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Editorial

Direct taxation and EU law: integration or disintegration?

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1. From the EC Treaty to the case law of the ECJ

Direct taxation is not mentioned in the EC Treaty. It falls within the competence of the Member States. The only possibility for action by the Community in this field lies in Art. 94 of the EC Treaty, general provision applicable to all areas and allowing for the adoption of measures for the approximation of laws which have a direct impact on the establishment or functioning of the Common Market.

The results are minimal, all the more because such decisions have to be unanimous, qualified majority voting being excluded by Art. 95 of the EC Treaty for approximation in the field of direct taxation. Only five Directives have been approved.

- 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.
- 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.
- 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.
- Directives 2003/48 and 49/EC on the taxation of payments of interests and royalties between associated companies resident in different Member States and on the effective taxation of savings income, which are not yet operational.

But this did not imply that 'the establishment or the functioning of the Common Market' or *a fortiori* of the Single Market and more specifically the four fundamental freedoms would never be impaired by national tax legislation. No wonder in fact, as tax systems can be obstacles to free movement or create distortions of competition, both having to be removed according to Art. 3 of the EC Treaty.

Perhaps because there were so many non-tax barriers to abolish in the first years of the Common Market, tax barriers were not challenged. But in the 1990s, with so many obstacles to free movement and the Single Market having been removed, tax barriers became more and more visible and taxpayers became aware of their possible inconsistency with Community law. This was confirmed by the famous sentence of the ECJ, used for the first time in the *Schumacker*[1] judgment of 1995 and since then in every judgment in the field: 'Direct taxation falls within competence of the Member States but they must exercise that competence consistently with Community law'.

Since then, in almost 40 decisions, applying in fact a rule already in force in other fields than direct taxation, using the Treaty Articles setting out the fundamental freedoms of the Single Market, the ECJ has defined the obligation to exercise the fiscal competence consistently with EC law in accordance with the prohibition in the fields of free movement of persons, services, capitals and of freedom of establishment of any discrimination or restriction, except if they are justified.

There is therefore no obligation to do something, more precisely, no obligation to harmonize, but an obligation not to do. I transpose to corporation tax what the Court said about income tax in the *De Groot* case[2] (point 115):

'Community law contains no specific requirement with regard to the way in which a Member State must deal with corporate tax provided that the conditions governing it do not constitute a discrimination, either direct or indirect, on grounds of nationality or an obstacle to the exercise of a fundamental freedom guaranteed by the EC Treaty.'

The Court has been very strict in the admission of justifications. Some of them were declared admissible in principle to justify a difference of treatment between residents and non-residents: that was the case for the necessity to preserve the cohesion of the national tax system or to increase the effectiveness of fiscal supervision or to prevent the risk of tax avoidance or to observe the principle of territoriality. However, in fact, with two exceptions (once, the cohesion of the national tax system in the *Bachmann* case[3] and once the principle of territoriality in the *Futura Participations* case[4]), the Court has systematically rejected the justifications put forward by the Member States.

[1] Schumacker, 14/02/95, C 279/93, Rec. 1995, I-225.
[2] De Groot, 12/02/02, C 385/00, Rec. 2002, I-11819.
[3] Bachmann, 28/01/92, C 204/90, Rec. 1992, I-249.
[4] Futura Participations, 15/05/97, C 250/95, Rec. 1997, I-2471.

Some other justifications have been declared inadmissible by the Court even in principle: that is particularly the case for the loss of tax revenue invoked by many Member States, even when, with the support of the Commission, the Member States have redefined this justification as the 'aim of avoiding an erosion of the tax base going beyond a mere diminution of tax revenue'.[5]

2. What to change?

Such a picture is troublesome for the future. Reading the case law of the ECJ, it is manifest that there are many problems of consistency of national tax systems with EC law; all judgments of the Court are not of equal importance but in more than 95 per cent of the cases, the national tax rules analyzed by the Court were declared incompatible with Community law. It is worthwhile noting that out of almost 40 cases, more than 35 of them were preliminary rulings, the Commission having been, surprisingly enough, very reluctant to challenge directly national tax legislations. This feature can also explain why these cases came out so late.

It is also very clear that we are not at the end of the process. The Commission is preparing some direct actions against national legislations and there are many preliminary references pending before the ECJ, some of them very important. Even if this case law can be criticized, it is stable and coherent: the high majority of cases are now decided by Chambers with five judges and in one case (*Mertens*[6]), the Court has decided by order, using the short procedure provided for by Art. 104(3) of its Rules of procedure.

Even if the case law of the ECJ was to become less clear or less strict, the situation is far from being satisfactory, from at least two points of view: first, the legal uncertainty is high, not only for taxpayers but even for national legislators. Even with such a clear case law as the current one, it remains difficult to predict the compatibility of national tax systems with Community law. Secondly, if the case law of the ECJ can strike down national legislations, it cannot build up a system which would be compatible with the Single Market. If there is integration, it is only negative by abolition of incompatible systems without any construction of an acceptable alternative. These elements can only increase the pressure for harmonization and I support the EU Commissioner Fritz Bolkenstein when he says:

'As an alternative to this "destructive" process, I favour closer cooperation between Member States and the Commission. Such cooperation could include guidelines for Member States, bilateral tax treaties on avoiding double taxation, Commission recommendations and codes of conduct agreed between governments as well as directives to harmonise national legislation.'[7]

To this statement, I would add, even if it is far from being accepted, qualified majority voting.

3. Perspectives

It does not seem that the Member States are ready to go in this direction. If the taxpayers woke up in the 1990s, if the Commission initiates again and again proposals to harmonize direct taxation, some Member States do not seem to be awake or interested and others are making or inspiring unacceptable proposals because they are angry at the case law of the ECJ and refuse to harmonize direct taxation, even by unanimous vote.

In the first category, you find Member States like Italy, Spain, Portugal, Ireland or Austria, the direct tax rules of which have never been struck down by the ECJ, not because they have been declared consistent with EC law by the ECJ, but because no case has ever been brought against them before the Court. It is difficult to know why: are their systems really compatible with EC law? Are their taxpayers satisfied or are their judges reluctant to refer cases to the ECJ? In any case, other Member States, the systems of which have been challenged only once or twice with very tiny consequences on their statutes or budget, are not asking for harmonization because they do not feel any inconvenience from the current system. Then there is the satisfaction of some Member States in seeing the tax systems of other Member States struck down by the ECJ. There is no small gain in tax competition!

In the second category, you find Member States like Germany, the Netherlands and the United Kingdom, of which some fundamental elements of the corporate tax system have been struck down by the ECJ and which have suffered a major loss of corporate tax revenues. In a report[8] Alistair Craig has estimated the historical cost for the UK Exchequer of the ECJ judgments to be more than UKP10 billion and another UKP10 billion could represent the potential costs of future ECJ judgments.

Sometimes, in panic, these countries changed their legislation. After the *Hoechst* case,[9] the UK replaced its system of advanced corporation tax with a system whereby companies pay the corporation tax in quarterly instalments and after the *ICI* case,[10] it changed its 'group relief' rules, which are still under discussion in the *Marks and Spencer* case pending before the ECJ. This also happened in Germany which, after the *Lankhorst-Hohorst* case,[11] made its thin capitalization rules applicable to a loan from a German parent company to its German subsidiary and finally for the Netherlands, which after the *Bosal* judgment[12] had to rush in new legislation about the deduction by a parent company of the costs associated with its participations in its subsidiaries. No doubt that what Alistair Craig calls the 'sticking plaster' approach is not satisfactory for Member States or taxpayers.

5 Bosal Holding, 18/09/03 C168/01, not yet published.
6 Mertens, Ord 12/09/02, C 431/01, Rec 2002, I-7073.
7 Article in the Financial Times, 21/10/2003.
8 Alastair Craig published by the Centre for Policy Studies on 5 December 2003 (*EU Law and British Tax: which comes first ?*).
9 Metallgesellschaft and Hoechst, 08/03/2001, C 397-410/98, Rec. 2001, I-1727.
10 ICI, 16/07/98, C 264/96, Rec. 1998, I-4695.
11 Lankhorst - Hohorst, 12/12/02, C 324/00, Rec. 2002, I-11779.
12 Bosal Holding, 18/09/2003, C 168/01, not yet published.

What are the possible alternatives since, as the *Economist* said (5 December 1998), 'not even Mr Brown can veto the judgments of the Court'? The worst alternative has been suggested at the Inter-governmental Conference, which should lead to the adoption of the new Treaty Constitution of Europe: to exclude any tax implications from the provisions of the Treaty related to the fundamental freedoms or to limit the powers of the ECJ. This would mean, for example, making it compulsory to take into consideration or to accept (to what extent?) the loss of tax revenue as justification of discriminations or restrictions to the fundamental freedoms. Such an approach would mean a backward move in the establishment and the operation of the Single Market. For once, I am a strong supporter of the rule of unanimity to prevent such an evolution. Even if it is significant that such a proposal has been made during the Conference because it indicates that even the foundations of the Community can be threatened, I think that this proposal probably will not succeed.

Apart from some countries creating an entirely new tax system which would comply with the ECJ's interpretations of the requirements of the Single Market (which would represent huge legislative work) the only reasonable improvement of the system lies in some coordination or harmonization of the national systems. It would not necessarily mean common rules but at least a system (home state taxation for small and medium business, common consolidated tax bases, for example) which would make the national systems compatible with each other and with Community law. Such a system would leave the Member States free to legislate for the surplus, particularly with respect to tax rates.

Despite all this, some countries (led by the UK) remain opposed to any EU harmonization of direct taxation. In the presentation of the UK negotiating position at the Inter-Governmental Conference, Tony Blair made clear that 'issues like tax, defence and foreign policy remain the province of the nation state'. As if tax did not have anything to do with the Single Market! Not only do these countries want to keep unanimity for any movement in this direction (even fearing the introduction of qualified majority voting where 'administrative cooperation or combating tax fraud and tax evasion are concerned', as provided by Art. III – 63 of the draft Constitution), but they hold to this rule to arm against any progress.

Besides leaving the EU, an alternative which is suggested by Craig in his above-mentioned report, the UK could finally yield to the increased pressure for tax harmonization, even with unanimity, because it is ultimately the only way to conciliate the requirements of a Single Market, including free movement and fair competition, with some tax sovereignty of the Member States, and more particularly some control over the way they set corporate tax, including budgetary predictability for legislators and legal certainty for taxpayers.

It is unrealistic to believe that tax can remain unaffected by Community law. Even the UK has accepted the Code of Conduct listing 66 so-called 'harmful' tax measures which would distort the choice of location of business in the EU. Indeed, this Code, decided by unanimity, is only a political commitment to abolish and not to reintroduce any harmful measure, without any possible judicial enforcement. With optimism, we could see it as the recognition that tax matters may not remain completely at the discretion of the national authorities and thus as a first step towards coordination and harmonization of the national tax systems.

Perhaps we are going to make progress in this field as with the European Charter of Fundamental Rights. Today a text without any legally binding force may tomorrow be a true part of the European Constitution with binding force and judicial enforcement.