exchange initiative is that the OECD still produces annual reports, which are not legally binding instruments.¹⁴⁵ These reports present a written analysis of progress in the process of developing legal and administrative frameworks in the areas of transparency and exchange of information for tax purposes. They assess the level of adoption of the internationally agreed tax standard, which was developed by the OECD in co-operation with non-OECD countries. The standard requires exchange of information on request in all tax matters for the administration and enforcement of domestic tax law without regard to a domestic tax interest requirement or bank secrecy for tax purposes. It also provides for extensive safeguards to protect the confidentiality of the information exchanged.

Between January 2000 and January 2008, only 23 Tax Information Exchange Agreements were signed. However, the international setting altered the situation. The

¹⁴⁴ The importance of the interpretation is also associated with the Commentaries on the OECD MC. However, there are (yet) no commentaries on the model agreement on exchange of information on tax treaties. See: K Vogel, *Klaus Vogel on Double Taxation Conventions: a Commentary to the OECD-, UN- and US Model Conventions for the Avoidance of Double Taxation of Income and Capital with Particular Reference to German Treaty Practice*, (London: Kluwer, 1997), p. 44.

¹⁴⁵ Reports are prepared by the Global Forum on Transparency and Exchange of Information for Tax Purposes.

revelation of the Lichtenstein affair in February 2008¹⁴⁶ and the strong political condemnation of tax evasion practices that followed provoked a reaction in many countries. Between February 2008 and April 2009, an additional 41 agreements were signed. The G20 Communiqué issued in April 2009¹⁴⁷ left no doubt regarding the willingness of the member countries to take tax haven issues seriously, including a commitment to develop a set of counter-measures that would be utilised against non-cooperative countries.

On 2 April 2009, the OECD published an important progress report on the implementation of its tax standards regarding transparency and information exchange.¹⁴⁸ The latest report was published in March 2011. It proves that progress was achieved in developing transparency and information exchange.¹⁴⁹ This report contains two lists. The white list includes 81 (40 in 2009) countries which substantially implemented the OECD tax standards. The indicator of progress applied by the OECD is whether the jurisdiction signed at least 12 tax exchange agreements that meet OECD standards, taking into consideration the identity of the treaty partner, the willingness to sign additional agreements in the future and the effectiveness of implementation. The grey list included five (31 in 2009) tax havens and three (eight in 2009) financial centres which expressed a commitment to implementing the standards but had not yet done so. Finally, in 2009, four jurisdictions were on the black list of jurisdictions which had not committed to the standards. This naming and shaming exercise had important consequences. The four jurisdictions agreed to commit to the standards and were moved to the grey list. The challenging task will now be to maintain the momentum of the new agreements and to peer review progress in the participating countries effectively.

¹⁴⁶ See note 103 in Chapter 2.

¹⁴⁷ Declaration on delivering resources through the international financial institutions, London, 2 April 2009, available at http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf.

¹⁴⁸ A Progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standards, 2 April 2009, available at <http://www.oecd.org/dataoecd/38/14/42497950.pdf>.

¹⁴⁹ The Global Forum on Transparency and Exchange of Information for Tax Purposes: a Background Information Brief, 9 March 2011, available at <http://www.oecd.org/dataoecd/11/57/46084660.pdf>. The current lists are available at <http://www.oecd.org/dataoecd/50/0/43606256.pdf>.

This section determined that the OECD initiative against harmful tax competition combines hard law and soft law governing methods. Their close relationship is most evident when the Model Agreement is applied as a foundation of an international treaty. Then, it can be argued that soft law accommodates agreement, which is consequently transformed into legally binding provisions of a hard law treaty. In other words, soft law contributes to the creation of international law in the field of taxation, which can be enforced. Three conclusions can be drawn. First, hard law and soft law can coexist and create a reinforcing structure. Second, hard law developments in the area of international tax issues depend on the states being ready to adopt legally binding treaties. The scope of the altered initiative is limited but simultaneously indicates the frontiers of national tax sovereignty. Third, the OECD still wants to shape the sphere of taxation by producing standards of behaviour. The TIEAs operate in the area of international law, excluded from the direct impact of the OECD. They are subject to the will of treaty parties. Subsequently, the only means of influence left for the OECD, after proposing the Model Agreement, is to issue progress reports and blacklists.

Conclusions

This chapter proved that the EU Code of Conduct for Business Taxation, which aimed at tackling harmful tax competition, displays soft law characteristics. It was designed as a solution to problems surrounding the harmonisation of direct taxation in the EU. Soft law in corporate tax regulation enables Member States to avoid difficulties with fulfilling the requirement of reaching a unanimous decision in harmonising direct taxes. Soft law in the form of the Code of Conduct can encourage dialogue to explore issues, without imposing legal obligations on the Member States.

The acceptance of the tax package comprising a variety of measures appeared to have been a compromise and more feasible than proposing a purely hard law package. This multi-dimensional strategy balances various interests by using different regulatory measures and correlating various tax problems under one umbrella was a new path for the development of tax law within the EU.

The example of the tax package, in which the Code of Conduct is embedded, suggested also that soft law does not supersede hard law. Both regulatory approaches are currently present in direct tax regulation. They form a network of co-dependent regulatory measures, which respond to different regulatory needs and thus counterbalance each other's shortcomings.

This chapter demonstrated that the soft law approach to the problem of harmful tax competition was not exclusive to the EU. At the outset of its initiative, the OECD attempted to create a regulatory framework established on principles of the soft law approach. Due to the fact that the OECD is mainly a normative regime,¹⁵⁰ not creating legal obligations, the enforcement of the objectives of the tax competition project became problematic. Compliance with the OECD tax competition regime was attempted through 'naming and shaming' and exerting peer pressure. This strategy rested on the preparation of a list of jurisdictions classified as tax havens and demanding that these jurisdictions adapted their tax policies to the OECD project. However, to tackle the problem of tax competition, soft law on its own did not appear to have been a fully workable solution.

The hardening of the tax competition initiative, expressed in the adoption of international bilateral agreements on information exchange, can be perceived as a desirable development. The scope of the problem dealt with might be limited in comparison with the original ambition of the OECD project. Nevertheless, in the field of sensitive tax issues, states realised the value of concluding treaties in the restricted sphere of information exchange. It can be argued that, in some cases, the combination of cooperation and legal enforcement mechanisms is essential to ensure progress.

The situation in the EU has been somewhat reversed. The EU as a regulatory body, unlike the OECD, is not limited to the soft law approach in its choices of regulatory measures. It was granted powers to produce hard law in the sphere of direct taxation.

¹⁵⁰ It encompasses the generation of shared knowledge, anticipated standards of behaviour and the influence this has over national and international policymaking. The normative regime can be contrasted with the legal governance, which means the capacity of the OECD Members to adopt legally binding acts, i.e. the creation of international law. See: R Woodward, note 105 above, p. 62-63.

However, restrained by the unanimity requirement, hard law has not been unproblematic. For that reason, the EU attempted to use soft law in the direct tax field, as demonstrated in this chapter. A question has to be posed as to whether the lack of full adequateness of the soft law approach to tax issues, noticeable in relation to the OECD anti-harmful tax competition action, was also relevant in the EU. Did the Code succeed in achieving its goals merely on soft law grounds? As will be presented in Chapter 5, the Code of Conduct turned out not to be a sufficient soft law option, just like soft law in the OECD initiative. But soft law in EU did not develop *towards* hard law. In essence, the Code of Conduct itself turned out to be ‘the wolf in sheep’s clothing’. It was a hard law measure under its soft law features.

CHAPTER 5. THE CODE OF CONDUCT FOR BUSINESS TAXATION: A HARD LAW MEASURE?

Chapter 4 presented the Code of Conduct for Business Taxation as a measure of an ostensibly soft law character. It displays features that are distinctive of a soft law instrument, such as, for example, the engagement of various stakeholders at the stage of the preparation of the Code or the lack of a possibility to enforce the Code before the ECJ. However, it was also shown that soft law did not appear to have been a fully successful strategy for dealing with international tax problems.

This chapter investigates whether the soft law approach to tax problems, imparted through the Code, was a productive solution. Essentially, it is argued that the nature of the Code is not as simple to determine as it would appear at first sight. In fact, the Code can be described as a rather hard law measure as regards its operation. Although formally classed as a soft law instrument and a ‘statement of mutual understanding between parties’,¹ the Code constitutes harder law than might seem apparent. Beneath the soft law language, the EU constructed a rather hard regulatory measure. This hypothesis is supported by three main arguments developed throughout this chapter.

The first argument is formed on the basis of the analysis of what measures were condemned under the rules of the Code. Many of the measures placed on the Primarolo list constituted core elements of the attractiveness of national tax systems, at times with established historical presence in those systems. Additionally, some of the measures played a part in supporting the economic development of certain regions. Consequently, the Code often attacked tax measures that were applied by national authorities to increase the attractiveness of the national economy for investors or to enhance regional development. Hence, the measures which the Code aimed at removing from the tax laws of the Member States were important to national tax systems and were not insignificant.

¹ This description of the Code of Conduct was given by Luja. See: R H C Luja, *Assessment and Recovery of Tax Incentives in the EC and WTO: a View on State Aids, Trade Subsidies and Direct Taxation*, (Antwerp, Oxford, New York: Intersentia, 2003), p. 106.

Within the context of this first argument, this chapter concentrates on the reactions of the Member States in relation to work of the Code of Conduct Group. This part of the investigation follows two strands. The first line of the analysis focuses on objections raised by some of the Member States to the list of harmful tax measures established in the Primarolo Report. The second line of discovery examines the process of rollback and standstill of harmful tax measures. Both elements of the inquiry testify to the fact that the Code can be perceived as a strong instrument, capable of exerting an obligation on the Member States. Had the Member States perceived it in practice as a pure soft law instrument, as the Code was portrayed at the stage of its preparation, it is highly possible that the Member States would not have challenged the work of the Code of Conduct Group. Demonstration of disagreement constituted a way of expressing the discrepancy between the presented nature of the Code and the manner in which it was implemented.

The second argument refers to the status conferred upon the Code in the process of the 2004 and 2007 EU enlargements. It is demonstrated that the Code constituted an element of the *acquis communautaire* which the Acceding States had to incorporate into their national legislation. Currently, the Code holds the same status with regard to states waiting to join the EU in the future.

The third argument for the harder nature of the Code of Conduct stems from the relationship between the Code and the Treaty-anchored provisions on State aid. The Code includes a paragraph² establishing a link with the State aid provisions of the TFEU.³ In effect, two independent mechanisms for investigating national tax regimes, founded on separate legal bases, were connected. Through paragraph J, a relationship between a political regulatory tool and legally binding, hard law provisions of the TFEU has been set up. Thus, indirectly, the State aid provisions were employed to strengthen the Code and to enforce the regulatory principles created by it.

² Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy, OJ 1998 C 2/1, paragraph J.

³ Articles 107-109 TFEU, previously Articles 87-89 TEC.

The discussion about the hard law characteristics of the Code is of great importance because these features alter the perception of the regulatory power that the Code, commonly described as a political commitment undertaken by the Member States, has been capable of exerting on national tax systems. Despite the fact that the hard law elements of the Code have been noted in the literature,⁴ there is a distinct lack of a comprehensive analysis or explanation of the significance of the dual nature of the Code. The hard law aspects of the Code appear to be merely reported by the commentators. The influence of the hard law side of the Code is not explored in detail.⁵ Therefore, this chapter aspires to clarify the gravity of introducing hard law aspects within the context of a regulatory measure officially presented as a soft law instrument. It is claimed here that the hard law features of the Code determined the success of the anti-harmful tax competition project and contributed to imposing restrictions on national tax sovereignty. However, this chapter asks also about the implications of the hard law features of the Code for the concepts of soft and hard law, and for legitimacy, in the EU.

5.1. Questioning the soft law status: Member States and the Code of Conduct:

The first argument for the harder-in-fact nature of the Code can be formulated indirectly on the grounds of a number of connected elements investigated in this section. Essentially, some of the tax measures attacked by the Primarolo Report were crucial for national tax systems. As such, they were defended by the Member States who were not persuaded that the soft law language applied in the process of introducing the Code was reflected in the process of its implementation. Member States challenged the Code both at the stage of the creation of the list of harmful tax measures and in the rollback and standstill processes.

⁴ For instance: H Gribnau, 'Soft Law and Taxation: EU and International Aspects', (2008) 2:2 *Legisprudence* 67-117, at 67.

⁵ The relationship between the State aid provisions and direct tax measures under the Code attracted some attention in the literature: A C Santos, 'Point J of the Code of Conduct or the Primacy of Politics over Administration', (2000) 40:9 *European Taxation* 417-421; F Nanetti and G Mameli, 'The Creeping Normative Role of the EC Commission in the Twin-track Struggle against State Aids and Harmful Tax Competition', (2002) 11:4 *EC Tax Review* 185-191; C Panayi, 'State Aid and Tax: the Third Way?', (2004) 32:6-7 *Intertax* 283-306; P Nicolaidis, 'Fiscal State Aid in the EU: the Limits of Tax Autonomy', (2004) 27:3 *World Competition* 365-396.

5.1.1. The significance of the national tax measures under attack

A closer look at the measures classed as harmful in the Primarolo Report suggests that the Code attacked rather important components of the national tax systems of the Member States.⁶ If the Code had been concerned with measures of little significance for domestic fiscal arrangements, it would then have been logical to argue that the strength of the Code was meaningless and its impact would have been trivial. Two features of the tax measures on the Primarolo list point to their importance in the national setting: importance through nature and importance through volume.

With respect, first, to importance through nature, some of the measures included in the Primarolo list constituted tax solutions which ‘defined’ national tax systems, embodied their spirit and were well known to those who sought tax incentives. In an open economy, decisions about the location of businesses, corporate borrowing or transfer pricing have become more sensitive to a tax factor.⁷ This has been confirmed in empirical studies.⁸ Corporations, having the possibility to transfer production factors at no cost, get involved in complex transactions which enable them to take advantage of different tax privileges offered in various jurisdictions. Governments incorporate these factors in their approaches to taxation in order to become attractive for investors.⁹

Among the Primarolo list of harmful tax measures, one can distinguish tax rules with established historic presence.¹⁰ There were also tax measures with shorter history but, nevertheless, constituting the essence of the attractiveness of the tax systems.¹¹

⁶ The literature is dominated by discussions about a selection from the 66 harmful tax measures established by the Primarolo list. My argumentation is also supported by reference to the most widely known tax incentives.

⁷ Nevertheless, the tax factor is not the only element considered when taking investment decisions. Other determinants may include the political stability of the state, closeness to other markets, technological development, labour profile and so on. A Steichen, ‘Tax Competition in Europe or the Taming of Leviathan’, in W Schoen (ed.), *Tax Competition in Europe*, (Amsterdam: IBFD, 2003), 43-121 at 61-62.

⁸ For example: J R Hines Jr., ‘Lessons from Behavioural Responses to International Taxations’, (1999) 52:2 *National Tax Journal* 305-322; M P Devereux and R Griffith, ‘Taxes and the Location of Production: Evidence from a Panel of US Multinationals’, (1998) 68:3 *Journal of Public Economics* 335-367.

⁹ *Ibid.*

¹⁰ For instance: the 1929 Luxembourg holding companies regime, Belgian coordination centres launched in 1982 and the Irish ten per cent manufacturing rate introduced in 1980.

Another expression of importance through nature lies in the fact that some of tax measures classed as harmful were introduced to relieve problems related to specific characteristics and constraints of peripheral regions and small islands.¹² The reasons resulted from the structural, social and economic situation of those territories, which was compounded by their remoteness, small size, difficult topography and climate and their economic dependence on a few products.

Finally, the Code of Conduct Group gave priority to tax measures common to a large number of Member States.¹³ Priority was accorded to the examination of intra group services, financial services and offshore companies. The rationale behind the initial focus on the three selected categories of tax measures was to secure relatively quick progress in the assessment procedure. It can also be added that by streamlining its work, the Code of Conduct Group anticipated that a significant number of harmful tax measures would be removed from national tax systems.

Turning to importance through volume, it was stated in Chapter 4 that the lengthy Primarolo Report contains a description of all the measures that were examined against the criteria of harmful tax measures. Out of more than 200 assessed measures, a list of 66¹⁴ harmful tax measures was created. In this section, I present merely a selection of tax measures considered harmful under the principles of the Code. Due to the number and variety of tax measures on the Primarolo list, presentation of all measures could be subject to entirely separate research. Moreover, the characterisation of all of the listed tax regimes is not necessary to put forward the key argument which this section attempts to convey. Selected tax measures are described to demonstrate substantively that the Code attacked important tax regimes. A removal of or alterations to these tax regimes deprived Member States of important fiscal tools that had enhanced the attractiveness of their economies and distinguished them from economies of other Member States.

¹¹ E.g. the Gibraltar 1992 companies regime; regulation of Åland Islands' captive insurance companies from 1993.

¹² E.g. the Madeira free zone regime, the Basque country coordination centre.

¹³ Interim Report from Code of Conduct Group (Business Taxation) to the ECOFIN Council on 1 December 1998, 12530/98 LIMITE FISC 164, paragraph 12.

¹⁴ According to the Primarolo Report, 40 out of 66 harmful tax measures were found in the Member States and 26 in dependent and associated territories. It has to be added that an additional 30 harmful tax measures were identified in the states that joined the EU in 2004 and 2007.

5.1.1.1. The 1929 holding companies regime

One of the most significant examples of tax measures found harmful by the Code of Conduct Group¹⁵ was the Luxembourg regulation of tax privileges for holding companies¹⁶ (hereinafter the 1929 holding companies regime).¹⁷ Taxation of 1929 holding companies was favourable as they were exempt from corporate tax, income tax, capital gains tax and liquidation tax. Additionally, to avoid double taxation, there was no withholding tax on income distributed from or to 1929 holdings by their subsidiaries. The only direct taxes payable by a 1929 holding company were a capital duty on incorporation and an annual registration tax on the value of their shares.¹⁸

For many decades, this measure had formed an integral part of the Luxembourg tax system, before it became subject to an assessment under the principles of the Code. The legislation was created in order to attract foreign capital to Luxembourg.¹⁹ The regulation served its purpose because this regime was a highly popular business vehicle among multinational companies and high net worth individuals.²⁰ For instance, Luxembourg was regarded among US investors as a prominent place for locating holdings.²¹ In 2007, there were nearly 12000 holding companies incorporated in Luxembourg.²² The regime was well established in a politically

¹⁵ See measure A013 in the Primarolo Report. Report of 29 November 1999 from the Code of Conduct Group to the ECOFIN Council, SN 4901/99.

¹⁶ A holding company is a primary entity that serves to control other companies through the holding of major shares. It may also finance other companies in their group by providing the companies with funds and may collect income from other companies (dividends, loan interest or patent royalties), potentially to accumulate income in a low-tax jurisdiction. A holding company does not conduct economic activity because its *raison d'être* is holding shares in other companies. See: J F Avery Jones, *Tax Havens and Measures against Tax Evasion and Avoidance in the EEC*, (London: Associated Business Programmes, 1974), p. 109.

¹⁷ The name of this tax regime is derived from the fact that legislation from July 1929 provided for a preferential tax treatment of holding companies in Luxembourg. See: J Głuchowski, *Oazy podatkowe*, (Warszawa: Dom Wydawniczy ABC, 1996), p. 34.

¹⁸ PwC, *End of 1929 Holding Company Regime*, available at http://www.pwc.com/en_LU/lu/tax-consulting/docs/pwc-tax-011010.pdf, p. 1.

¹⁹ Bonn, Schmitt, Steichen Avocats, *Doing Business in Luxembourg*, 2010, available at http://www.bsblaw.net/pdf/BSS_Doing_Business_2010.pdf, p. 23.

²⁰ R Bogaerts, 'Luxembourg Adapts 1929 Holding Companies Regime to Comply with EU Code of Conduct', (2005) 45:8 *European Taxation* 356-359 at 357.

²¹ R Eicke, *Tax Planning with Holding Companies-Repatriation of US Profits from Europe: Concepts, Strategies, Structures*, (Alphen aan den Rijn: Kluwer, 2009), p. 151.

²² UHT, *Doing Business in Luxembourg*, 2009, available at http://www.uhy.com/media/PDFs/doing_business_guides/Doing%20Business%20in%20Luxembourg.pdf, p. 4.

secure and investor-friendly environment.²³ It was abolished at the end of 2006 and existing 1929 holding companies were granted a transitional period until the end of 2010. After that date, the Luxembourg holding companies automatically became fully taxable unless they were liquidated or converted to adopt another tax regime before the deadline.

5.1.1.2. *The Belgian coordination centres*

Another example of important measures condemned under the Code of Conduct were tax breaks in the form of coordination centres in Belgium.²⁴ In order to attract foreign investors and provide them with a tax-effective vehicle for centralised management, the coordination centre regime was implemented in the early 1980s.²⁵ Coordination centres were a form of headquarters' operations for multinational corporate groups. Belgian coordination centres could engage in a wide range of administrative and financial coordination activities; however, these activities were restricted to intra-group transactions.²⁶

Belgian coordination centres were subject to corporate income tax at a standard rate; however, instead of the actual profits, coordination centres were taxed on a cost-plus basis. That meant that tax was imposed only on a notional tax base determined as a percentage of certain operating costs incurred by the coordination centres. Certain items, such as personnel costs, financing costs and taxation were excluded from the tax base.²⁷ All payments of dividends, interests and royalties made by the coordination centre were exempt from Belgian withholding taxes. Interest paid to individuals or legal entities subject to tax in Belgium would not benefit from this exemption. The underlying principles of the coordination centres went beyond mere avoidance of double taxation. The Belgian regime was founded on a separation of income from earnings and profit in an accounting sense.

²³ R Eicke, note 21 above, p. 150.

²⁴ This tax regime was classed as measure A001 in the Primarolo Report, note 15 above.

²⁵ At that time, the regime was accepted by the Commission under the State aid rules.

²⁶ J Malherbe and O Neiryck, *Harmful Tax Competition: Belgian Measures Considered Tax Harmful*, available at <http://www.eatlp.org/uploads/Members/Belgium02.pdf>, p. 7.

²⁷ J Malherbe, 'Harmful Tax competition and the Future of Financial Centres in the European Union', (2002) 30:6-7 *Intertax* 219-224 at 221.

The Belgian coordination centres regime appealed to a number of enterprises. For instance, Malherbe states that between 1992 and 1996, 379 coordination centres were established.²⁸ Among them were large American, Japanese and European groups from all types of industries.²⁹ In addition, the coordination centre regime was described as a vehicle that put Belgium in the lead on low-tax structures for group finance in the European market and one that should always be considered in the process of tax planning.³⁰

Developments regarding the Belgian coordination centres concluded in the context of State aid proceedings. The final result was a transitional arrangement for some of the coordination centres authorised to operate until the end of 2010. I will return to this problem in section 5.3. of this chapter.

5.1.1.3. *Special economic zones*³¹

The last example of a tax measure categorised as an illustration of harmful tax competition was the Polish special economic zones regime.³² The legislation constituting the foundation for SEZs was introduced in 1994.³³ Special economic zones are singled out administrative regions in Poland where investors can conduct

²⁸ *Ibid.*, at 221.

²⁹ P A A Vanhaute, *Belgium in International Tax Planning*, (Amsterdam: IBFD, 2008), p. 253. Groups which set up as coordination centres in Belgium included: Volvo, Siemens, Carrefour, Yves Rocher. See: M P Styczen, 'Financial Centres in Belgium: a Comprehensive Case Study of Multinationals' Financial Centres in Belgium'. Working Paper No 31/10, Institute for Research in Economics and Business Administration, Bergen, June 2010, available at http://bora.nhh.no/bitstream/2330/2782/1/AN31_10.pdf, p. 7.

³⁰ J Meyers and P Verhaeghe, 'Coordination Centres Make Belgium the Market Leader', (1991-1992) December-January *International Tax Review Supplement* 5-9 at 5.

³¹ Hereinafter SEZs.

³² This regime was classed as harmful by the Enlargement Group (Tax Experts) on the basis of the Commission Services document. See: Report to Council Enlargement Group concerning the Code of Conduct for Business taxation (harmful tax competition) of 5 June 2003, ENLARGEMENT MD 82/03. I gained access to this document through the Commission as it was not available online. The list of harmful tax measures detected in the tax systems of the countries which joined the EU in 2004 was included in the Item Note from the Enlargement Group (Tax Experts) to the Permanent Representatives Committee/Council on the Code of Conduct for Business Taxation-Harmful tax measures in the acceding States and commitments for rollback, 13213/03 LIMITE ELARG 94 FISC.

³³ Ministerstwo Gospodarki i Pracy, Specjalne strefy ekonomiczne: stan na dzień 31 grudnia 2004, Warszawa, marzec 2005, available at <http://www.mg.gov.pl/NR/rdoonlyres/F158E11B-4E7D-40F6-A5DC-2AA99B567837/49062/mso2E8.pdf>.

economic activity on preferential terms, taking advantage of exemptions from income tax, local taxes and fees, and accelerated amortisation of fixed assets.³⁴

The core objective of the functioning of SEZs was to facilitate the development of regions of Poland with structural unemployment³⁵ by encouraging investment in these regions. They acted as an important tool in tackling problems resulting from the challenging political and economic transformation of the 1990s. Tax incentives were a strong stimulus to invest in the special economic zones, especially since, at the time, tax rates on income in Poland were relatively high.³⁶ Legislation allowed for complete tax exemption from income tax for a period of ten years and then a 50% reduction of income tax for investors operating in the SEZs.³⁷ The investor was also exempted from property tax. In some zones, exemption from local taxes was also granted.

The Code of Conduct Group classed as harmful two tax rules regarding SEZs. First, measure PL01 was an unlimited tax exemption granted before 2001. On the basis of the Accession Treaty, a transition period was secured for small and medium enterprises (until 31 December 2011 and 2010, respectively). Second, measure PL02 referred to amended rules on SEZs. Upon accession, Poland committed to amendments to the rules so that the Minister would not have an authorisation to issue permits without a tender.³⁸ Poland complied with the Code as regards the harmful nature of the amended rules on SEZs.

³⁴ Currently, there are 14 special economic zones in Poland. See: <http://www.mg.gov.pl/Wspieranie+przedsiębiorczosci/Wsparcie+finansowe+i+inwestycje/Specialne+strefy+ekonomiczne>.

³⁵ Structural unemployment is characterised by a discrepancy between skills possessed by the labour force and skills required by employers.

³⁶ Ministerstwo Gospodarki i Pracy, Specjalne strefy ekonomiczne, note 33 above, at 2.

³⁷ *Ibid.*, at 2.

³⁸ SEZs were condemned not only under the principles of the Code but also by Monti, the Competition Commissioner, who warned that the Polish Government would have to withdraw some privileges given to companies investing in special economic zones since investors' obligations contradict European regulations on State aid. The issue of SEZs was one of the most controversial aspects of the negotiation process. Poland amended its legislation under pressure from the EU in the pre-accession stage. SEZs still operate but are scheduled to cease to exist by 2017. It is hard to imagine that ten years will be enough time for Poland to catch up with its EU western counterparts in terms of standards of living and employment levels.

The three examples of measures considered as harmful under the principles of the Code demonstrated that the Code hit at the heart of national tax systems. The tax regimes under attack were not insignificant. Conversely, these tax measures were known on the international tax arena and were widely appreciated by businesses in their tax planning strategies. The common denominator of these measures was the fact that Member States introduced tax incentives in order to distinguish their economy and become (more) attractive for investors or to relieve economic problems of certain regions.

5.1.2. Objections to the Primarolo Report

Since the Code of Conduct condemned many tax measures lying at the heart of the Member States' tax arrangements at least some of the Member States challenged the classification of tax measures prepared by the Group. Member States questioned both the process and the outcome of the exercise.

In general, analysis of the Primarolo Report reveals that reaching an agreement on the blacklist of harmful tax measures, necessary for the adoption of the Report, was not an easy task. A unanimous decision on the content of the Report might have been a desirable result. However, it was not attained. Whilst the criteria for harmful tax measures described in the Code were formally agreed by all the Member States in the process of preparing the Code, the Primarolo Report was not.³⁹ The Report states that where unanimity was not achieved with regards to the harmful nature of certain tax measures, the Report reflects the broad consensus and alternative views are revealed in its footnotes.⁴⁰

An overview of the Primarolo Report shows that 47 dissenting opinions of various Member States were included in the footnotes of the Report.⁴¹ That is a clear manifestation of objections to and lack of unanimous support for the results of the

³⁹ Member States did not formally reject the Report and its list of harmful tax measures. In the interim agreement in November 2000 (see Chapter 4), the Council adopted sets of guidelines containing general criteria founded on those set out in the Primarolo Report, which take into consideration the criticism of some of the Member States. These guidelines concern three out of six categories into which harmful tax measures were divided in the Primarolo Report.

⁴⁰ Primarolo Report, note 15 above, paragraph 30.

⁴¹ *Ibid.*, footnote 7, 21, 38, 45-51. These footnotes express the reservations of some of the Member States on specific claims included in the Primarolo Report.

Primarolo Group's work. Member States that provided substantive objections to the content of the Primarolo Report, and general comments on its work were mainly the Netherlands, Luxembourg and Ireland. This is a revealing pattern as these are the three EU countries with most harmful tax measures under the Report. It does not surprise, then, that these Member States had many comments to offer.

Moreover, it appears that the fact of the inclusion of the objections of national delegations with regard to the content of the Primarolo Report is a success that can be attributed to the contesting Member States. Examination of the two interim reports,⁴² which preceded the Primarolo Report, shows that objections were not noted there. With the exception of an annexed note from the Dutch delegation, *General remarks about the Netherlands' Ruling Practice*,⁴³ the interim reports create a false impression of a uniform acceptance of the work conducted by the Code of Conduct Group.

Lastly, it can be argued that the importance of the challenges raised by some of the Member States appears to have been downplayed. As acknowledged, the objections were incorporated into the Report; however, they were not integrated into its main text but positioned in the footnotes, suggesting secondary importance of the information included therein.

5.1.2.1. General criticism

Primarily, it was argued by the Netherlands⁴⁴ that the process of evaluating potentially harmful tax regimes did not provide a wide, cross-country review of tax measures and did not explain how measures regarded to have been harmful influenced the choice of the investment location, which was clearly required by the Code.⁴⁵ Thus, the Primarolo Group did not fulfill its mandate. Ireland expressed a similar objection, challenging the Report on the basis of its failure to identify for each of the individual measures the extent to which the effective level of taxation was lower than those levels which generally apply in the Member States in question,

⁴² Interim Report 12530/98 LIMITE FISC 164, note 13 above; Interim Report from Code of Conduct Group (Business Taxation) to the ECOFIN Council on 25 May 1999, 8231/99 LIMITE FISC 119.

⁴³ Interim Report 12530/98 LIMITE FISC 164, note 13 above, at 39-41.

⁴⁴ Primarolo Report, note 15 above, footnote 2.

⁴⁵ Code of Conduct, note 2 above, paragraph A.

as required by the Code.⁴⁶ Some commentators claimed, nevertheless, that the meetings of the Code of Conduct Group fostered a fruitful discourse and in-depth review of national tax systems.⁴⁷

Having contested the fulfillment by the Primarolo Group of its mandate, the Netherlands also accused the Group of exceeding its mandate. As said before, the basis of the evaluation of the national tax regimes was the criteria listed in paragraph B of the Code. In the Report, however, it was decided that these criteria are not to be understood literally. A broader interpretation of some of the criteria was in fact recommended.⁴⁸ Of course, that spurred critique from some of the Member States, who claimed that the Code of Conduct Group went too far. According to the Netherlands, new criteria and features had been used to identify the measures that affect or may affect in a significant way the location of business activity in the EU. These criteria and features were not based on the criteria of the Code itself and the Group thus exceeded the mandate conferred by the Council. In short, the Dutch delegation could not accept the use of criteria which were not discussed in depth by all the Member States during the preparation of the Code. The application of the new criteria in assessing the harmful nature of tax measures in effect led to pseudoharmonisation.⁴⁹

I do not fully accept the critique of the Dutch delegation. It has to be underlined that the Code clearly states that the criteria for harmfulness included therein constitute merely some of the potential criteria which can be applied in the process of evaluating harmful features of national tax regimes. As stated in Chapter 4, section 4.2.2., the Code enumerates conditions for harmfulness *inter alia*, therefore the Code of Conduct Group was entitled to extend or use additional criteria in order to identify harmful tax measures.

On the other hand, the Primarolo Report does not provide clear justifications for recognising the harmful (or otherwise) nature of specific tax measures. Admittedly,

⁴⁶ Primarolo Report, note 15 above, footnote 4.

⁴⁷ F Parly, 'The Code of Conduct and the Fight against Harmful Tax Competition', (2000) 40:9 *European Taxation* 406-409 at 408.

⁴⁸ Primarolo Report, note 15 above, paragraph 14.

⁴⁹ *Ibid.*, footnote 7.

the Report includes Annex A which offers descriptions of tax measures, both regarded as harmful and those tax measures which were found not to be harmful. However, the combination of these description regimes in one section of the Report adds to the confusion. Despite being a dominant section of the Primarolo Report,⁵⁰ Annex A does not clarify why certain measures included in it were classed as harmful and some were not. It is not demonstrated either which criteria of harmfulness national tax regimes met or did not fulfill.

A conclusion can therefore be drawn that the Primarolo Report fails to play its fundamental role. It does not constitute a reliable, convincing foundation to establish a list of harmful tax measures because an in-depth analysis of tax measures in the light of the Code criteria is missing. Accusations of arbitrariness on the part of the Primarolo Group are understandable. While it is true that attempts openly to evaluate tax measures against Code of Conduct criteria were made in the scholarly literature, such efforts should have been shown in the Primarolo Report itself.

Furthermore, Luxembourg and the Netherlands stressed the asymmetrical approach of the Code of Conduct Group to different types of tax measures. It appeared that tax measures falling into categories of intra group services, financial services, and offshore companies were treated in a stricter fashion. In fact, they were the only tax regimes evaluated as harmful.⁵¹ That, of course, creates an impression of persecution of some of the Member States, those that rely on a financial sector. It is also justified to claim that the available documentation does not discuss measures which are found harmful in detail. However, it is possible that during debates leading to the creation of the harmful measures list, discussions were extensive and covered the measures in question in depth. Unfortunately, there is no access to such documents to confirm whether the summary of measures presented in the Primarolo Report is merely an imperfect reflection of detailed debates that took place.

⁵⁰ Annex A covers pages 30-298 of the Primarolo Report.

⁵¹ Primarolo Report, note 15 above, footnote 5.

5.1.2.2. Protests regarding specific tax measures

In addition to general objections, some Member States expressed alternative views regarding classification of specific tax measures. For example, Belgium contested the finding made in respect of its distribution centres regime⁵² on the basis that a summary of the features of this tax measure provided in Annex B of the Report (i.e. that this regime is founded on reduced base/cost plus 5%) did not correspond with reality.⁵³ The Spanish delegation, on the other hand, claimed that the Basque country coordination centres and the Navarra coordination centres regimes⁵⁴ should not (yet?) be assessed by the Primarolo Group due to the fact that these tax measures were being evaluated by national courts in Spain. In effect, it was argued that the Code of Conduct Group should have waited until there was a verdict from domestic courts.⁵⁵ It can therefore be suggested that the Primarolo Group might have been expected to take the opinion of domestic courts into consideration in the process of evaluating the two measures against the rules of the Code.

Interestingly, the Netherlands defended one of its tax measures⁵⁶ on the grounds that a British tax measure for cost plus ruling was not grouped as a harmful tax measure and because, for both of these measures, the OECD guidelines were incorporated in a similar manner. Two points are worth making in this context. First, it is interesting to see how a Member State turns to international tax principles and standards in order to influence the outcome of a review held within the EU. A question could be posed as to whether that points to a greater importance for the international standards agreed at the OECD level than evaluations occurring at the level of the EU.

Second, this situation suggests that the approach of the Primarolo Group was to review all measures on a case-by-case basis. The fact that various Member States had similar tax measures did not automatically mean that, for instance, all coordination centres would be classified as harmful tax measures. Individual reviews were supported. Of course, in this context, an unambiguous explanation as to why a

⁵² *Ibid.*, measure A002.

⁵³ *Ibid.*, footnote 17

⁵⁴ *Ibid.*, measures A004 and A005, respectively.

⁵⁵ *Ibid.*, footnote 19.

⁵⁶ *Ibid.*, footnote 20. The Netherlands referred to measure A008 (cost plus ruling).

certain tax measure was believed to have met the Code's requirements whilst another measure, with a similar name, hence implicitly with a comparable function, did not, becomes even more critical and essential.

National tax systems can be established on similar principles and some tax systems share tax solutions which can be created according to certain templates. At times national tax measures are borrowed by other tax jurisdictions and ideas spread across the globe. On the other hand, tax solutions applied in one tax system are not necessarily transposed without any alterations to another tax system. Moreover, tax measures of a similar structure and function may operate differently in relation to the rest of the tax system. Then, an automatic approach would be unworkable. Regardless of which approach was adopted by the Code of Conduct Group, the priority and the starting point would always have to be the need to justify the classification.

Overall, it can be argued that certain Member States did not accept the work of the Primarolo Group and the blacklist of harmful tax measures. It was presented that the measures attacked under the Code were of great significance to national tax systems. The Code did not attempt to eradicate marginal tax solutions but was hitting at the heart of tax systems and national tax sovereignty. Moreover, it was attacking a great number of measures. This was a sign that the soft law presentation of the Code and the language of mutual learning, sharing and voluntarism, so keenly used at the stage of the Code's adoption, might not have been translated to practice. The Code was gaining a hard side. Disagreement with the not-so-soft layer of the Code was expressed through the non-acceptance of the results of the Code of Conduct Group work. But, objections to the work of the Code of Conduct Group were not recognised as important. They were positioned in the footnotes of the Report, suggesting their minor significance.

5.1.3. The process of rollback and standstill

Under the provisions of the Code, the Member States undertook commitments to review (and amend if required) existing tax measures and practices which met the criteria of harmful tax competition, and not to introduce new measures which were

harmful within the meaning of the Code. Exploration of the standstill and rollback processes provides a valuable insight into another aspect of the recognition by Member States of the harder nature of the Code. Since the implementation of the rollback and standstill commitments was a multifaceted process, it is suggested that through these processes, the duality of how the Code was presented and how it attempted to operate was also expressed. Examples used in this section suggest that the harder nature of the Code is reflected in the Member States' respect for the rollback deadlines and can also be seen in the way that the State aid mechanism achieved results aimed at by the Code.

5.1.3.1. Recognition of the existence of the obligation

As presented in Chapter 4, section 4.2.3., the rollback provision had to be implemented by the Member States by January 2002. In addition, on a case-by-case basis and in exceptional circumstances, permission for the continuation of certain harmful tax measures beyond 2005 could be granted. The Council agreed, at the final adoption of the tax package and in the context of agreement on the assessment of the results reached on the rollback of harmful measures, that extensions beyond the end of 2005 for the following measures were granted: Belgium: Co-ordination Centres, extension to 31 December 2010; Ireland: Foreign Income, extension to 31 December 2010; Luxembourg: 1929 Holding Companies, extension to 31 December 2010; Netherlands: International Financing, extension to 31 December 2010; and Portugal: Madeira's Free Economic Zone, extension to 31 December 2011.⁵⁷

Extensions permitting Member States to continue the use of harmful tax regimes were also issued later with regard to tax measures for associated and dependent territories, and also states that joined the EU in 2004 and 2007. For instance, the ECOFIN Council conclusions of the meeting on 21 January 2003 explained that the Council granted extensions on request relating to seven measures for the Channel Islands.⁵⁸ Benefits were extended until 31 December 2007 with regard to the

⁵⁷ See: Report from the Code of Conduct Group (Business Taxation) to ECOFIN Council on 7 March 2003 on the Code of Conduct (Business Taxation), 7018/1/03 REV 1 (en) LIMITE FISC 31, paragraph 10. It can be argued that this concession was allowed in return for a shorter deadline for the rollback procedure.

⁵⁸ *Ibid.*, paragraph 15.

Guernsey tax regime for exempt companies, regulation of international loan business, flexible tax rate 0-30% for international bodies, the tax regime for the offshore insurance companies and the tax regime for insurance companies.⁵⁹ The tax exempt companies regulation received an extension until five years after agreement on the tax package.⁶⁰ Benefits stemming from the sliding scale for profit of international operations were extended until 31 December 2011.⁶¹

As far as extensions regarding tax measures in the new Member States are concerned, Poland, for instance, was granted a transitional period by the Accession Treaty with reference to its special economic zones (original rules). Poland may apply a transitional period to small enterprises up to and including 31 December 2011 and to medium-sized enterprises up to and including 31 December 2010.⁶² Slovakia, on the other hand, was allowed to apply a transitional period until the end of the fiscal year 2008 with regard to one beneficiary of the ten-year tax holiday for foreign owned companies.⁶³

The requests for extensions submitted by the Member States to the Council are interpreted here as recognition of the fact that the Code of Conduct had created an obligation which had to be respected by the Member States. In other words, requests for extensions of benefits from harmful tax measures indicate the hard nature of the Code. They suggest that the Member States realised that they could not have simply ignored the rollback deadlines established in the Code. They needed to ask for permission in order to be able to apply, in an acceptable way, harmful tax regimes beyond the deadlines set by the Code of Conduct Group. Thus, the reasoning of the Member States appears to have been founded on the conviction that if no extensions of benefits were secured, such behaviour would be mean breaching meaningful rules.

⁵⁹ These measures were classed as harmful: F037, F038, F040, F042, respectively. See Annex 1 to the Primarolo Report, note 15 above.

⁶⁰ *Ibid.*, measure F045.

⁶¹ *Ibid.*, measure F047.

⁶² Measure PL01 in the Item Note from the Enlargement Group (Tax Experts) to the Permanent Representatives Committee/Council on the Code of Conduct for Business Taxation-Harmful tax measures in the acceding States and commitments for rollback, 13213/03 LIMITE ELARG 94 FISC, p. 13.

⁶³ *Ibid.*, measure SL01, p. 14.

5.1.3.2. Acting in accordance with the Code's soft nature

There were also cases where the timeframe for rollback determined in the Code was ignored. Member States did not implement the Code on time which could, in fact, mean that they simply acted in accordance with the soft law nature of the Code. As explained, the soft character of a regulatory measure entails a voluntary decision about whether to follow the standards presented in the measure in question or not. However, as will be demonstrated in Chapter 5, section 5.3. on State aid, the hard edges of the Code were a powerful tool in securing compliance with the Code eventually.

A good example of a tax measure classified as harmful tax competition, which for a number of years was difficult to remove from a national tax system, is the exempt (offshore) companies and captive insurance regime in Gibraltar.⁶⁴ This tax regulation was included in the list of harmful tax measures in 1997. According to the Code provisions, the Gibraltar tax regulation should have been amended or abolished by 2002. However, the analysis of the progress reports shows clearly that Gibraltar did not remove this measure from its tax system by that deadline.

The 2002 progress report notes that the Government of Gibraltar proposed to abolish the existing regime within the context of a general reform of corporate taxation. The Gibraltar Government announced the outline of the envisaged reform publicly but the details remained confidential. It was proposed that the reform would be introduced with effect from 1 July 2003.⁶⁵ The proposals were also subject to State aid examination by the European Commission⁶⁶ and adoption by Gibraltar's Parliament.

In the progress report in 2004, the Code of Conduct Group noted that it discussed the three tax measures in Gibraltar, including measure B012. The Group noted that this measure had not yet been abolished, and remained available for new entrants. Until

⁶⁴ Primarolo Report, note 15 above, measure B012.

⁶⁵ Report from the Code of Conduct Group (Business Taxation) to ECOFIN Council on 3 December 2002 on the Code of Conduct (Business Taxation) 14812/02 LIMITE FISC 299, p. 54.

⁶⁶ The Commission decided to initiate the State aid procedure in October 2002. Commission, Aid C 66/2002 (ex N 534/2002)-Gibraltar government corporation tax reform, OJ 2002 C 300/2.

the measure was abolished, it retained harmful features.⁶⁷ In the second report in 2004, the Code of Conduct Group again reported that Gibraltar had not yet complied with rollback in relation to measure B012. The Group also agreed that, to accord with the terms of the Code, the measure could and should have been abolished, irrespective of the Commission's decision and ongoing work on State aid, and that it should have been closed to new entrants immediately.⁶⁸ The Group urged Gibraltar to look for an urgent rollback solution in relation to measure B012, in particular relating to not having new entrants in 2005, noting that the measure should have been closed to new entrants since 2001. The UK noted that, in these circumstances, the acceptance of the State aid decision⁶⁹ constituted the best possible, most practical and legally binding rollback proposal, stressing that, notwithstanding the absence of certainty about future tax provisions in Gibraltar, measure B012 was nonetheless now being rolled back.⁷⁰

In the reports of 2005 and 2006, the Group expressed its continuing dissatisfaction with the failure to fulfil the commitment to rollback measure B012 within the prescribed timeframe.⁷¹ Finally, in the 2009 report, it was noted that the Government of Gibraltar had closed B012 to new entrants from 30 June 2006, with some limited benefits for existing beneficiaries continuing until 2010, in accordance with the timeframe established in the State aid decision.⁷²

This example shows that, in the rollback process, there were cases where jurisdictions did not show concern about the deadlines established in the Code. Gibraltar did what it wanted for an extensive time. The deadline of 2002 established

⁶⁷ Report from the Code of Conduct Group (Business Taxation) to ECOFIN Council on 2 June 2004 on the Code of Conduct (Business Taxation) 9805/04 LIMITE FISC 113, paragraph 15.

⁶⁸ Report from the Code of Conduct Group (Business Taxation) to ECOFIN Council on 26 November 2004 on the Code of Conduct (Business Taxation) 15317/04 LIMITE FISC 249, paragraph 16.

⁶⁹ Commission Decision of 30 March 2004 on the aid scheme which the United Kingdom is planning to implement as regards the Government of Gibraltar Corporation Tax Reform, OJ 2005 L 85/1.

⁷⁰ Report from the Code of Conduct Group (Business Taxation) to ECOFIN Council on 27 May 2005 on the Code of Conduct (Business Taxation) 9427/05 LIMITE FISC 55, footnote 1.

⁷¹ Report from the Code of Conduct Group (Business Taxation) to ECOFIN Council on 6 December 2005 on the Code of Conduct (Business Taxation) 15434/05 LIMITE FISC 156, paragraph 13; Report from the Code of Conduct Group (Business Taxation) to ECOFIN Council on 7 June 2006 on the Code of Conduct (Business Taxation) 9655/06 LIMITE FISC 73, paragraph 16.

⁷² Report from the Code of Conduct Group (Business Taxation) to ECOFIN Council on 29 June 2009 on the Code of Conduct (Business Taxation) 10200/1/09 REV 1 LIMITE FISC 69, page 5.

by the Code of Conduct Group did not play a significant part in the rolling back of the harmful tax measure. The timeframe indicated by the Commission decision on State aid for the removal of the tax measure appeared to have been more favourable to Gibraltar, which decided to respect this deadline over deadlines in the context of the Code. In other words, even when a state attempts to disregard principles of the Code, a hard law edge in the form of State aid can be employed in order to assure the enforcement of Code principles. The influence of the State aid regime on the regulatory strength of the Code is closely examined in Chapter 5, section 5.3.

Overall, it can be concluded that despite issues arising in the context of rollback and standstill, as presented in this section, measures from the Primarolo list were either removed from national tax systems or modified to comply with the Code. The Member States might have protested against the Code's harder ambitions by attempting not to reform their tax systems but, in the end, they gave in. There is also evidence from literature⁷³ that Member States reformed their tax systems in order to comply with the Code of Conduct. Consequently, this suggests that the Code was generally successful and achieved its set goals. However, it did so because of the hard law features connected with the Code as it is unlikely that Member States or dependent territories would voluntarily resign from the attractive elements of their national tax systems.

5.2. The Code of Conduct as an element of the accession *acquis*⁷⁴ in the 2004 and 2007 enlargements

For the states applying for the EU membership, the Code of Conduct, agreed upon by 15 Member States in 1997, has not been just a soft law measure which they might or might not follow. The new Member States in the process of the 2004 and 2007 enlargements, and also in pending accessions, were required to accept regulation of tax competition provided for by the Code as part of the body of EU legislative

⁷³ R Bogaerts, note 20 above, at 356-359; W Loukota, 'Tax Law Amendments in Response to EC Code of Conduct', (2003) 43:7-8 *European Taxation* 273-275; K O'Donnell and S Nonnenkamp, 'The Demise of 1929 Holding Companies', (2007), 18:6 *International Tax Review* 57-60.

⁷⁴ Gialdino distinguishes four different categories of *acquis*. The concept of the *acquis* which is most relevant to the analysis conducted in this section is the accession *acquis*. See: C C Gialdino, 'Some Reflections on the *Acquis Communautaire*', (1995) 32:5 *Common Market Law Review* 1089-1121 at 1090-1100.

achievements that they needed to adopt if they wanted to become members of the EU.

Surprisingly, the fact that the Code formed part of the *acquis* is not discussed in the literature.⁷⁵ Conversely, an overview of the EU enlargement literature suggests that the Code and the issue of regulating EU tax competition in the context of the Central and Eastern enlargements did not raise alarm or curiosity among academics. According to my research, no issues in this regard were described or debated; negotiations in the field of direct taxation between the EU and the new Member States have been largely ignored in the EU enlargement writings. The fact that the Code of Conduct was applied as a part of the *acquis communautaire* which the candidate states had to incorporate into their national legal systems did not seem to have been a step too far. This may indicate lack of recognition of the importance of classifying the Code as a part of the *acquis communautaire* in the EU.

According to the Guide to the Negotiations regarding the process of negotiating the accession to the EU of 12 new countries, the state of play in December 2004 was that most candidate states had declared that they accepted and would apply the principles of the Code.⁷⁶ In a series of articles published in 2004 in *European Taxation*, tax experts from the Acceding States presented national preparations for EU accession in the context of their tax systems. In some of the articles, the Code of Conduct is not mentioned.⁷⁷ In many of them, it is just stated that certain tax regimes were classified by the Code of Conduct Group as potentially harmful⁷⁸ and the need to bring the

⁷⁵ See on enlargement e.g.: M J Baun, *A Wider Europe: the Process and Politics of European Union Enlargement*, (Lanham, Boulder, New York and Oxford: Rowman & Littlefield Publishers, 2000); M Cremona (ed.), *The Enlargement of the European Union*, (Oxford: Oxford University Press, 2003); M Maresceau (ed.), *Enlarging the European Union: Relations between the EU and Central and Eastern Europe*, (London and New York: Longman, 1997); U Sedelmeier, *Constructing the Path to Eastern Enlargement: the Uneven Policy Impact of EU Identity*, (Manchester and New York: Manchester University Press, 2005).

⁷⁶ Enlargement of the European Union: Guide to the Negotiations Chapter by Chapter, available at http://ec.europa.eu/enlargement/archives/pdf/enlargement_process/future_prospects/negotiations/eu10_bulgaria_romania/negotiationsguide_en.pdf, p.36.

⁷⁷ M Babič and K Janežič, 'EU Accession and the Slovenian Tax System', (2004) 44:4 *European Taxation* 171-174; C C Torregiani and S Aquilina, 'EU Accession and the Maltese Tax System', (2004) 44:4 *European Taxation* 178-183.

⁷⁸ G Erdős and T Locsei, 'EU Accession and the Hungarian Tax System', (2004) 44:2-3 *European Taxation* 99-106 at 105.

national tax system in line with the Code was reported.⁷⁹ Occasionally, it was noted that there were no outstanding issues regarding compliance with the Code.⁸⁰ The common feature of these articles is that none of them questions the status of the Code and its position as part of the *acquis communautaire*.

This section aims to fill that gap in the enlargement literature. It attempts to emphasise the significance of the redefinition of the Code's legal character in the process of EU enlargement. In order to achieve this goal, the main features of the pre-accession framework are first presented in section 5.2.1. It has to be clarified that the framework for the development of relations between the EU and Central and Eastern European states is demonstrated in a general fashion. I sketch broadly the central elements of the legal framework in order to create the background for a discourse about the concept of the *acquis communautaire*, which follows in section 5.2.2. The concept of the *acquis* is fundamental for the accession procedures. Acts developed in the pre-accession stage shared a goal of strengthening the capability of candidate states to adopt and to put into practice the *acquis communautaire*.

Section 5.2.3. describes the position of the Code of Conduct in the 2004 and 2007 enlargements. It is shown that the Acceding States committed themselves to the Code as a component of the body of EU legislative achievements. In section 5.2.4., the consequences of the classification of the Code as an element of the *acquis* are assessed both from the perspective of the Acceding States and the Member States.

5.2.1. The legal framework for relations between the EU and CEE States

The history of relationships between the EU and Central and Eastern European states (hereinafter CEE states) is relatively short and can be described as leading towards the intensification of mutual relations.⁸¹ The pursuit of strengthening relations with

⁷⁹ *Ibid.*, at 106; P De Ruiter and F Świtała, 'EU Accession and the Polish Tax System', (2004) 44:4 *European Taxation* 165-170 at 169.

⁸⁰ Y Tsangaris, 'EU Accession and the Cyprus Tax System', (2004) 44:2-3 *European Taxation* 107-114 at 113.

⁸¹ The term CEE encompasses twelve states which joined the EU in 2004 and 2007. They are: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia, and Bulgaria and Romania. I acknowledge that it is a simplification to summarise developments of EU- CEE states relations in just a few words; nonetheless, it is sufficient for the purpose of this chapter. For decades, the existence of the European Communities was ignored by the CEE states primarily due to the

the EU was beneficial for both the EU and the CEE states.⁸² From the perspective of establishing relations and subsequent preparations for accession, the main elements of the pre-accession framework included the Association Agreements,⁸³ Accession Partnerships and Regular Reports of the Commission on the Progress of Applicants towards Accession.⁸⁴

The Association Agreements, signed between 1991 and 1996, created a legal foundation for the relations between the EU and CEE states. Article 217 TFEU⁸⁵ provided an express legal basis for entering into the Europe Agreements. This provision empowers the EU to conclude ‘with third countries or international organisations agreements establishing an association involving reciprocal rights and obligations, common action and special procedure.’ As far as the legal status of the Europe Agreements is concerned, they were classic international agreements. They were agreements of a mixed character, which means that both the Member States and the Communities were contracting parties to the agreements.⁸⁶ In effect, they were binding upon the institutions of the EU and on its Member States.⁸⁷ Such agreements form part of the EU legal order⁸⁸ and could produce direct effect. Provided that provisions of the agreements are clear, precise and unconditional, an individual could rely on those provisions before national courts.

The Europe Agreements aimed at establishing the boundaries for a political dialogue which would secure close relationships between the EU and CEE states. They were a basis for gradual integration. The Europe Agreements also constituted a foundation

influence of the Soviet Union over these countries. Only when the influence of the socialist regime in the CEE states started to weaken did the CEE states began to seek relations with the Communities.

⁸² The benefits include the expansion of the internal market, political stability in Europe and increasing the status of the CEE countries.

⁸³ They are also called the Europe Agreements.

⁸⁴ A number of documents regarding the 2004 and 2007 enlargements is archived at http://ec.europa.eu/enlargement/press_corner/key-documents/index_archive_en.htm and http://ec.europa.eu/enlargement/archives/enlargement_process/past_enlargements/eu10/index_en.htm.

⁸⁵ At that time, Article 310 TEC.

⁸⁶ M Maresceau, ‘On Association, Partnership, Pre-accession and Accession’, in M Maresceau, note 75 above, at 9.

⁸⁷ Article 216 TFEU. This provision rejects the principle of public international law that only contracting parties to the international agreement are bound by it.

⁸⁸ The fact that international agreements are a source of EU law was confirmed by the Court of Justice. See, for example Case C-192/89 *S. Z. Sevince v Staatssecretaris van Justitie* [1990] ECR I - 3461, paragraph 8.

for financial and technical support offered to the associated states by the Union. Finally, the Association Agreements pointed out the interest of the respective states in becoming members of the EU; however, the Europe Agreements did not express an obligation on the EU's part to this end. It has to be emphasised that, initially, the Europe Agreements were perceived as an alternative to membership rather than part of the pre-accession strategy. Nevertheless, this changed and the Association Agreements were transformed into a key component of the pre-accession strategy.⁸⁹

To assist CEE states with preparations for accession and to help them with the necessary adaptations of national legal systems, permitting, at the same time, for Commission supervision over fulfilling the obligations, the laws of the applicant states were screened against the *acquis communautaire*. The screening process was an opportunity for the candidate states to familiarise themselves with the *acquis*. Simultaneously, it enabled the Commission to assess the level of preparation of the state for EU membership. The whole *acquis communautaire* was divided into chapters⁹⁰ to facilitate the process of examination and of the following substantive negotiations between the EU and the particular candidate country.

As a consequence of the screening process, in the Accession Partnerships,⁹¹ priority areas for membership preparation (i.e. for further work) were indicated. The Accession Partnerships were instruments developed by the Commission for each of the applicant countries, after consultation with the government of the applicant state. The key role of the Accession Partnerships was to identify short-term and medium-

⁸⁹ M Maresceau, note 86 above at 9.

⁹⁰ Currently, the *acquis* is composed of 35 chapters. See for example: http://ec.europa.eu/enlargement/enlargement_process/accession_process/how_does_a_country_join_the_eu/negotiations_croatia_turkey/index_en.htm. The number of chapters of the *acquis communautaire* is not set in stone.

⁹¹ The legal act which established the Association Partnerships was Council Regulation 622/98 of 16 March 1998 on assistance to the applicant States in the framework of the pre-accession strategy, and in particular on the establishment of Accession Partnerships, OJ 1998 L 85/1. Council Decisions of 30 March 1998 adopted, for the first time, principles, priorities, intermediate objectives and conditions applicable to each candidate state contained in the Accession Partnership. The Decisions specified priorities for each state, assisting them in preparing for membership within a framework of economic and social convergence and in developing their National Programme for the taking up of the *acquis* as well as a relevant timetable for its implementation. See e.g. Council Decision of 30 March 1998 on the principles, priorities, intermediate objectives and conditions contained in the Accession Partnership with the Czech Republic, OJ 1998 L 121/41.

term priorities for reform in each state with respect to which that state would then make commitments.⁹² In other words, the Accession Partnerships:

*would be the key feature of the enhanced pre-accession strategy, mobilising all forms of assistance to the candidate countries within a single framework. In this manner, the Community targets its assistance towards the specific needs of each candidate so as to provide support for overcoming particular problems with a view to accession.*⁹³

The Accession Partnerships created models of preparation for EU membership which the candidate states should have aimed at achieving. As a part of the partnership, the candidate states were required to establish, in coordination with the Commission, National Programmes for the Adoption of the *Acquis*. These Programmes indicated how and when the *acquis* would be implemented. They determined legal, administrative and institutional adaptations necessary within the national setting to meet the pre-accession targets.

Another important element of the pre-accession strategy was the Annual Progress Reports. They allowed the progress of the candidates towards accession to be monitored and reviewed by the Commission. Moreover, these reports formed a basis for taking necessary decisions on the conduct of the accession negotiations. The Progress Reports concentrated on what was achieved by each of the candidate states regarding the transposition of the *acquis*. In addition, the Accession Partnerships were updated to reflect Commission findings in the Progress Reports.⁹⁴

It can be argued that the Europe Agreements formed the ground for developing the relationship of the EU and the Member States with CEE states. In the context of the legal framework, the Europe Agreements were undoubtedly a source of EU law, legally binding for the Member States and the institutions of the Union. The provisions of the Europe Agreements fell within the scope of ECJ jurisdiction

⁹² M J Baun, note 75 above, at 82-83.

⁹³ Council Decision 2002/94/EC of 28 January 2002 on the principles, priorities, intermediate objectives and conditions contained in the Accession Partnership with Slovenia, OJ 2002 L 44/102. The same statement is repeated in all Council Decisions of 28 January 2002 regarding the remaining eleven Acceding States.

⁹⁴ M Maresceau, 'Pre-accession' in M Cremona (ed.), *The Enlargement of the European Union*, (Oxford: Oxford University Press, 2003), 9-40 at 31.

because the association agreements form a part of the EU legal system.⁹⁵ The Court confirmed that provisions of the Europe Agreements had direct effect, just as EU law instruments. For instance, in the *Gloszczuk* case,⁹⁶ the ECJ reasoned that the fact that the Europe Agreement is a political document, assisting in preparations for EU membership, does not prevent it from having direct effect. The right to the same treatment as an EU Member State national in regard to freedom of establishment enshrined in the provision of the Polish Association Agreement, had direct effect and allowed Polish nationals to pursue activities in a Member State.⁹⁷

The approximation of the candidate countries' existing and future legislation to EU law remains at the heart of the integration process within the EU. Therefore, it can be concluded that the *acquis* is a cornerstone of integration.⁹⁸ The Accession Partnerships and the Progress Reports were primarily applied with a view towards supporting the candidate states in their efforts to take on the *acquis communautaire*. The fact of the existence of the review procedure and regular reporting on progress in the implementation of the *acquis* could create pressure on the candidate states. The publication of the reports contributed in a considerable manner to raising awareness among the candidate states about the necessity to fulfil objectives established in the Accession Partnerships in order to move forward in the negotiations.⁹⁹

5.2.2. The EU *acquis communautaire*

The EU *acquis communautaire*, translatable as its patrimony,¹⁰⁰ can be defined as a body of common rights and obligations which binds all the Member States within the EU, in order to secure continuity of the EU.¹⁰¹ The concept of the *acquis* is not static; on the contrary, it is subject to constant evolution and development. Put differently,

⁹⁵ Case C-192/89 *S. Z. Sevince v Staatssecretaris van Justitie* [1990] ECR I-3461, paragraph 8.

⁹⁶ Case C-63/99 *The Queen v Secretary of State for the Home Department, ex parte Wieslaw Gloszczuk and Elzbieta Gloszczuk* [2001] ECR I-6369. See also: Case C-235/99 *The Queen v Secretary of State for the Home Department, ex parte: Eleonora Ivanova Kondova* [2001] ECR I-6427.

⁹⁷ This right is not absolute, however.

⁹⁸ G Marks, F W Scharpf, P C Schmitter and W Streeck, *Governance of the European Union*, (London: SAGE, 1996), p. 162.

⁹⁹ M Maresceau, note 94 above at 32.

¹⁰⁰ C C Gialdino, note 74 above, at 1089.

¹⁰¹ K E Jørgensen, 'The Social Construction of the *Acquis Communautaire*: A Cornerstone of the European Edifice', (1999) 3:5 *European Integration Online Papers* 1-24, available at <http://eiop.or.at/eiop/pdf/1999-005.pdf>.

the *acquis* could be characterised as a snapshot of the legal situation existing at the moment of accession.¹⁰² The notion of the *acquis* has been part of EU vocabulary for a long time.¹⁰³

The *acquis communautaire* can be characterised as one of the most significant EU concepts. It encompasses the sum of total obligations that have accumulated since the founding of the first Communities, embedded in Treaties and protocols. The *acquis*, according to the Europa Glossary, comprises the content, principles and political objectives of the Treaties, the legislation adopted in application of the Treaties and the case law of the Court of Justice, the declarations and resolutions¹⁰⁴ adopted by the Union, measures relating to the common foreign and security policy and measures relating to justice and home affairs, and international agreements concluded by the Union and by the Member States between themselves in the field of the Union's activities.¹⁰⁵

The *acquis* can be found in the EUR-Lex directory list of Community legislation.¹⁰⁶ Chapter 9 on taxation specifies what measures constitute the *acquis* as far as taxation in the EU is concerned. The *acquis communautaire* in the sphere of taxation predominantly covers indirect taxation. However, an *acquis* on direct taxation also exists. In subsection 9.10, listing general legislation in force, the Code of Conduct is also mentioned.¹⁰⁷ Under the Guide to the Negotiations regarding the 2004 and 2007

¹⁰² C C Gialdino, note 74 above, at 1092.

¹⁰³ Scholars disagree whether the origins of the concept of the *acquis* lie in four decisions of the Court of Justice in the 1960s (Case 6/64 *Flaminio Costa v E.N.E.L* [1964] ECR 585; Case 26/62 *NV Algemene Transport- en Expeditie Onderneming van Gend en Loos v Netherlands Inland Revenue Administration* [1963] ECR 1; Joined Cases 56/64 and 58/64 *Établissements Consten S.à.R.L. and Grundig-Verkaufs-GmbH v Commission of the European Economic Community* [1964] ECR 299) or can be found in the processes leading to the first enlargement in 1973. Pescatore supports the first view. Gialdino and Jørgensen, on the other hand, are in favour of the second scenario, claiming that this principle of acceptance of the *acquis* was founded during the first negotiations about the enlargement of the Community. See: P Pescatore, 'Aspects judiciaires de l'acquis communautaire'. *Revue trimestrielle de droit européen*, (1981) 21 617-652; C C Gialdino, note 74 above, at 1091; K E Jørgensen, note 101 above at 9-10.

¹⁰⁴ The Code of Conduct has the form of a resolution.

¹⁰⁵ Europa Glossary available at

http://europa.eu/legislation_summaries/glossary/community_acquis_en.htm.

¹⁰⁶ The EUR-Lex directory list of European Union legislation in force in taxation can be found at <http://eur-lex.europa.eu/en/legis/20101001/chap09.htm>, chapter 9 is about taxation.

¹⁰⁷ See: <http://eur-lex.europa.eu/en/legis/20101001/chap0910.htm>.

enlargements,¹⁰⁸ including a summary of the *acquis* in each chapter, and the progress of negotiations per country in each chapter, the direct tax *acquis* is restricted to corporate taxation and capital duties. Among other instruments, the Code of Conduct is again named as an element of the *acquis* in the field of direct taxes.

From a legal perspective, approximation¹⁰⁹ of a national legal order to the requirements of the EU is vital in the accession strategy. Approximation of national legal orders is an autonomic, unilateral set of activities which relates to the adoption of the *acquis communautaire* and the securing of its proper application. In this context, with regard to the Central and Eastern enlargements, it is worth mentioning an important document. The White Paper of 1995¹¹⁰ underlined the fact that legal integration of the *acquis communautaire* was a key objective for a successful accession policy.¹¹¹ From the day of entry into force of the Europe Agreements, the CEE states were obliged to bring their existing and future laws into line with EU law. Contravening this obligation could result in a refusal to grant membership of the EU.

A question can be posed as to what significance, if any, the categorisation of a regulatory measure as an element of the EU *acquis* might have. The delimitation of the scope of the *acquis* plays a fundamental role in exerting influence over the legal systems of the candidate states because, as mentioned, it is a condition that all candidate states have to accept the *acquis*. The acceptance of the *acquis* and the subsequent guarantee to ensure its effective implementation¹¹² in the national context through appropriate administrative and judicial structures is considered to be one of the formal requirements necessary to open accession negotiations with a candidate

¹⁰⁸ The Guide, updated on 17 December 2004, is available at http://ec.europa.eu/enlargement/archives/pdf/enlargement_process/future_prospects/negotiations/eu10_bulgaria_romania/negotiationsguide_en.pdf.

¹⁰⁹ This process is occasionally called harmonisation; however, after Mik, I refer here to the approximation of legal orders. The notion of harmonisation is limited to harmonisation of laws of the Member States on the basis of the Treaties. C Mik, *Europejskie prawo wspólnotowe. Zagadnienia teorii i praktyki: Tom I*, (Warszawa: C. H. Beck, 2000), p. 794.

¹¹⁰ White Paper on the Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union, COM (1995) 163 final.

¹¹¹ The White Paper made it clear that it focused on the internal market and did not cover the whole *acquis communautaire*. See: *ibid.*, paragraph 3.2.

¹¹² The condition of effective implementation was added to the list of membership requirements in 1995 as a result of the Madrid summit. See A Albi, *EU Enlargement and the Constitutions of Central and Eastern Europe*, (Cambridge: Cambridge University Press, 2005), p. 47.

state.¹¹³ It can be therefore concluded that incorporation of the *acquis* into national legislation is not in itself sufficient; it is also necessary to ensure that the *acquis* is actually applied to the same standards as those which apply within the Union.

Due to the fact that without acceptance of the *acquis communautaire*, a candidate state would not be able to initiate the process of negotiations leading to accession to the EU, it is of great significance which regulatory measures are included in the notion of the *acquis communautaire* and which measures are left outside the scope of this concept. This determines the extent of the obligations that candidate states must embark upon if they wish to become EU members.

The influence of the Accessing States on the range of obligations to be undertaken is rather weak due to the fact that negotiations leading to EU enlargement are conducted in a ‘take-it-or-leave-it’ fashion.¹¹⁴ Effectively, the EU does not present the Accessing States with a wide margin for actual negotiations. Essentially then, it can be argued that the result of negotiations is predetermined. The applying states have to transpose the *acquis communautaire*, as defined by the existing Member States, into their national legislation and implement it from the day of their accession to the EU. In general, all of the *acquis* has to be adopted in its entirety. The candidate states may have some influence on the speed of the approximation process. Derogations from the *acquis* and transition periods can be granted in exceptional circumstances and only insofar as they are explicitly established in the Act of Accession. The *acquis communautaire* is expressly designed to prevent any prospective member from ‘shopping around’ for its own mix of obligations and to make it possible for EU law to be uniformly applied in the extended Union.

¹¹³ The condition of the candidate's ability to take on the obligations of membership is one of the criteria determining which states are eligible to join the EU. The membership criteria were laid down in 1993 at the European Council in Copenhagen. See: http://ec.europa.eu/enlargement/enlargement_process/accesion_process/criteria/index_en.htm.

¹¹⁴ K E Jørgensen, note 101 above, at 9

5.2.3. The Acceding States¹¹⁵ and the Code of Conduct

The previous section defined the concept of the *acquis communautaire* and demonstrated that the Code of Conduct is listed as one of the measures constituting this notion. In turn, this section explores in more detail the status of the Code within the setting of the EU 2004 and 2007 enlargements.¹¹⁶ On the basis of the available enlargement documents, it is here determined how the Acceding States approached the issue of the Code of Conduct.

The first Council Decisions on the Accession Partnerships for the ten states which became EU Member States in 2004 were concluded in 1998.¹¹⁷ At this stage, the Code of Conduct was not yet mentioned among the priorities and objectives which the Acceding States were required to achieve on their road to EU accession. It can be suggested that the Code of Conduct was not included in the 1998 Accession Partnerships because this regulatory measure was adopted merely three months before the 1998 Accession Partnerships.¹¹⁸

Compliance with the principles of the Code was soon regarded as a short or medium-term priority throughout the pre-accession stage, as seen in the 1999 and 2001 Accession Partnerships. In the Accession Partnerships of 1999, the Code of Conduct is referred to among priorities, as defined in the analysis of the situation in each state, on which preparations for accession must concentrate in view of the political and economic criteria and the obligations incumbent upon a candidate state. With regard to the Code of Conduct, the Applicant States were asked either to confirm acceptance of Code of Conduct principles (e.g. Czech Republic, Estonia, Hungary),¹¹⁹ to ensure

¹¹⁵ The term Acceding States encompasses twelve states which joined the EU in 2004 and 2007. They are: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia, and Bulgaria and Romania.

¹¹⁶ Due to the fact that the Code of Conduct was adopted in 1997, the question of the position of the Code with regard to the legal systems of the acceding states did not arise until 2004 and 2007.

¹¹⁷ For Bulgaria and Romania, which became EU Member States in 2007, the first Accession Partnerships were prepared in 1999.

¹¹⁸ The 1998 Accession Partnerships are dated 30 March 1998. E.g.: Council Decision 1998/262/EC of 30 March 1998 on the principles, priorities, intermediate objectives and conditions contained in the Accession Partnership with the Slovak Republic, OJ 1998 L 121/16.

¹¹⁹ Council Decision 1999/858/EC of 6 December 1999 on the principles, priorities, intermediate objectives and conditions contained in the Accession Partnership with the Czech Republic, OJ 1999 L 335/55; Council Decision 1999/855/EC of 6 December 1999 on the principles, priorities, intermediate objectives and conditions contained in the Accession Partnership with Estonia, OJ 1999 L 335/35;

that new tax measures comply with the principles of the Code of Conduct (e.g. Bulgaria, Latvia)¹²⁰ or to review existing tax measures in order to ensure their compatibility with the Code of Conduct (e.g. Poland, Romania, Slovakia).¹²¹ Candidate states were prompted and reminded of the need to implement the principles of the Code into their national legislation and to secure compliance with the principles of the Code with regards to existing and new tax laws. Thus, the text of the Accession Partnerships indicates that the Acceding States undertook a formal commitment in relation to the Code of Conduct and realisation of its principles, and indirectly proves that the Code constituted one of the elements of the *acquis communautaire* which the Acceding States had to accept and adopt.

Some progress in the realisation of the commitments made regarding the Code can be seen between 1999 and 2001. Examination of the 1999 and 2000 Accession Partnerships suggests that the candidate states which were required to review their national systems against the principles of the Code had finalised this task. Their subsequent objective, set out in the 2001 Accession Partnerships, was to ensure compatibility with the Code principles, which effectively meant putting the principles of the Code into practice.

As explained in Chapter 5, section 5.2.1., the Acceding States' ability to assume membership obligations was regularly examined. Therefore, the exercise of establishing priorities in implementing the *acquis* in the Accession Partnerships was followed by assessments carried out by the Commission. Additionally, advice was offered to the Acceding States about how they could improve the process of attaining

Council Decision 1999/850/EC of 6 December 1999 on the principles, priorities, intermediate objectives and conditions contained in the Accession Partnership with the Republic of Hungary, OJ 1999 L 335/1, respectively.

¹²⁰ Council Decision 1999/857/EC of 6 December 1999 on the principles, priorities, intermediate objectives and conditions contained in the Accession Partnership with the Republic of Bulgaria, OJ 1999 L 335/48; Council Decision 1999/854/EC of 6 December 1999 on the principles, priorities, intermediate objectives and conditions contained in the Accession Partnership with the Republic of Latvia, OJ 1999 L 335/29.

¹²¹ Council Decision 1999/851/EC of 6 December 1999 on the principles, priorities, intermediate objectives and conditions contained in the Accession Partnership with the Republic of Poland, OJ 1999 L 335/8; Council Decision 1999/852/EC of 6 December 1999 on the principles, priorities, intermediate objectives and conditions contained in the Accession Partnership with Romania, OJ 1999 L 335/15; Council Decision 1999/853/EC of 6 December 1999 on the principles, priorities, intermediate objectives and conditions contained in the Accession Partnership with the Slovak Republic, OJ 1999 L 335/22.

the full capability of becoming a member of the EU, also as concerns the Code of Conduct. From 1998, on a yearly basis, the Commission reported to the European Council. These reports addressed the progress towards accession of each of the candidate states in specific chapters of the *acquis*. In this context, the commitment to the Code of Conduct was also noted and assessed.

It can also be argued that the Acceding States were treated as fully fledged members of the EU as far as their commitment to the Code of Conduct was concerned. As part of the accession process, in 2002 and 2003, therefore before the Acceding States formally became members of the EU, the tax systems of the Acceding States were analysed by the European Commission for potentially harmful tax measures. In preparing reports, the Commission services endeavoured to apply as closely as possible the procedure followed with the existing Member States; however, in the case of the Acceding States, no peer review process took place. The descriptions of the potentially harmful tax measures were agreed with the Acceding States. Following agreement, the Commission services made initial assessments of potentially harmful tax measures. The Acceding States had the opportunity to comment on these initial assessments.¹²² Subsequently, the Commission made its final assessments and presented the findings to the Council.

The core aim of this task was to assist the Council in deciding whether the Acceding States met their commitment to comply with the principles of the Code of Conduct for Business Taxation. The Council was required to establish which potentially harmful tax measures in the Acceding States must be eliminated or amended in order to bring their tax systems into line with the Code of Conduct.¹²³ In the tax systems of the ten states¹²⁴ which joined the EU in 2004, the Commission had identified 30 measures fulfilling the criteria of harmfulness under the Code of Conduct. With regard to Bulgaria and Romania, 13 potentially harmful measures were identified by

¹²² Report to Council Enlargement Group concerning the Code of Conduct for Business taxation (harmful tax competition) of the Commission services submitted to the Enlargement Group of 6 June 2003, MD ELARG 82/03, p. 2.

¹²³ *Ibid.*, p. 1.

¹²⁴ Estonia was the only acceding state in which the Commission did not identify any potentially harmful tax measures at the time of the review. See: *ibid.*, p. 1.

the Commission.¹²⁵ It has to be noted that, on the grounds of the Commission services' reports, the Council Enlargement Group (tax experts) prepared a final list of harmful tax measures in the Acceding States.¹²⁶ It mirrored the list suggested by the Commission.

Subsequently, the suggested harmful tax regimes were discussed by the Council and included in the accession negotiations. The Acceding States had to eliminate or amend tax measures regarded as harmful in order to bring their corporate tax systems into line with the principles of the Code of Conduct by the date of accession.¹²⁷ The fact that the Acceding States were obliged to bring their tax systems into line with the Code by the accession date indicates that the Acceding States had to comply fully with its principles before they formally joined the Union, that is before they were in a position to receive the full benefits connected with the EU membership. However, they were expected to execute fully their commitment to the Code of Conduct before then. In effect, the Acceding States' obligation regarding compliance with the Code could be treated as a price to pay to become a member of the EU.

The progress of abolishing and amending harmful tax regimes by the Acceding States was closely monitored.¹²⁸ The Commission incorporated its findings about the stage of realising the commitment to the Code by individual countries in the 'Comprehensive monitoring report on preparations for membership' drawn up for each of the candidate countries. In these documents, the Commission also presented its recommendations for each state about how to improve the execution of the commitment. The process proved successful, since the candidate countries had abolished most of the harmful arrangements before enlargement. In general, it can be

¹²⁵ Report of the Commission services submitted to the Working Party on Enlargement on 11 May 2006, MD ELARG 74/06.

¹²⁶ See Annex to Item Note from the Enlargement Group (Tax Experts) to the Permanent Representatives Committee/Council on the Code of Conduct for Business Taxation-Harmful tax measures in the acceding States and commitments for rollback, 13213/03 LIMITE ELARG 94 FISC and Annex to Item Note from the Working Party on Enlargement to the Permanent Representatives Committee/Council about the Code of Conduct for Business Taxation-Harmful tax measures in Bulgaria and Romania and commitments for rollback 10879/06 LIMITE ELARG 66 FISC 96.

¹²⁷ Report to Council Enlargement Group concerning the Code of Conduct for Business taxation, note 122 above.

¹²⁸ Chapter 5, section 5.1.3. discusses the continuation of this process. It examines the problem of the application of rollback and standstill commitments by the Member States and the findings of the biannual Commission reports on progress in this context.

argued that the Acceding States did not ignore the Code of Conduct and complied with its principles.¹²⁹ By the accession date, harmful tax measures were repealed (some states received an extension regarding the use of harmful tax regimes). After accession, the new Member States' tax systems are still monitored on the same basis as the systems of the old Member States. In other words, standstill and rollback of the new Member States' harmful arrangements is now monitored by the Code of Conduct Group. Conclusions from the reviews are published in biannual progress reports.

The fundamental conclusion which can be drawn from the enlargement documentation is that, in the context of the accession process, the Acceding States committed themselves to complying with the principles of the Code of Conduct as part of the accession *acquis* and, notably, to introducing only new tax measures which are in conformity with these principles. Moreover, as indicated, during the accession negotiations, the EU closely monitored the implementation measures as regards full alignment with the principles of the Code, including possible measures to eliminate any tax provisions which may be contrary to these principles.¹³⁰

The Code of Conduct holds a comparable position in relations with the current EU applicant countries, such as, for example, Montenegro and Serbia.¹³¹ Article 100 of the Stabilisation and Association Agreements with each of the countries provides that the parties to the Agreements shall establish cooperation in the field of taxation, including measures aiming at the further reform of Serbia's and Montenegro's fiscal systems. Then, it is specified that tax cooperation shall take due account of priority areas related to the *acquis* in the field of taxation and in the fight against harmful tax

¹²⁹ See Annex to Item Note from the Enlargement Group (Tax Experts) to the Permanent Representatives Committee/Council on the Code of Conduct for Business Taxation-Harmful tax measures in the acceding States and commitments for rollback, 13213/03 LIMITE ELARG 94 FISC. It provides for the final assessment and overview of the rollback of potentially harmful measures in ten acceding states. A similar document regarding Romania and Bulgaria is the Item Note from the Working Party on Enlargement to the Permanent Representatives Committee/Council about the Code of Conduct for Business Taxation-Harmful tax measures in Bulgaria and Romania and commitments for rollback 10879/06 LIMITE ELARG 66 FISC 96. Its annex also contains the final assessment and overview of the rollback of potentially harmful measures in Bulgaria and Romania.

¹³⁰ Item Note from the Enlargement Group (Tax Experts) to the Permanent Representatives Committee/Council on the Code of Conduct for Business Taxation-Harmful tax measures in the acceding States and commitments for rollback, 13213/03 LIMITE ELARG 94 FISC 138.

¹³¹ Applications were submitted by Albania, Bosnia and Herzegovina, Montenegro and Serbia.

competition. Elimination of harmful tax competition should be carried out on the basis of the principles of the Code agreed by the Council on 1 December 1997.¹³²

The tax systems of applicant and candidate countries are screened against the principles of the Code. When any discrepancies are detected in the national tax system of an applicant or candidate country, it is expected to introduce modifications which enable compliance with the Code. For example, as far as Bosnia and Herzegovina is concerned, in the area of business taxation, a gap analysis was carried out to identify existing measures that might be contrary to the Code. In line with the subsequent report, some measures harmful for competition have been removed from the Bosnian tax system.¹³³ Similarly, the tax system of the Former Yugoslav Republic of Macedonia was examined. It was concluded that limited progress was made in the sphere of direct taxation. The commitment to the Code has yet to be implemented. However, preparations in this area were described as advanced.¹³⁴

5.2.4. The position of the Code in the setting of EU accessions: summary

The determination that the Code was regarded as a component of the *acquis communautaire* in the process of the 2004 and 2007 enlargements is a crucial and valuable finding. It entails the necessity to revise the understanding of the legal position of the Code and its potential influence on national tax systems. The Code of Conduct, perceived in the context of the *acquis*, ceases to be a regulatory instrument

¹³² See Article 100 of Stabilisation and Association Agreement of 29 April 2010 between the European Communities and their Member States, of the one part, and the Republic of Montenegro, of the other part, OJ 2010 L 108/3; Article 100 of Stabilisation and Association Agreement of 29 April 2008 between the European Communities and their Member States, of the one part, and the Republic of Serbia, of the other part, pending the entry into force, available at http://ec.europa.eu/enlargement/pdf/serbia/key_document/saa_en.pdf.

¹³³ Commission Staff Working Document of 14 October 2009, Bosnia and Herzegovina 2009 Progress Report, Accompanying the Communication from the Commission to the European Parliament and the Council: Enlargement Strategy and Main Challenges 2009-2010 (COM (2009) 533 final), SEC (2009) 1338 final.

¹³⁴ Commission Staff Working Document of 14 October 2009, the Former Yugoslav Republic of Macedonia 2009 Progress Report, Accompanying the Communication from the Commission to the European Parliament and the Council: Enlargement Strategy and Main Challenges 2009-2010 (COM (2009) 533 final), SEC (2009) 1335 final.

functioning solely on the basis of a voluntary decision not creating enforceable obligations.¹³⁵

For states joining the EU in 2004 and 2007, the Code became a hard measure. As a consequence, it can be argued that a soft law measure gained a hard law dimension. In effect, as Gribnau summarised, ‘a switch appears to have been made: soft law became a form of “extremely hard law”’.¹³⁶ Although Gribnau states this, no reflection on or analysis of the consequences or implication of this finding follow. As the Code maintains such status in the pending EU accessions analysis of this finding is not only a matter of assessing the past. Closer exploration of the position of the Code in relation to the acceding state also brings up questions relevant in the future.

The Acceding States did not have a choice in deciding whether or not to implement the principles of the Code in their national tax regimes as their position and the Member States’ position in the process of negotiations were unequal. As noted by Avery and Cameron, in principle, international agreements have a purpose of reaching a mutually balanced agreement, involving concessions and advantages on both sides. However, in the case of the accession negotiations, their nature is less symmetrical and balanced.¹³⁷ The length and, indeed, the outcome of the pre-accession negotiations are greatly influenced by differences in the fulfillment of the criterion of *acquis* implementation.¹³⁸ The rejection of the Code of Conduct and its principles during the accession process could have resulted in not closing the negotiation process with the EU and, subsequently, not acceding to the Union. This is why the Code can be described as a price to pay by acceding states if they wanted to become EU Member States.

It is assumed that priority in the accession negotiations is given to joining the EU by the candidate state and not to achieving a change in the established body of the Union rules. EU membership, to which the candidate aspires, entails not only rights

¹³⁵ This statement is qualified by the restrictions from the link with the State aid rules on the actual voluntary decision regarding adoption of the Code by the existing Member States.

¹³⁶ H Gribnau, note 4 above, at 84.

¹³⁷ G Avery and F Cameron, *The Enlargement of the European Union*, (Sheffield: Sheffield Academic Press, 1998), p. 33.

¹³⁸ C Schneider, *Conflict, Negotiation and European Union Enlargement*, (Cambridge: Cambridge University Press, 2009), p. 14.

and benefits but also confers obligations which have to be respected. Therefore, the accession process is focused on the *acquis communautaire* and its fullest implementation by the acceding countries. That secures relative uniformity within the EU. Derogations from the *acquis* are granted reluctantly by the EU.¹³⁹

The explanation of the status of the Code in the enlargement process could also be related to the tax competition problem which has been an issue since the 1990s. In this context, it has to be emphasised that the 12 new Member States, which joined the EU in 2004 and 2007, differ significantly from the old Member States as far as tax systems are concerned.¹⁴⁰ The 2004 and 2007 accessions were made by Central and Eastern European states, with different political and economic pasts than the Western part of the EU. Consequently, the two enlargements turned the EU into a more diversified area, also in terms of tax systems and the values that those tax systems support. The new Member States were perceived as using their tax systems in order to attract foreign investment.¹⁴¹ The decision to attribute the Code of Conduct with the status of an element of the *acquis communautaire* could be perceived as a strategy to reduce one form of harmful tax competition on the part of the acceding states. It has to be borne in mind that the Code does not forbid tax competition via general tax measures.¹⁴²

¹³⁹ Avery estimates that in the 2004 enlargement, 332 transitional measures in 17 of 31 chapters were allowed. This is a low number bearing in mind the scope of the *acquis communautaire*. See: G Avery, 'The Enlargement Negotiations', in F Cameron, (ed.), *The Future of Europe: Integration and Enlargement*, (Cambridge: Routledge, 2004) 35-62 at 40.

¹⁴⁰ For a more general discussion on the socio-economic gap between the old Member States and states which joined in the last two enlargement rounds, see G Amato and J Batt, *Final Report of the Reflection Group on the Long-term Implications of EU Enlargement: the Nature of the New Border*, (Florence: European University Institute, 1999), p. 29-33.

¹⁴¹ C Bellak and M Leibrecht, M., 'Corporate Income Tax Competition and the Scope for National Tax Policy in the Enlarged Europe', in K Andersson, E Eberhartinger and L Oxelheim K Andersson, E Eberhartinger and L Oxelheim (eds.), *National Tax Policy in Europe: to Be or Not to Be?*, (Berlin, Heidelberg, New York: Springer, 2007) 11-43, at 23.

¹⁴² For an overview of the differences in national tax rates between the EU Member States after the Eastern enlargement see, for example: Taxation Trends in the European Union, 2011 edition available at

http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_structures/2011/report_2011_en.pdf. It shows that corporate tax rates across the EU continue to decrease. Moreover, it is also evident that differences in tax rates between Member States are still visible. A statutory corporate income tax rate varies from 10% (in Bulgaria and Cyprus) to 35% in Malta and 34% in France and Belgium, for instance, p. 130.

In the context of the tax competition problem, and bearing in mind the arduous process of securing the adoption of and compliance with the Code in the EU of 15, it should not come as a surprise that the EU wanted to ensure the quickest and smoothest adherence to the principles of the Code by the newly joining states as was possible. The classification of the Code as an element of the *acquis*, and thus, the emphasis on the obligations of the acceding states, presented the Code as a given, largely non-negotiable measure. In effect, the risk of time-consuming talks about the Code with the new Member States and bargaining about compliance with the Code were minimalised. Such an approach also reduced the possibility of questioning and reopening compromises already reached.

A more fundamental question arises as to *whether* the Code should constitute a part of the *acquis*. As stated, the inclusion of various instruments and principles in the scope of the *acquis* is of great importance due to the fact that it influences the breadth of obligations undertaken by acceding states. The decision to treat a measure, originally presented as soft law, falling into the category of soft law resolutions under Article 288 TFEU, as a component of the *acquis* causes confusion and uncertainty about the legal position of this instrument and creates a broader problem as to what is 'law'. Two aspects of such a classification pose a challenge. First, clearly, one regulatory measure simultaneously has two contrasting legal natures. In relation to the old Member States, it can be perceived as a soft law measure.¹⁴³ On the other hand, for the acceding states, the Code becomes a hard law instrument. Second, it is thought-provoking to consider, what happens to the status of the Code after the accession? Is it still a hard law for the new Member States and soft law for the old Member States? Or maybe the nature of the Code reverts back to soft law also for the new Member States? In effect, would the new Member States be able simply to abandon reforms stemming from the commitment to the Code undertaken in the process of applying for EU membership?

¹⁴³ Although as will be shown in Chapter 5, section 5.3. on State aid, the Code has a harder nature in relation to the old Member States or the candidates states after accession.

It is interesting to consider a hypothetical situation when a case against a new Member State, applying a measure which meets the Code's criteria, is lodged before the ECJ. Bearing in mind AG Mazák's Opinion in *ELISA*, the potential result would be that the operation of a harmful measure would be assessed in the setting of fundamental freedoms. The classification of a measure as harmful could not restrict freedom of movement. Hence, the Code would be regarded as soft law. However, if it was found that the classification of a measure as hard law had to be respected by a new Member State, asymmetric law would develop and the broader issue of what is law for internal EU purposes and in the accession context would arise. That would undermine the credibility of EU law.

From the perspective of legal stability, clarity is essential in this regard. It is desirable that one regulatory instrument holds the same position regardless of the fact whether it is applied within or outside the accession process. If agreement was reached that the principles of the Code should have the power of hard law, the Code should have been transformed into an unambiguously hard law instrument.

5.3. Strength through the State aid rules¹⁴⁴

The regulatory influence of the Code has been enhanced by the application of the State aid provisions to the tax competition initiative in the EU. The Code of Conduct includes a paragraph¹⁴⁵ establishing a link with the State aid provisions of the TFEU.¹⁴⁶ Paragraph J of the Code establishes that some of the measures falling within the scope of the Code can be regarded as examples of prohibited State aid. For that reason, the Commission committed itself to strict application of the State aid rules to tax measures. Paragraph J connected a political regulatory tool and legally binding, hard law provisions of the TFEU. In an indirect manner, the State aid provisions were employed to strengthen the Code and to enforce, at least partially, its regulatory principles.

¹⁴⁴ The topic of State aid in general, and case law regarding State aid in the form of tax measures, could be the subject of separate research due to the wide scope of questions involved. In effect, this section places emphasis on those aspects of the State aid problem which are of particular significance for the exploration of the hard law side of the Code.

¹⁴⁵ Code of Conduct, note 2 above, paragraph J.

¹⁴⁶ Articles 107-109 TFEU.

The analysis conducted in this section demonstrates that the Commission exercised influence over harmful tax measures, so determined under the principles of a soft law instrument. It was clarified that harmful tax measures can also meet the requirements of forbidden State aid and State aid can be structured as a direct tax measure. Direct taxation cannot be excluded from the sphere of State aid regulation despite the fact that, until recently, litigation against Member States granting State aid in the form of a tax measure was scarce.

State aid regulation is a powerful tool to exert control over national legislation. Being enshrined in the Treaty, the State aid regime has a legally binding nature and is enforceable before the ECJ. Consequently, the linkage between the Code initiative and the State aid provisions can be perceived as generating pressure on Member States otherwise reluctant to follow the principles of the Code.

5.3.1. State aid in the internal market

The regulation of State aid seeks to reconcile national interests with the interests of the EU. On the one hand, it recognises national interests in supporting certain undertakings as an instrument of social or economic policy. On the other hand, the State aid regime endeavours to recognise the interests of the EU in ensuring compliance with the rules on the internal market and competition. The fundamental objective of the State aid regime is regulation of financial support¹⁴⁷ granted by the Member States to businesses operating within the internal market.

The internal market enables goods, services, capital and people to move freely across the territory of the EU. Selective aids offered by the national governments to some businesses may provide these enterprises with a competitive advantage over their competitors, who do not benefit from such support, also operative within the internal market. Member States must not provide to some enterprises unjustifiable selective support, which would distort market forces and, thus, interfere with the smooth functioning of the internal market. In the pursuit of a free internal market, the EU

¹⁴⁷ State aid can take various forms, for instance: subsidies or grants transferred directly to the beneficiary. State aid can also be granted indirectly through tax expenditures. In this case, tax liability is not created in the first place or tax is not collected after tax liability was created. For a detailed description of potential forms of State aid see: R H C Luja, note 1 above, at 29-37; C Pinto, *Tax Competition and EU Law*, (The Hague, London and New York: Kluwer, 2003), p. 100-103.

State aid regime offers a safeguard against the (potentially) distortionary effects State aid measures may create on competition between Member States and subsequent influence on intra-EU trade.

The basic State aid definition is provided for in Article 107 TFEU, which reads that State aid is in principle incompatible with the internal market, unless it can be saved by the exceptions expressly described by Articles 107(2) and 107(3) TFEU.¹⁴⁸ The fiscal aid Notice¹⁴⁹ clarifies that in applying State aid rules, it is irrelevant whether the measure is a tax measure, since Article 107 TFEU applies to aid in any form whatsoever. The wording of Article 107 TFEU does not leave doubts that it is irrelevant which form a measure takes in order to be examined under the State aid rules.

In order to be termed 'aid', a tax measure must meet four cumulative tests. First, the measure must confer on recipients an advantage which relieves them of charges that are normally borne from their budgets. Second, the advantage must be granted by the State or through State resources. In order to meet the second condition, the aid has to be financed by a Member State or through State resource, which is relatively unproblematic to establish as far as tax measures are concerned. The less tax a subject pays the smaller tax revenues will be. A loss of tax revenue is equivalent to consumption of State resources in the form of fiscal expenditure. This criterion also applies to aid granted by regional or local bodies in the Member States.¹⁵⁰

¹⁴⁸ Article 107(2) TFEU lists exceptions that automatically justify state aid rules. *De jure* approval of State aid occurs when aid has a social character, in the case of natural disasters or exceptional occurrences, and aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division. Article 107(3) TFEU provides for situations where aid may be compatible with the internal market. Discretionary approval of State aid may be granted when aid is expected to promote the economic development of areas where the standard of living is abnormally low or areas with high levels of unemployment. Aid may also be accepted in instances of serious disturbances in the economy of a Member State. Conservation of national and European heritage and the promotion of culture are also a potential justification for a State aid. Other categories of aid may be specified by decision of the Council on a proposal from the Commission.

¹⁴⁹ Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation, (1998) OJ C 384/3.

¹⁵⁰ R H C Lujja, note 1 above, at 40.

Third, the measure must affect or threaten to distort competition and must influence or potentially affect trade between Member States. This criterion presupposes that the beneficiary of the measure exercises an economic activity in a market open to competition, regardless of the beneficiary's legal status or means of financing. It can be argued that this element of the State aid definition is met rather easily. It is sufficient if a support measure is capable of having an impact on competition or intra-EU trade. Fourth, the measure must be specific or selective in that it favours certain undertakings or the production of certain goods. The favourable effect of a State aid measure must be restricted, in law or in fact, to one or a group of undertakings or to the production of certain goods.

In this context, it can be noted that the selectivity criterion caused controversies in relation to the autonomous regions of some EU Member States. The Court was faced with a question whether beneficial corporate tax measures adopted by regional governments, which have legislative powers, fulfil the selectivity requirement? In the *Azores* case,¹⁵¹ the Commission argued that a reduced corporate tax rate adopted in Azores, the autonomous region of Portugal, constituted State aid. The specific nature of this tax measure was established by a comparison between the beneficial tax measure adopted by the regional government and the tax treatment within the framework of the whole territory of Portugal, not only in Azores. The Court decided that an autonomous territory can be the reference framework, when assessing its tax measure in the light of the State aid criteria, if the regional authority is sufficiently autonomous in the institutional, financial and procedural sense.¹⁵² As mentioned in Chapter 4,¹⁵³ the Primarolo Report did not clearly determine the reference framework for regional harmful tax measures.

¹⁵¹ Case C-88/03 *Portuguese Republic v Commission of the European Communities* [2006] ECR I-7115.

¹⁵² See R Greaves, 'Autonomous Regions, Taxation and EC State-Aid Rules', (2009) 34:5 *European Law Review* 779-793 for an apt summary of the problem of the geographical selectivity in tax case law.

¹⁵³ Chapter 4, footnote 38.

5.3.2. State aid and the Code of Conduct

Before the early 2000s, tax cases in the context of State aid proceedings were very rarely initiated by the Commission.¹⁵⁴ In the 1950s and 1960s, some of the Member States expressed the view that the State aid regime should not be applicable to any form of fiscal incentive because of the sovereignty issue.¹⁵⁵ However, this attitude changed after the adoption of the Code of Conduct. In the Code, the Council observed that some business tax measures may not only be covered by the Code of Conduct but can also be assessed under the State aid rules. As a consequence, the Commission was urged to commit itself to the strict application of the State aid rules, taking into consideration the negative results of aid in the light of the application of the Code.¹⁵⁶ It was also noted that the Commission intended to publish guidelines on the application of the State aid rules to business taxation.

5.3.2.1. Notice on the State aid rules and business taxation

In December 1998, the Commission published its Notice on the application of the State aid rules to measures concerning direct business taxation, explaining how the State aid rules should be understood in the context of business taxation.¹⁵⁷ This Notice pays special attention to the influence of the Code of Conduct on the State aid regime. The Notice partially codifies the existing jurisprudence of the Court of Justice on State aid and attempts to clarify the overlap between the principles of the Code of Conduct and the State aid regime.¹⁵⁸ This was necessary due to the fact that the Commission intended to examine or re-examine existing business tax arrangements and proposed new tax measures, even those which were already examined by the Code of Conduct Group. According to the Notice, the Member States are required to take the EU dimension into consideration (i.e. the impact of a tax measure on the internal market) when constructing their business tax incentives.

¹⁵⁴ F P Sutter, 'The Influence of the European State Aid Rules on National Tax Policy', in K Andersson, E Eberhartinger and L Oxelheim, note 141 above, 121-164 at 124.

¹⁵⁵ R H C Lujá, note 1 above, at 108.

¹⁵⁶ According to Nanetti and Giovanni, the commitment of the Commission was dictated by many Member States as an equivalent to the political agreement to the Code of Conduct. F Nanetti and G Mameli, 'The Creeping Normative Role of the EC Commission in the Twin-track Struggle against State Aids and Harmful Tax Competition', (2002) 11:4 *EC Tax Review* 185-191 at 186.

¹⁵⁷ Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation, OJ 1998 C 384/3, hereinafter the Notice.

¹⁵⁸ *Ibid.*, paragraphs 2 and 4.

When EU Member States fail to do so, the Commission can examine national tax arrangements.

On the basis of the Notice, the relationship between the Code and the State aid regime can be described as perplexing. On the one hand, despite the established link with the State aid regime in paragraph J of the Code, both the Notice and the Report on the Implementation of the Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation (hereinafter the Report on Notice implementation) underline the fact that the two regimes are not entwined.¹⁵⁹ The two procedures are separate and can lead to different conclusions. In other words, the qualification of a tax measure as harmful under the Code does not affect its possible qualification as a State aid.¹⁶⁰ Therefore, measures included in the Primarolo Report as harmful business tax measures are addressed under the principles of the Code and *per se* cannot be automatically classified as prohibited State aid. In order to establish whether aid granted through a tax measure violates the internal market, another investigation is required.

On the other hand, the Notice states that assessment of the compatibility of fiscal aid with the internal market should consider the effects of aid that are brought to light in the application of the Code. Consequently, it can be argued that the Code of Conduct and the State aid regime are, nevertheless, connected, and the results of assessments under the Code of Conduct have an impact on the perception of whether a measure contains elements of State aid or not. In evaluating whether or not a tax measure constitutes incompatible State aid, negative effects of aid established in the process of the application of the Code should be taken into account. In that sense, there is an overlap between rules on State aid and the initiative against harmful tax competition. Thus, the Commission should take account of the harmful character of a scheme in its compatibility review. In that way, findings of the Code of Conduct Group with regard to tax measures have an influence on the State aid proceedings.

¹⁵⁹ Commission of the European Communities, Report on the Implementation of the Commission Notice on the Application of the State Aid Rules to Measures Relating to Direct Business Taxation, C(2004) 434, paragraph 64.

¹⁶⁰ Notice, note 157 above, paragraph 30.

The question as to whether the State aid regime is suitable for combating harmful tax competition is a separate issue. This problem is examined in more detail in Chapter 5, section 5.3.3., which sums up the complex relationship between the State aid rules and the anti-tax competition initiative.

5.3.2.2. 2001 litigation

Although, on the formal level, assessment of a tax regime against the criteria of harmful tax competition and against the definition of a prohibited State aid were presented as independent, it can be argued that these two exercises are closely associated in practice. The connection is clear from as early as the Communication entitled *Towards Tax Co-ordination in the European Union: Package to Tackle Harmful Tax Competition* in 1997. As a matching commitment to the Code, many Member States urged the Commission to re-examine its policy in the field of fiscal state aid and to make full use of its powers under the Treaty to support the fight against harmful tax competition. The Commission responded positively to this call.¹⁶¹ This is expressed in the Communication *A Package to Tackle Harmful Tax Competition in the European Union*.¹⁶² Already in 1997, therefore, before the review of national tax systems was launched, even before the Code of Conduct was formally adopted, the Commission began to reflect on these issues in order to come forward with guidelines.

Under the Code of Conduct, the Member States with harmful tax regimes identified by the Primarolo Report were required to roll back these measures by 1 January 2003. If satisfactory action was not taken, harmful tax regimes could have been challenged under the State aid rules. In February 2000, Commissioner Monti announced that all measures included in the Primarolo Report would be subject to investigation in order to test them against the EU State aid rules.¹⁶³

¹⁶¹ Communication from the Commission to the Council of 1 October 1997: *Towards Tax Co-ordination in the European Union: a Package to Tackle Harmful Tax Competition*, COM (97) 495 final, paragraph 17.

¹⁶² *Ibid.*, paragraph 13.

¹⁶³ Statement by Commissioner Monti concerning the control of fiscal state aids, 23 February 2000, Press release IP/00/182, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/00/182&format=HTML&aged=1&language=EN&guiLanguage=en>.

In July 2001, the Commission launched formal proceedings into 11 business tax schemes in eight Member States with respect to their preferential tax regimes, considered to have been forbidden State aid under the Treaty.¹⁶⁴ The Commission also invited four Member States to terminate existing, previously accepted, fiscal measures which could no longer be justifiable due to the 'economic changes of the EU single market'.¹⁶⁵ In other words, state aid, which was accepted before, stopped being justifiable. It also happened that these no longer acceptable measures were found harmful by the Primarolo Group.

As a result of refusals by Belgium and Italy to adopt changes to the regimes suggested by the Commission, formal proceedings concerning the Belgian co-ordination centres and Trieste financial services and insurance centre were opened.¹⁶⁶ These measures, harmful under the Code of Conduct, were also found to constitute State aid.¹⁶⁷

The EU does not have direct competence on the grounds of direct taxation. The Treaty equipped the Commission with the competence to institute proceedings against Member States that infringe the State aid rules which in turn are the foundation for the creation of the internal market. The link between the Code and the State aid rules sent a clear message that direct taxation is not a special regulatory field. Even here, the Treaty restrictions regarding State aid are fully operative.

¹⁶⁴ Commission launches large scale state aid investigation into business taxation schemes, 11 July 2001, Press release IP/01/982, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/01/982&format=HTML&aged=0&language=EN&guiLanguage=en>. 15 investigations concerning 12 Member States were then initiated. With regard to four tax measures, the Commission proposed appropriate measures to put an end to their incompatibility with the State aid rules. As far as the other 11 measures were concerned, the Commission decided to open formal investigations under the State aid regime. It is interesting to note that 13 of the 15 measures were found harmful under the rules of the Code of Conduct. Among tax regimes under formal investigation against the criteria of the State aid rules were, e.g. co-ordination centres regime in Luxembourg, Spanish special fiscal regime for Basque co-ordination centres, tax exemption on foreign income provided by Ireland and the Netherlands special fiscal regime for international financing activities.

¹⁶⁵ Press release IP/01/982, note 164 above.

¹⁶⁶ Tax aid: Commission opens formal proceedings regarding Belgian coordination centres and Trieste Financial Services and Insurance, 27 February 2002, Press release IP/02/325, available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/02/325>.

¹⁶⁷ Commission Decision of 8 September 2004 concerning the aid scheme which Belgium is proposing to implement for coordination centres (notified under document number C(2004) 3348), OJ 2005 L 125/10; Commission Decision of 11 December 2002 on the existing aid scheme that Italy was authorised to implement for the Trieste Financial Services and Insurance Centre (notified under document number C(2002) 4829), OJ 2003 L 91/47.

The approach of conducting the State aid investigations alongside the determination of their harmfulness under the Code can be interpreted as imposing pressure on Member States which were disinclined to implement the Code within the established timeframe. The delay in the process of implementing the Code of Conduct triggered the opening of several formal investigations simultaneously.¹⁶⁸ Here, the State aid rules acted as a way of forcing Member States who were non-compliant with the Code actually to follow its principles. From the EU perspective, a failure to implement the Code by a Member State did not mean that nothing else could have been done as the Code, a soft law measure, did not present any enforcement procedures. On the contrary, there was always a potential path for (re-)assessing national tax rules against the criteria of a forbidden State aid. The role of State aid proceedings in ensuring greater effectiveness of the process of Code implementation was admitted by the Commission in its Report on the Notice implementation.¹⁶⁹ It stated that the activity of the Commission in the field of State aid tax measures provided a further incentive to the Member States to comply with the Code of Conduct, especially in cases where Member States had not yet planned to abolish harmful tax measures.

In addition, Commissioner Monti also stated that the increased activity of the Commission in the field of fiscal State aid resulted from not enough progress with regard to the Code of Conduct. He observed that:

Without our State aid proceedings,¹⁷⁰ some Member States may well have not negotiated this year's tax package.

The Commission, as the guardian of the Treaties, is competent to review national tax system in search of discrepancies between tax systems and the Treaties. It therefore plays a pivotal role in the application of the State aid provisions. In State aid cases, the Commission also enjoys the power to examine whether and, if so, which measures are going to be assessed. The Member States exercising their national tax sovereignty have to reflect on whether their tax rules in direct taxation, apart from

¹⁶⁸ R H C Luja, note 1 above, at 110.

¹⁶⁹ Report on Notice implementation, note 159 above, paragraph 70.

¹⁷⁰ Final negative State aid decisions on special tax schemes in Belgium, the Netherlands and Ireland, 18 February 2003, IP/03/242, available at

<http://europa.eu/rapid/pressReleasesAction.do?reference=IP/03/242>.

the fundamental freedoms, are in accordance with the State aid rules. If the Member States breach the State aid provisions, national tax rules might also be challenged by the Commission. Such decisions may spur political controversies because the competence of the Commission in respect of decisions about initiating State aid proceedings is not submitted to the control of the ECJ.

The relationship between the Code and State aid has had a reverse influence. In practice, there was a factual correspondence between the end results of State aid and the Code reviews because almost all of the harmful measures examined by the Commission under the State aid regimes were found to be specific. This means that the results of the Primarolo Group had an impact on the findings of the Commission with regard to State aid. It suggests that the Commission used the Primarolo results in its state aid proceedings: just as the Notice and paragraph J suggested.

Through the connection established between the State aid rules and the harmful tax competition initiative, it can be argued that the State aid provisions can act as a hard law stick that might be used against Member States in order to limit harmful tax competition carried out with help of measures that simultaneously fall into the category of forbidden State aid. Essentially, this means that the ECJ could review national tax measures falling under the provisions of the Code which are at same time suspected to be forbidden State aid. Consequently, the Court, on the initiative of the Commission, would be able to carry out judicial review within the area that, under the Code, was out of the Court's reach. It can take place either through a Member State challenging the decision of the Commission or the Commission may bring an action against a Member State when the state did not remove aid established as incompatible with EU law. The link between the Code of Conduct and the State aid rules expands the potential scope of judicial review.

Despite declaring that the Code and the State aid rules are two independent exercises, the Commission stated in the Notice that the results of assessments conducted under the Code shall be taken into consideration. Therefore, results of the Primarolo Group can be used as a justification and a driver of the review process under the State aid regime. But, at the same time, they do not restrict the Commission's power to investigate other tax measures. Moreover, there is often an option to revert to the State aid procedure when the Code of Conduct is not complied with by a Member State. This way, Member States reluctant to follow Code of Conduct principles may be exposed to the pressure of legally binding provisions and, in effect, decide to abide by the Code. As the State aid regime is regulated by the Treaties, it is the source of a legal obligation for Member States. One way or another, a harmful tax measure may be removed from a national tax system.

Conclusions

In the introduction to Chapter 4, I submitted that little is known about the origins of the Code as a soft law measure. On the basis of available circumstances, I claimed that the soft law governance roots seem a viable answer to the origins of the Code. However, this statement should be corrected having presented my analysis in Chapter 5. It appears that a third way was taken. In essence, this chapter supported an argument that the Code is a 'wolf in sheep's clothing' displaying *both* soft and hard law characteristics. As my research indicates, existing 'soft' tax competition regulation constitutes 'harder' regulation than might seem apparent.

The Code led to the eradication of many important elements of national tax systems and noticeable changes in the national tax systems. Indirectly, that suggests that the Code was an important regulatory measure. It created a sense of legal obligation on the Acceding States by becoming part of the *acquis communautaire*. It also influenced (compelled?) the Member States to remove or amend tax measures regarded as harmful by the option of evaluation of tax measures under the State aid principles.

It can be argued that soft law in direct taxation at EU level was not really employed because behind soft law vocabulary and soft law features, a rather hard measure was hidden. These hard law features of the Code coerced the Member States to comply with it and left little scope for a truly voluntary decision as to whether to follow Code principles or not. Similarly to the OECD initiative, the EU action against harmful forms of tax competition manifests the fact that soft law solutions in tax issues may not be fully successful. The soft law approach to the harmful tax competition problem was not a fully effective solution.

It appears that when one expects results in resolving tax issues, a legally binding element is important. It would allow undertaken commitments to be enforced. The soft law approach in the area which is sensitive in terms of national sovereignty might not bring desirable results when no legal obligation exists. When the states face the prisoners' dilemma, soft law regulation on its own might be ineffective.

CHAPTER 6. CONCLUSIONS

Introduction

This thesis has provided a comprehensive study of corporate tax regulation in the EU in order to gain a greater appreciation of the diversity of applied regulatory methods and to reflect on the future of corporate tax regulation. As a result of this in-depth study, one can draw conclusions about where the EU currently stands regarding the advancement of coordination (and/or harmonisation) of corporate tax policy. This chapter summarises the key points that emerged from the research and presents the core findings of this thesis. Then, it suggests what the future may hold for the regulation of corporate taxes in the EU and which regulatory path seems to be most achievable.

Key research findings

The first chapter prepared a foundation for the discussion conducted throughout the thesis. It explained that direct taxation is an important regulatory sphere for the EU and for the Member States. Due to difficulties inherent in reaching a unanimous decision about how to regulate direct taxes, various regulatory modes were applied in the field of corporate taxes. Hard law and soft law were presented as offering different advantages but also creating different problems. Nevertheless, it was established that hard law and soft law can interact in various ways: as alternatives, as antagonists or in creating a hybrid system. The remaining chapters presented regulation through hard law and soft law in detail, with the aim of indicating the substance and boundaries of each EU regulatory method.

Chapter 2 presented the first element of the regulatory puzzle of direct taxation, focussing on the traditional hard law approach. It highlighted that the existing framework of directives is not extensive. The lack of success in harmonising direct taxes in the EU can be attributed to the political sensitivity of the issue: Member States are not ready to transfer tax powers to the EU and, thus, to transform the EU into a polity one step closer to a state. Consequently, the Treaty still provides for the unanimity rule in harmonising direct taxes, which makes that process time-consuming and problematic. Generally, it was concluded that further regulation of

corporate taxes through directives appears highly unlikely. With a growing number of Member States, this process is likely to become even more challenging for the reasons summarised above.

This finding was supported by the recent developments regarding the CCCTB. Despite a directive proposal being tabled, alternative solutions are being considered. Potentially, the CCCTB can be adopted within the framework of enhanced cooperation. Thus, uniformity of regulation linked with hard law directives is compromised.

The second, and more influential, element of hard law regulation was investigated in Chapter 3. It was discovered that case law is an important regulatory force as far as direct taxation is concerned. It is a complex and yet currently dominant method of regulation. However, it was shown that in direct tax jurisprudence, the Court of Justice does not fully transpose the broad interpretation of the fundamental freedoms that it has developed in its general case law. Direct taxation is treated by the Court as a somewhat special regulatory area and the ideal of the internal market is compromised. Double burdens created by substantive laws appear to have been permitted by the ECJ if they are generated by direct tax rules. This is undesirable from the perspective of legal coherence of the case law. It was also established that regulation of direct taxes has its limitations because it only deals with problems on a case-by-case basis and does not create general solutions. In spite of these limitations, hard law regulation through case law will most likely continue to shape direct tax regulation in the future, and in significant ways.

Chapter 4 reflects on the fact that hard law is not the only regulatory method applied by the EU. It concentrated on soft law regulation in the form of the Code of Conduct for Business Taxation. Thus, it was shown that hard law and soft law can coexist and be applied in the same regulatory field at EU level. Examination of the OECD anti-tax competition initiative demonstrated that soft law is not exclusive to the EU but is also applicable through other forums in order to tackle international tax problems. However, it was concluded that soft law in the context of the OECD project proved ineffective and the initiative moved towards the application of legally binding

treaties, only supported by soft law mechanisms. This analysis provoked a question about whether similar developments are relevant for the EU.

Finally, Chapter 5 established that behind soft law language, a hard law measure was in fact created and applied. In short, the Code of Conduct exerts a considerable regulatory influence. Moreover, its hard-er features determined the success of the tax competition exercise. The converse of this argument is, however, that the soft law approach has not been given a chance to be truly tested with regard to its usefulness for the field of direct taxation.

The future of corporate tax regulation

The usage of both hard and soft law instruments may indicate a ‘crisis’ for the traditional hard law approach and expose a need to discover different, alternative ways of regulation. Regulation of direct taxes in the EU did not develop in a linear fashion. Hard law was not replaced by soft law. This thesis shows that hard law and soft law are not necessarily alternative choices, but that both approaches can be applied simultaneously in order to influence one regulatory field. Moreover, these two different approaches offer different strengths. Drawing from the typology set out in Chapter 1, a mixture of both regulatory modes creates ‘hybrid’ regulation of direct taxes.

This thesis established that soft law can be a valuable regulatory solution on its own terms. It can be perceived as a solution dictated by the need for pragmatism when there are difficulties restricting or even preventing agreement on the adoption of (hard law) directives. It offers an opportunity for mutual learning and building a common understanding among the Member States, generating opportunities to create shared practices. Soft law in this context is an answer to the call for more open governance and encouraging discourse about tax systems, which is still in embryonic form in the EU.

The thesis also presented that hard law can be an effective way of exerting regulatory influence over direct taxation. The existing direct tax directives and important relevant case law demonstrated this point. However, hard law regulation can be

problematic. Case law cannot create a coherent tax system and the ECJ can only provide guidance on the interpretation of EU law on a case-by-case basis. The traditional hard law approach through directives can be time-consuming and is restricted by the unanimity requirement.

In the EU direct tax regulatory framework, hard law regulation has been introduced through the back door. As shown by the example of the Code of Conduct for Business Taxation, hard law measures can be hidden under the soft features of a regulatory measure. That raises a problem of legitimacy and suggests that the currently operating hybrid regulation of direct taxes in the EU is disingenuous in nature.

This thesis does not challenge the fact that both soft law and hard law are necessary in direct tax regulation. A hybrid regulatory structure for direct taxation is, in fact, strongly advocated, because soft law and hard law offer different strengths and make distinct regulatory contributions. In a field as politically sensitive as direct taxation, soft law may help to create shared knowledge and practices, but it might be insufficient to bring changes. The examples of both the OECD initiative against tax competition and the Code of Conduct show the inadequacy of direct tax regulation only through soft law. The value of hard law, in its legally binding form, secured the effectiveness of regulation.

However, the *disingenuous* hybrid regulation is unacceptable and should be condemned as far as the future of EU direct tax regulation is concerned. A more open and transparent hybrid regulation should be encouraged instead. Thus, the legitimacy of regulation of this politically sensitive area will be more fully endorsed and might stimulate a more fruitful discussion about the future direction of EU direct tax regulation.

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