

Income Tax and Income Shift by Individuals

I INTRODUCTION

There are increasing concerns with double non-taxation or insufficient taxation of remote work, mobile individuals and their wealth. This is not a new topic from the angle of hidden wealth, and the problem has been primarily dealt with by the international standard on exchange of information, i.e., from the perspective of harmful tax competition and tax evasion.¹ Recently, the inadequacy of the international tax system for taxing individuals with cross-border income is raising different proposals to restore the allocation of taxing rights and attempt to effectively address planning and avoidance.²

In this editorial, I want to discuss some critical issues related to residence, source, and alternative connecting elements that are considered for taxing income of mobile individuals. I take the opportunity to also refer to some of the chapters in the forthcoming book *Taxing People: The Next One Hundred Years*, ed. by Tsilly Dagan and Ruth Mason, Cambridge University Press.

2 INCOME SHIFT BY RESIDENT INDIVIDUALS

Overall, there is some parallel in this discussion on how to tax individuals with the base erosion and profit-shifting (BEPS) project that concerns multinationals (MNEs).³ One is that the wealthier entities, like MNEs, are not paying their fair share because they can choose where to be taxed. Moreover, jurisdictions compete to attract wealthy taxpayers by reducing taxes in the same manner that those

same jurisdictions reduce them to attract MNEs. Moreover, there is also awareness that residence, as a condition to tax worldwide income, and as legally defined, is no longer sufficient for taxing individuals in a globalized economy even if we face deglobalization trends. Ultimately, residence should be replaced or complemented by other more meaningful connecting elements that would reflect some type of allegiance with the taxing jurisdiction. A discussion on the proper connecting elements to tax MNEs has also been occurring for some years now as market states are claiming that they do not receive their fair share in the current digitalized economy.⁴

3 DO WE STILL WANT FULL TAX LIABILITY? THE EUROPEAN UNION CASE

Thus, there is concern on rising inequalities due to stateless taxpayers and the fact that states are not receiving enough revenue for redistribution under residence taxation. There is certainly a preliminary question related to fair taxation of individuals with global income.

That is the question of whether we still want to distinguish between full and limited liability under income tax, at least in the case of mobile individuals.⁵ We could, for example, keep residence as a connecting element and apply progressive rates combined with the exemption of foreign income (exemption with progression). Full liability would be relevant for calculating progressive rates and that would still allow the residence state to maintain some redistributive role.⁶ But then, for symmetry reasons and to

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¹ Ana Paula Dourado, Article 26, in *Klaus Vogel on Double Taxation Conventions*, vol. II (5th ed., Ekkehart Reimer & Alexander Rust eds, Wolters Kluwe, 2002), mno 2–4, 21, 26.

² See the several contributions in: *Taxing People: The Next One Hundred Years* (Tsilly Dagan & Ruth Mason eds, Cambridge University Press), forthcoming.

³ OECD, *Base Erosion and Profit Shifting*, <https://www.oecd.org/en/topics/base-erosion-and-profit-shifting-beps.html> (accessed 1 Dec. 2024). See the reference to a BEPS project addressed to individuals in: Wolfgang Schön, *Must Everybody Pay Tax Somewhere?*, in *Taxing People*, *supra* n. 2, Ch. 1.

⁴ A. P. Dourado, *Digital Taxation Opens the Pandora Box: The OECD Interim Report and the European Commission Proposals*, 46 *Intertax* 565–572 (2018), doi: 10.54648/TAXI2018058 (accessed 1 Dec. 2024); Wolfgang Schön, *One Answer to Why and How to Tax the Digitalized Economy*, 47 *Intertax* 1003–1022 (2019), doi: 10.54648/TAXI2019105, <https://kluwerlawonline.com/journalarticle/Intertax/47.12/TAXI2019105> (accessed 1 Dec. 2024).

⁵ In Ch. 2 (*Comfortably Numb: Should the Reign of Residence Over the International Tax Regime Continue in the 21st Century?*) of: *Taxing People*, *supra* n. 2, Yariv Brauner recommends abandoning residence taxation in favour of exclusive source taxation and contends for a formulary approach to determining source.

⁶ This solution was adopted by the Netherlands in its tax treaties with France, Germany, and the United Kingdom at the time of the facts of the *De Groot* case: CJEU, 12 Dec. 2002, Case C-385/00, *de Groot*, EU:C:2002:750.

avoid loss of revenue, personal and family circumstances would not be fully taken into account by the residence state. Thus, the taxpayer would be in a weaker position, and the role of the residence state would be less relevant in terms of personal taxation. To overcome this disadvantage, the source states could allow a deduction of personal and family-related expenses in proportion to the income received in those jurisdictions and, if this would be the case, progression should also be applied by the source states.

For EU tax lawyers, the latter solution would not be a novelty as it has been required by the Court of Justice of the European Union (CJEU) under certain circumstances.⁷ However, the same court did not permit the residence state to restrict the deduction of expenses related to personal and family circumstances in proportion to the income obtained in that state.⁸ By deciding in that way, it reinforced the rights to personal taxation in the European Union,⁹ but it did so without paying attention to the revenue aspect because it forced residence states to incur expenses while suffering a loss of revenue. This outcome is inherently a problem as it reduces financial resources for supplying public goods and services and for redistribution. In any event, currently in the EU, there is some ambiguity in the role that the residence and source states take regarding full tax liability, progressive taxation, and personal and family circumstances related expenses.

4 HOW TO ENSURE FULL TAX LIABILITY: CITIZENSHIP OR RESIDENCE? THE PROBLEM OF NON-DOM REGIMES

Let us assume without discussing it that full tax liability still makes sense and that it is still applicable in a certain state. But which state? Full tax liability has generally been related to taxation of residents and global income. Article 4 of the OECD Model Convention contains the criteria to define a resident of a contracting state under a tax treaty that follows the model: domicile, residence, place of management, or any other criterion of a similar nature. There is broad consensus that the enumerated criteria would each constitute a basis for full tax liability on world-wide income.¹⁰ They aim at covering, as far as

individuals are concerned, 'the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax)'.¹¹

The second sentence of Article 4 §1 currently excludes from the concept of residence 'any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein'. Even so, the option for territorial taxation in the residence state does not preclude application of a bilateral tax treaty concluded on the basis of the OECD Model Convention as long as it is the standard criterion.¹²

However, territorial regimes applied to a specific category of residents (non-habitual or non-domiciled residents, i.e., *non-dom regimes*) providing tax exemptions or other more favourable regimes (such as special rates on gross income and exempting passive income accrued abroad) do not seem to be covered by tax treaties as results from the cited second sentence of Article 4 §1. *Non-dom regimes* are not the standard or the reference regimes applicable to residents, and non-habitual residents do not necessarily reveal a relationship of proximity (personal attachment) with the non-habitual residence state. They also foster tax exiles, a shift in residence for which the principal purpose is or may be to obtain the advantageous *non-dom* regime.

Moreover, these regimes targeted at individuals have close similarities with those examined by the European Commission and the EU Member States under the Code of Conduct and its criteria on harmful tax competition.¹³ There are also similarities between the *non-dom regimes* and the state aid regimes prohibited in the European Union and concerning corporations because, as mentioned before, the former are not the reference regime for taxing income from resident individuals.

Non-dom regimes are a way to circumvent full taxation by a residence state, but the shift of residence to any state for tax reasons – i.e., due to lower taxation – poses the question of whether residence is still the proper connecting element for determining personal taxation. Tax competition to attract highly mobile individuals connected with revenue loss and wealthy individuals not paying their fair share could justify replacing residence by citizenship. States would then tax the global income of their

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⁷ CJEU, 14 Feb. 1995, Case C-279/93, *Schumacker*, EU:C:1995:31.

⁸ CJEU, *de Groot*, *supra* n. 6.

⁹ On a symmetric case to *de Groot* requiring the source state to allow deductions of personal benefits: CJEU, 9 Feb. 2017, Case C-283/15, X., EU:C:2017:102: 'Article 49 TFEU must be interpreted as precluding a Member State, the tax legislation of which permits the deduction of "negative income" relating to a dwelling, from refusing the benefit of that deduction to a self-employed non-resident where that person receives, within that Member State, 60% of his total income and does not receive, within the Member State where his dwelling is located, income that enables him to qualify for an equivalent right to deduct': para. 43.

¹⁰ Klaus Vogel on Double Taxation Conventions, Kluwer 154–159 (1991); Supreme Court of Canada, *Crown Forest Industries Ltd v. Canada*, 2 SCR 802 [1995].

¹¹ Paragraph 8 of the Commentary on Art. 4 of the 2017 OECD Model Tax Convention.

¹² This option for territorial taxation is illustrated by the Netherlands regime under the aforementioned *De Groot* case (judged by CJEU), *supra* n. 6.

¹³ A. P. Dourado, *Aggressive Tax Planning and Harmful Tax Competition*, in *Research Handbook on European Union Taxation Law*, Ch. 18, 390–409 (Christiana HJI Panayi & Werner Haslechner eds, Edoardo Traversa, Elgar 2020).

citizens independently of them being residents or non-residents and, in this manner, a shift of residence for tax reasons, i.e., a tax exile, would be prevented.¹⁴

However, this option would require international coordination as individuals could otherwise shift their citizenship to states that do not tax non-resident citizens. In the absence of international coordination and if a state would not tax them, residence states should intervene and do so.¹⁵ A combination of citizenship as the main criterion plus residence as a complementary one would revert the order of the current Article 4 of the OECD Model Convention, and it is doubtful that there are many advantages in that reversal.

First, the main problem with selecting citizenship as the principal connecting element for personal taxation lies in its justification. The old *US Cook v. Tait* decision (1924) basing taxation of non-resident citizens on the benefits principle seems correct by addressing it as a principle to be tested: does the government benefit the citizen and her or his property wherever found, and does it have the power to make the benefit complete? It must be questioned whether there is relevant personal protection, property protection, a right to vote, a right to enter the state, and past benefits legitimizing citizenship taxation. If the answer is negative, and it will be in most countries around the world, it does not seem legitimate to tax non-resident citizens because there is not enough political allegiance (including the right to vote) and insufficient economic allegiance.

Citizenship taxation would also be extremely complex to implement,¹⁶ and there is another practical problem. Resident states are the primary beneficiaries of exchange of information on tax matters as they receive information from the source states to implement full liability – worldwide income taxation. Because residence is ascertained by criteria that reveal permanence, it is expected that a significant part of the taxpayer's assets will be located in the residence state. If so, those assets could be seized to pay the tax due on worldwide income as revealed by exchange of information and if enforced payment is necessary.

In contrast, non-resident citizens may often possess no assets in the state of citizenship since their permanent home or centre of vital interests is elsewhere. It would therefore be of no benefit to provide information to the state of citizenship in the absence of assets therein unless states would engage in assisting in collection on behalf of

the citizenship state which is not realistic. In fact, this issue as foreseen in the current OECD Model Convention is optional due to existing national legal constraints in many countries to engage in it.¹⁷

In the European Union, there is a (binding) directive for assistance in collection on the basis of source and residence,¹⁸ but replacement of residence by citizenship as a connecting element for full taxation could be held as a restriction to the free movement of workers and establishment. It would therefore be incompatible with the Treaty on the Function of the European Union.

Thus, residence is still the element that reveals stronger allegiance for the purposes of full taxation and its implementation, at least while and if digital nomads are not a significant number of taxpayers. Stated otherwise, the hierarchy in Article 4 OECD Model Convention for determining the meaning of residence and consequent entitlement to full liability in the residence state is still correct: permanent home, centre of vital interests, and nationality. The fact that non-citizen residents are not generally entitled to vote and are therefore not members of the political community in which they reside is compensated by their constructed social, cultural, and family links in that community of residence.

5 CONCLUDING REMARKS: A REINFORCED RESIDENCE AND SWITCH-OVER RULES

We go back to where we began whereby countries still face the challenge of reduced tax revenue due to mobile individuals and tax competition to attract them. We will probably need some minimum coordination on personal income tax as is the case for taxation of MNEs as well as other taxes levied on wealth.¹⁹ Right now, it is important to strengthen implementation of the residence as a connecting element if full taxation and redistribution are to be kept and combine it with switch-over rules.

An effective implementation of residence recommends continuously improving exchange of information and adopting rules that prevent double non-taxation. Unilateral or coordinated exit taxes as well as trailing taxes on the transfer of residence could deter or reduce the number of tax exiles, especially if there is an abusive (non-genuine) shift of residence. Exit taxes are levies imposed by a country on individuals or businesses when they decide to leave the jurisdiction permanently

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¹⁴ This is the recommendation by Reuven Avi-Yonah, *Taxing Nomads: Reviving Citizenship-based Taxation for the 21st Century*, in *Taxing People*, *supra* n. 2, Ch. 3.

¹⁵ This is also proposed by Reuven Avi-Yonah, *Taxing Nomads*, *supra* n. 14.

¹⁶ In favour of a combination between citizenship and residence: Tsilly Dagan & Ruth Mason, *Reconsidering Citizenship Taxation* in *Taxing People*, *supra* n. 2, Ch. 4.

¹⁷ *Model Tax Convention on Income and on Capital*, Full version as it read on 20 Nov. 2017, (Footnote to Art. 27 OECD Model Conventions: M-75).

¹⁸ COUNCIL DIRECTIVE 2010/24/EU of 16 Mar. 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures, JOL 84 (31 Mar. 2010), <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32010L0024> (accessed 1 Dec. 2024).

¹⁹ See other chapters in *Taxing People*, discussing how to tax individuals such as: Daisy Ogembo, *Transformative Constitutionalism: The Role of Citizens in (Tax) State Building – the Case of Kenya*, in *Taxing People*, *supra* n. 2, Ch. 8; Diane Ring, *A Century of Labor and Taxation*, in *Taxing People*, *supra* n. 2, Ch. 9.

or transfer their tax residency to another country.²⁰ Trailing taxes are levied on previous nationals or residents, for a subsequent period limited in time (e.g. ten years).²¹ Because trailing taxes rely on legal fictions and therefore artificially create a citizenship or residence connection, their compatibility with tax treaties could be questioned.

In the European Union, exit taxes and trailing taxes have had different readings by the CJEU. While exit taxes on individuals have been declared restrictive to the exercise of the fundamental freedoms,²² a trailing tax concerning exit to a non-EU country has been allowed.²³ It was not clear in the CJEU judgment why the latter was compatible with the European Community Treaty, however I am not going to comment on the CJEU decisions on exit taxes and trailing taxes in this editorial.

The point I would like to briefly raise is that exit taxes could be allowed in the EU in the case of abuse, that is, if the transfer of residence to another Member State or a third country is not genuine. In turn, trailing taxes could be interpreted as connecting elements that expand the meaning of citizenship or residence and are under the competence of the EU Member States. In contrast, the

introduction of exit taxes and trailing taxes by individual EU Member States on the mere grounds of revenue loss would be incompatible with settled jurisprudence by the CJEU on the fundamental freedoms.²⁴ The CJEU would most probably accept exit taxes and trailing taxes on individuals if they would be adopted by a directive, especially after being recommended by an international organization such as the OECD.²⁵

Furthermore, auditing whether declared residents are effective residents is also necessary, and instead of introducing taxation of citizens, it is preferable to eliminate *non-dom* regimes. Applying a Code of Conduct to personal income tax would allow auditing Member States' harmful tax competition.

Finally, rules that prevent double non-taxation could also be coordinated in a joint effort to prevent income shifting. Some of these rules are already a component of a number of tax treaties: the entitlement to benefits clauses are an example. They allow source countries to tax if the residence country does not tax an individual on the full amount of income (a switch-over clause).²⁶

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²⁰ Exit taxes often take the form of a capital gains tax against unrealized gains attributable to the period in which the taxpayer was a tax resident of the country in question.

²¹ This is done via legal fictions. For example, in the European Union, the Court of Justice decided on the compatibility of the following Netherlands legislation with the free movement of capital in the European Community Treaty. According to the Netherlands legislation at the time of the facts, '[a] Netherlands national who, having resided in the Kingdom, dies or makes a gift within 10 years after ceasing to reside there shall be deemed to have been resident in the Kingdom at the time of the death or of the making of the gift' (CJEU, 23 Feb. 2006, Case C-513/03, *Van Hilten*, EU:C:2006:131).

²² CJEU, 11 Mar. 2004, Case C-9/02, *De Lasteyrie*, EU:C:2004:138.

²³ CJEU, 23 Feb. 2006, Case C-513/03, *Van Hilten*, EU:C:2006:131.

²⁴ CJEU: 12 Dec. 2002, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, Case C-324/00, para. 36, ECLI:EU:C:2002:749; 11 Mar. 2004; *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie*, Case C-9/02, para. 60, ECLI:EU:C:2004:138; 12 Sep. 2006, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Case C-196/04, para. 49, ECLI:EU:C:2006:544.

²⁵ Directives have not been declared incompatible with the TFEU fundamental freedoms, due to the presumption of legality of the EU institutions acts and to institutional cooperation: Rita Szudoczky, *The Sources of EU Law and their Relationships: Lessons for the Field of Taxation*, *Faculteit der Rechtsgeleerdheid*, e.g., 8.3.4, 8.3.5 e 8.3.6; Dourado, 'The Relationship between Primary and Secondary EU Law in Tax Law: The Legitimacy of Different Interpretation Criteria Applied to EU and National Legal Sources', *Traditional and Alternative Routes to EU Integration* (ed. Dennis Weber), IBFD, 2010, at 171 e ss.

²⁶ See e.g., Art. 28 (3) of the Tax treaty between Gibraltar and the United Kingdom entered into force on 24 Mar. 2020: '(3) Where under any provision of this Agreement, income or capital gains are relieved from tax in a territory and, under the laws in force in the other territory, an individual, in respect of that income or that capital gain is subject to tax by reference to the amount thereof which is remitted to or received in that other territory and not by reference to the full amount thereof, then the relief to be allowed under the Agreement in the first mentioned territory shall apply only to so much of the income or capital gain as is taxed in that other territory' https://assets.publishing.service.gov.uk/media/5e8dd67686650c18cb34ea4b/UK-Gibraltar_in-force_April_2020.pdf (accessed 1 Dec. 2024).

Tax Administration AI: The Holy Grail to Overcome Information Asymmetry in Tax Enforcement?

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Liberal democracies are based on the concept of the free person who is a rational being capable of understanding their behaviour and taking responsibility for it. The state may only interfere with individual freedom when it has a legal basis, if it is necessary to safeguard the functioning of a democratic society. Therefore, in liberal democracies, citizens have duties to fulfil and responsibilities to bear. In return, they are not and must not be surveilled by the state. Tax enforcement is built upon this concept.

Tax administration Artificial Intelligence (AI) has the potential to change this concept. What is technically feasible is not necessarily appropriate for sustaining the fundamental values of a liberal society.

If society wants to uphold these values, any deployment of tax administration AI must be legally framed with clear rules on the origin of the data, the method of data processing, the aim of the data processing, and the possibility of human intervention. Additional legal prerequisites may be necessary depending on the purpose of the use of tax administration AI. If it is deployed in a mindful way, it is likely to increase both the efficiency and the equality of tax enforcement.

Keywords: Tax administration AI, tax enforcement, information asymmetry, liberal democracy, chatbot, tax risk management systems, automated tax collection and audit.

I INTRODUCTION AND PURPOSE OF THIS ARTICLE

Governments have realized that digital and psychology-based tools used by private businesses not only contribute to economic growth but also have the potential to improve public administration. Consequently, by transplanting private business concepts to public management, tax authorities have refined their 'Tax Compliance Risk Management' and servicing tools to increase their effectiveness.¹ In this context, the OECD has been recommending using advanced analytics for better tax administration for years.²

Given the fact that tax administration AI may use substantial amounts of data from various sources that are processed and subsequently used in different ways, also with automation, it seems necessary to reflect on the limits of their permissiveness in a liberal democratic society.

This article argues that only mindful deployment of tax administration AI is likely to increase equality in tax enforcement. Its unmindful deployment is thus likely to

decrease equality, increase inequality in tax enforcement, and threaten the core values of liberal democracies. Mindfulness is understood in the following ways.

- (1) Using new technologies in tax enforcement cannot be compared to deploying a simple mechanical tool with an objective of increasing efficiency. It entails a fundamental change in the way taxes have been being enforced for a long time. However efficient and effective their deployment may be, it must be clearly framed by law in an appropriate legal manner that allows preserving the values underlying liberal democracies.
- (2) Not anything that is legally framed can preserve liberal democracies. There might be opportunities of digitalized taxation that may be efficient, effective, and equality-increasing but still not in accordance with the fundamental values of a liberal democracy reflected in the Human Rights Convention that constitute the very foundation of personal autonomy.

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¹ Mark Pijnenburg, Wojtek Kowalczyk & Lisette van der Hel-van Dijk, *A Roadmap for Analytics in Taxpayer Supervision*, 15 Electronic J. e-Gov't 19, 24 (2017).

² OECD, *Advanced Analytics for better Tax Administration* (OECD Publishing 2016); OECD, *Technologies for Better Tax Administration* (OECD Publishing 2016); OECD, *The Changing Tax Compliance Environment and the Role of Audit* (OECD Publishing 2017); OECD, *Tax Administration 3.0: The Digital Transformation of Tax Administration* (OECD Publishing 2020); OECD, *Tax Administration 2023* (OECD Publishing 2023).

- (3) Tax administration AI has the potential to change the formerly agreed balance between the private interest in personal autonomy and the public interest in having everyone paying their fair share. Such a change for doing so for two potentially diverging interests must be deliberately and consciously performed. As this shift risks limiting personal autonomy in a substantive way, it must be democratically deliberated and must not ‘just happen’.

2 TAX ADMINISTRATION AI: DEFINITION AND POTENTIAL

2.1 Definition of Tax Administration AI

In accordance with the EU AI Act³ and the OECD Guidelines on AI,⁴ the tax administration AI defines as a machine-based system that processes vast amounts of data to generate output such as predictions on under-declarations of taxes or on taxpayers’ risk-aversity or risk-proneness.

AI is already being used for multiple purposes: among others, to predict the employability in the labour market,⁵ detect fraud or health risks,⁶ or prevent crime.⁷

2.2 Potential of Tax Administration AI

In tax matters, AI can be used for policy evaluation, taxpayer service, debt management, filing and payment compliance, to predict taxpayer behaviour or the likelihood of additional tax liability following an audit (predictive analytics), or to help tax administrations understand the impact of their actions on taxpayer

behaviour (prescriptive analytics).⁸ If AI is used to prevent some undesired behaviour or to lead to a specific desired conduct in the future, it is referred to as pre-emptive analytics.⁹

Having access to the insights provided by tax administration AI provides tax authorities more insight to taxable events and taxpayer’s behaviour and can improve targeted enforcement and increase efficiency and effectiveness. Tax administration AI allows tax authorities to identify taxable events on a real-time basis and predict the probability of a taxpayer’s readiness to comply with the laws. The OECD envisions that the final outcome will be taxation becoming a ‘seamless experience’ that is ‘embedded in a taxpayer’s natural and business system’.¹⁰ Such an experience would render behavioural prediction mechanisms unnecessary and not paying taxes would simply be impossible.¹¹ Indirectly forced compliance would supplant voluntary tax compliance

2.3 The OECD’s Vision for Tax Administration AI

In its Tax Administration 3.0 Report, the OECD has highlighted the improvements of digitalization in tax administrations’ effectiveness and efficiency. Accordingly, it allowed:

- introducing greater verified reporting through third parties, e.g., integrating information into administration processes coming from financial intermediaries, other parts of government, other taxpayers, and other tax administrations;
- adopting reporting systems that are more reliable;

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³ Regulation (EU) 2024/1689 of the European Parliament and of the Council laying down harmonized rules on artificial intelligence and amending Regulations (EC) No 300/2008, (EU) No 167/2013, (EU) No 168/2013, (EU) 2018/858, (EU) 2018/1139 and (EU) 2019/2144 and Directives 2014/90/EU, (EU) 2016/797 and (EU) 2020/1828 (Artificial Intelligence Act).

⁴ OECD, *Recommendation of the Council on OECD Legal Instruments Artificial Intelligence* (OECD Publishing 2024).

⁵ For example, the Austrian Labour-Market-Opportunity-Assistance-System (Arbeitsmarkt-Chancen-Assistenzsystem (AMAS)) i.e., used to distribute training resources on the basis of calculated labour market opportunities of jobseekers; Paola Lopez, *Reinforcing Intersectional Inequality via the AMS Algorithm in Austria*, in *Proceedings of the 18th Annual IAS-STs Conference on Critical Issues in Science and Technology Studies* 289 (Günter Getzinger & Michaela Jahrbacher eds 2019), LOPEZ_Paola_DOI-10.3217/978-3-85125-668-0-16.pdf (tugraz.at) (accessed 3 Jul. 2024); Melda Karaarduc, *Zur Frage der Systematischen Diskriminierung Durch das Arbeitsmarktchancen-Assistenz-System*, 6 EALR 35, 35 (2021).

⁶ For a comprehensive overview of existing use cases of Big Data, see e.g., Melanie Swan, *Sensor Mania! The Internet of Things, Wearable Computing, Objective Metrics and the Quantified Self 2.0*, 1 J. Sensor Actuator Networks 217, 217 et seq. (2012), doi: 10.3390/jsan1030217 (accessed 3 Jul. 2024); to the use of AI in Medicine see Emilia Gómez-González, *Artificial Intelligence in Medicine and Healthcare: Applications, Availability and Societal Impact* 30 et seq. (Publications Office of the European Union 2020), <https://doi.org/10.2760/047666> (accessed 20 Jun. 2024); Sebastian Scholz, *Evidenzbasierter Einsatz von KI in der Medizin: Der Beitrag des Rechts*, in *Smart Regulation: Theorie- und Evidenzbasierte Politik* 37 (Matthias Wendland, Iris Eisenberger & Rainer Niemann eds 2023); to the Dutch algorithm for the reclamation of childcare subsidies see David Hadwick & Shimeng Lan, *Lessons to Be Learned from the Dutch Childcare Allowance Scandal: A Comparative Review of Algorithmic Governance by Tax Administrations in the Netherlands, France and Germany*, 13 World Tax J. 609 (2021), doi: 10.59403/27410pa.

⁷ Cathy O’Neill, *Weapons of Math Destruction: How Big Data Increases Inequality and Threatens Democracy* (2016); Philippe Vion-Dury, *La nouvelle SERVITUDE VOLONTAIRE, Enquête sur le projet politique de la Silicon Valley* 137 et seq. (FYP édition, 2016); Ann Cavoukian & Jeff Jonas, *Privacy by Design in the Age of Big Data* 5 (2012) (accessed 20 Jun. 2024); Ian Kerr & Jessica Earle, *Prediction, Preemption, Presumption: How Big Data Threatens Big Picture Privacy*, 66 Stan. L. Rev. Online 65, 66 (2013), https://review.law.stanford.edu/wp-content/uploads/sites/3/2016/08/66_StanLRevOnline_65_KerrEarle.pdf (accessed 20 Jun. 2024).

⁸ OECD, *Advanced Analytics for Better Tax Administration* *supra* n. 2, at 11; OECD, *The Changing Tax Compliance Environment* *supra* n. 2 at 43.

⁹ For a description of the different aims that big data analytics may pursue, see Kerr & Earle, *supra* n. 7, at 65, 67.

¹⁰ OECD, *Tax Administration 3.0*, *supra* n. 2, at 12; OECD, *Towards Seamless Taxation* 15 (OECD Publishing 2022).

¹¹ OECD, *Tax Administration 3.0*, *supra* n. 2, at 12; OECD, *Towards Seamless Taxation*, *supra* n. 10, at 15.

- improvements in services for taxpayers ‘including through e-filing, e-payment, online self-service tools and targeted help such as online live chats’
- improvements in services for taxpayers ‘including through e-filing, e-payment, online self-service tools and targeted help such as online live chats’¹²
- The OECD’s vision would thus integrate taxation into the digital systems that taxpayers use in their daily lives (such as accounting software and electronic banking). Doing so would create compliance by design. Taxes would subsequently automatically occur which would render free-riding and being non-compliant burdensome.

According to this vision, taxation will become part of a resilient ‘system of systems’ transforming digital platforms into agents of tax administrations carrying out tax administration processes within their systems. In the OECD’s vision, these systems would seamlessly interact¹³ and thus be nearly invisible to the taxpayer.¹⁴

Furthermore, digitalization will provide real-time or close to real-time tax certainty.¹⁵ The OECD acknowledges that not all taxpayer events will be appropriate for handling by digital systems. It emphasizes that tax authorities of the future will be high-tech adaptive organizations with a human touch.¹⁶ Digitalization allows rapid and easy data sharing among institutions, and the OECD conceptualizes interconnecting taxation with other government services and functions as well as those of private actors (such as banks and insurance companies; known as the whole-of-government approach¹⁷).¹⁸ The seamless connection between different data sources and processes will be enabled by a single digital identity.¹⁹

The OECD’s vision seems aspirational, however, it is close to reality as it is already somewhat occurring. It consists of assembling bits and pieces that have been deployed for a couple of years and refining them for a more effective and efficient future of tax administration.

Deploying tax administration AI is occurring in many countries around the world and is increasingly streamlined among jurisdictions regardless of the underlying concept of the relationship between the state and the taxpayers.²⁰ It can be utilized to support or even supplant tax administrations that are actually fulfilling their duties.

It is thus a component of the set of activities in the tax world that are declaration, collection and control, briefly stated, the enforcement of the substantive tax laws.

To legally evaluate the impact of tax administration AI on liberal democracy, the fundamental rights and guarantees underlying the functioning of a democratic society and thus the architecture of tax enforcement must be highlighted. Only in the context of these underlying fundamental rights and guarantees is a proper evaluation possible.

3 TAX ENFORCEMENT AND THE UNDERLYING LIBERAL DEMOCRATIC PRINCIPLES²¹

3.1 Preliminary Remarks

Tax enforcement is the exercise of coercive power by the state and interferes with personal autonomy. The way taxes can be enforced in a society depends on the relationship between the state and the individual citizen. This relationship is based on the attitude a society takes towards the autonomy of the individual and the power of the collective represented by the state to limit individual autonomy. This article addresses the deployment of tax administration AI in liberal democracies that uphold personal autonomy as a core value of their society but does not discuss its impact on any other form of government.

It does not seem that states deploying tax administration AI have wanted to change their traditional understanding of the relationship between them and the taxpayer. Thus, to legally assess the impact of tax administration AI, the concept that underlies tax collection and enforcement must be recalled.

3.2 Fundamental Rights and Guarantees

3.2.1 Personal Autonomy

The assumption of citizens as rational beings with the capacity of taking responsibility is the basis of liberal societies. It is the foundation of personal autonomy that

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¹² OECD, Tax Administration 3.0, *supra* n. 2, at 10.

¹³ *Ibid.*, at 12 f.

¹⁴ OECD, *Tax Administration 2017: Comparative Information on OECD and Other Advanced and Emerging Economies* 190 (2017).

¹⁵ OECD, Tax Administration 3.0, *supra* n. 2, at 13.

¹⁶ *Ibid.*, at 14.

¹⁷ OECD, Technologies for Better tax administration, *supra* n. 2, at 37; OECD, *Communication and Engagement with SMEs* 16, 52 ff (2023).

¹⁸ OECD, Tax Administration 3.0, *supra* n. 2, at 14.

¹⁹ OECD, Tax Administration 2023, *supra* n. 2.

²⁰ *Ibid.*

²¹ For the purpose of this text, ‘society’ is meant as the totality of people living or/and working in a territory that is entitled to call itself a state and entitled to exercise power over ‘its’ people.

constitutes the core value of liberal democracies.²² It reflects dignity and underlies the rights to free exercise of religion,²³ free speech,²⁴ privacy,²⁵ private property,²⁶ assembling with others,²⁷ etc.²⁸ The right to protection of private and family life (Article 8 of the European Convention on Human Rights [hereinafter ECHR] and Article 7 [together with Article 8] of the European Charter of Fundamental Rights [hereinafter EuCHR]) encompasses the rights to personal development and establishing relationships with other human beings and the outside world.²⁹ It secures a sphere for individuals within which they can freely develop and fulfil their personality.³⁰ It thus enshrines the right to personal autonomy.³¹ A state's interference with this is only allowed when it is necessary to safeguard the functioning of a democratic society and to prevent others from harm.

Liberal democracies depart from the idea of rational autonomous citizens (and thus rational taxpayers) who are free to decide on their lives as long as they do not harm others. For the functioning of society, and duties are conferred upon them vis-à-vis the state.³² Citizens would comply with their duties because of intrinsic motivation (the feeling of 'belonging' to a society and being responsible for its functioning³³) and because of the costs of non-compliance in the form of penalties.³⁴

In return, the state respects a sphere of its citizens in which they do not have to expect that their behaviour will

be acknowledged.³⁵ In this concept, the state has the duty to control without being allowed to constantly surveil their citizens. It is thus obligated to uniformly and equally levy the taxes and control taxpayers based on rational risk management.³⁶

3.2.2 The Right to Respect for Private and Family Life

A very important ingredient of personal autonomy is the right to and the guarantee of confidentiality which is derived from the right to respect private and family life. According to the Austrian Constitutional Court 'freedom as a right of the individual and as a state of being of a society are determined by the quality of relationships of information'.³⁷ If a 'feeling of surveillance' arises in society, this 'can have repercussions on the free exercise of other fundamental rights, such as freedom of assembly and freedom of expression'.³⁸ Similar to the ECHR, broadmindedness and tolerance as hallmarks of a democratic society require – among others – privacy.³⁹ Consequently, certain information on individuals is traditionally unknown by the state, and the individual remains anonymous. The state is only granted access to personal data and information insofar as it is necessary to fulfil its legitimate duties. This is the fundament of tax enforcement rules.⁴⁰

However, the concepts of privacy differ from one state to another. In Austria, Belgium, Luxemburg, and

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²² See e.g., Loïc Philip, *Droit Fiscal Constitutionnel: Évolution d'une jurisprudence* 82 (Economica 2014), with further references.

²³ Article 9 of the European Convention on Human Rights (hereinafter ECHR).

²⁴ Article 10 ECHR.

²⁵ Article 8 ECHR.

²⁶ Article 1 Protocol No 1 to the ECHR.

²⁷ Article 11 ECHR.

²⁸ The principle underlying the right to respect private and family life is the concept of personal autonomy; see *Pretty v. the United Kingdom*, no. 2346/02, §61, Eur.Ct.H.R. 2002-III; *Gillan and Quinton v. the United Kingdom*, no. 4158/05, §61, Eur.Ct.H.R. 2010.

²⁹ *Niemietz v. Germany* no. 13710/88, §29, Eur.Ct.H.R. 1992; *Pretty v. the United Kingdom*, *supra* n. 28; *Oleksandr Volkov v. Ukraine*, no. 21722/11, §§165–167, Eur.Ct.H.R. 2013; *El-Masri v. the former Yugoslav Republic of Macedonia* [GC], §§248–250, Eur.Ct.H.R. 2012.

³⁰ *A.-M.V. v. Finland*, no. 53251/13, §76, Eur.Ct.H.R. 2017; *Brüggenmann & Scheuten v. Federal Republic of Germany*, no. 6959/75, §§55, 57, Eur.Ct.H.R. 1977; *National Federation of Sportspersons' Associations and Unions (FNASS) & Others v. France*, no. 48151/11 & 77769/13, §153, Eur.Ct.H.R. 2018.

³¹ *Jivan v. Romania*, no. 62250/19, §30, Eur.Ct.H.R. 2020; Eur.Ct.H.R., Guide on Art. 8 of the European Convention on Human Rights – Right to respect for private and family life, home and correspondence 70 (last update 9 Apr. 2024), https://www.echr.coe.int/Documents/Guide_Art_8_ENG.pdf (accessed 24 Jun. 2022) (hereinafter ECHR Art. 8 Guide).

³² Tina Ehrke-Rabel & Barbara Gunacker-Slawitsch, *Digitales Risikomanagement der Finanzverwaltung – Plädoyer für eine nähere Regulierung*, 19 ÖStZ 522, 531 (2023).

³³ This is the behavioural science approach, Ambra Brizi et al., *Intention to Pay Taxes or to Avoid Them: The Impact of Social Value Orientation*, 50 J. Econ. Psychol. 22, 22 (2015), doi: 10.1016/j.joep.2015.06.005; Leandra Lederman, *The Interplay Between Norms and Enforcement*, in *Tax Compliance*, 64 Ohio State L. J. 1453, 1456 (2003), doi: 10.2139/ssrn.391133; OECD, *Forum on Tax Administration, Information Note, Understanding and Influencing Taxpayers' Compliance Behaviour* 11 (OECD Publishing 2010).

³⁴ The 'deterrence' approach by classic rational economics; Michael G. Allingham & Agnar Sandmo, *Income Tax Evasion: A Theoretical Analysis*, 1 J. Pub. Econ. 323, 323 (1972), doi: 10.1016/0047-2727(72)90010-2; see also Lederman, *supra* n. 33, at 1456 et seq.

³⁵ Barbara Gunacker-Slawitsch, *Amtsuebigkeit und Mitwirkung im Abgabenverfahren* 425, 575 (2020).

³⁶ Ehrke-Rabel & Gunacker-Slawitsch, *supra* n. 32, at 536.

³⁷ AT: VfGH (Verfassungsgerichtshof [Constitutional Court]) (27 Jun. 2014), G 47/2012-49, ECLI:AT:VFGH:2014:G47.2012: „die Freiheit als Anspruch des Individuums und als Zustand einer Gesellschaft wird bestimmt von der Qualität der Informationsbeziehung“.

³⁸ AT: VfGH (Verfassungsgerichtshof [Constitutional Court]) (11 Dec. 2019), G 72/2019, ECLI:AT:VFGH:2019:G72.2019.

³⁹ *Dudgeon v. the United Kingdom* no. 7525/76, §§51–53, Eur.Ct.H.R. 1981.

⁴⁰ Gunacker-Slawitsch, *supra* n. 35, at 293 et seq.; Tina Ehrke-Rabel, *Big Data in Tax Collection and Enforcement*, in *Tax and Digital Economy* 283 (Werner Haslehner, Georg Kofler, Alexander Rust eds 2019).

Switzerland,⁴¹ for example, bank account information was protected for a long time from state intervention with privacy rules except in cases of criminal offences. In Sweden, on the contrary, it was never hidden from tax authorities, and individual tax liabilities have been being publicly accessible for years. This different approach to confidentiality is likely to rely on different social norms that stem from various cultural backgrounds. Considering their impact on the interpretation of fundamental rights, it is likely that, with societies adapting to digitalization and globalization, experiences and expectations of privacy and fundamental rights in general have evolved.⁴²

In relationships between private parties, the right to respect private and family life enshrines that of individuals agreeing to be under surveillance by or scrutiny of private actors. For digital natives, it at least seems that being screened, scrutinized, profiled by private parties to understand oneself, to prevent health problems, to become informed about what is occurring in the world but also about products that one may enjoy has become a widely accepted state of being. Transparency of someone's personality to a wide public does not seem to raise any concerns with digital natives. People seem to become accustomed to being constantly surveilled by others. Compared to the pre-Internet era, social norms regarding confidentiality could have changed which could – at least in the long run – also impact human perception on the extent to which states need to respect confidentiality.⁴³

By now, the law governing the relationship between citizens and the tax enforcing state has not adapted to potential changes in the perception of confidentiality. As long as legal systems have not consciously adapted to changed social norms, state interference with individual autonomy must adhere to the 'traditional' legal understanding of this relationship. The deployment of tax administration AI must thus be examined from the perspective of the traditional understanding of the

relationship between the state as the tax collector and the citizen as the taxpayer. For the purpose of this article, the traditional concept must be recaptured.

4 THE TRADITIONAL LEGAL VIEW OF THE RELATIONSHIP BETWEEN THE STATE AND THE TAXPAYER

4.1 The Problem: Information Asymmetry in Taxation

To assess the proper amount of taxes at the right time, tax authorities require a significant amount of information related to the taxpayer and the taxable events. The facts underlying taxation are determined by the taxpayer without involving the tax administration. Thus, the former has more information about the taxable event than the latter.⁴⁴ Only the taxpayers themselves possess complete information of the taxable events without permanent state surveillance on them.⁴⁵ Furthermore, the information necessary for appropriate taxation is generally not automatically perceivable by the tax administration. Information asymmetry is thus inherent to modern⁴⁶ tax systems and is at the origin of most of the difficulties in enforcing tax laws.⁴⁷

In situations of asymmetric information, rational individuals acting in pure self-interest are likely to attempt to take advantage of their information head start to the detriment of the collective. Under the deterrence model, the government counters this behaviour by using a method of applying legal rules that are based on detection and sanctions for non-compliance.⁴⁸ The findings of behavioural economics and psychology complement this model on the empirically tested thesis that the deterrence model does not fully reflect reality in which the level of compliance is higher than under the assumptions of the deterrence model.⁴⁹ According to the proponents of this approach, model tax compliance relies on social and

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⁴¹ More information on the Austrian Bank secrecy in Maximilian Auer & Christine Anwander-Hirsch, *Bankwesengesetz – BWG Kommentar*⁴, §38 ref. 11 (Markus Dellinger ed., LexisNexis 2022); René Laurer, *Bankwesengesetz – BWG Kommentar*⁴ §38 ref. 8 (René Laurer, Melitta Schütz, Armin Kammel, Thomas Ratka eds, Manz BWG online Kommentar zum Bankwesengesetz 2023); Renate Schaubmair, *Bankgeheimnis*, in *Handbuch zur Praxis der steuerlichen Betriebsprüfung* 258 (Werner Koller, Hannes Schuh & Hubert Woischitzschlagger eds, LexisNexis 2010); Cristoph Kerres & Florian Proell, *Aktuelle Entwicklungen zum Bankgeheimnis*, 7 *Ecolex* 623, 623 (2009).

⁴² Cavoukian & Jonas, *supra* n. 7, at 7.

⁴³ In this context, Shoshana Zuboff, *The Age of Surveillance Capitalism* 351 et seq. (2019).

⁴⁴ Michael Doran, *Tax Penalties and Tax Compliance*, 46 *Harv. J. Legis.* 111, 143 (2009), even speaks about 'sharp information asymmetry'.

⁴⁵ See also Tina Ehrke-Rabel & Barbara Gunacker-Slawitsch, *Governance im Steuerrecht*, 24 *SWK* 1054, 1055 et seq. (2014).

⁴⁶ The extent of information asymmetry inherent to the relationship between the taxpayer and the state depends on the design of the relevant tax itself. A lump-sum tax applied equally to all taxpayers regardless of any real-life events or personal circumstances does not require much information to be effectively enforced; whereas, currently, largely differentiated income tax is based on a substantial amount of information that is very different from one taxpayer to another that cannot be automatically observed by persons or institutions foreign to the taxpayer.

⁴⁷ In that sense, Alex Raskolnikov, *Revealing Taxpayer Choice to Target Tax Enforcement*, 109 *Colum. L. Rev.* 689, 711 (2009); Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 *Fordham L. Rev.* 1733, 1758 (2010); Gunacker-Slawitsch, *supra* n. 35, at 1.

⁴⁸ Michal G. Allingham & Agnar Sandmo, *supra* n. 34, at 323, modified in *A Note on Income Tax Evasion: A Theoretical Analysis*, 3 *J. Pub. Econ.* 201, 201 (Shlomo Yitzhaki eds 1974).

⁴⁹ Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play In Tax Compliance*, 60 *Stan. L. Rev.* 695, 697 (2007); Michael Doran, *supra* n. 44, at 115; Alex Raskolnikov, *supra* n. 47, at 694; Leigh Osofsky, *Some Realism About Responsive Tax Administration*, 66 *Tax L. Rev.* 301, 310 (2012), doi: 10.2139/ssrn.2018905; OECD, *Forum on Tax Administration*, *supra* n. 33 at 11.

personal norms that are valid for most taxpayers whereas other taxpayers are better deterred by sanctions. In contrast to the deterrence concept, under this concept, the negative effects of information asymmetry can be at least partially overcome by increasing the trust of the taxpayers.⁵⁰ Consequently, the appropriate instruments should not be limited to prohibitions, controls, and sanctions but extend to tools that shape social norms and intrinsic motivation.⁵¹

Information asymmetry has a negative impact on taxation. First, overcoming it and enforcing it is expensive for the tax administration. Second, since tax law enforcement via audits and other instruments of control are limited by budgetary constraints, it is very unlikely that it will be totally overcome. Moreover, given that not all taxpayers behave in a tax compliant way without the threat of incurring sanctions if detected, trust alone cannot compensate for the information asymmetry either. As a result, it can constitute an obstacle to horizontal equity that is understood as similar treatment of comparable cases which is a principle underlying taxation in modern democracies.⁵²

4.2 Transparency

If the taxpayer and the tax administration possessed all of the information relevant for taxation, information asymmetry would be suppressed. Both parties would be – legally speaking – transparent. Regardless of whether one believes in the deterrence model or in a more tax morale based concept, this could be a remedy to tax non-compliance.⁵³ In a situation of full transparency, there cannot be any information asymmetry with cheating

becoming impossible. Taxpayers would then probably be fully compliant.

Transparency would reduce or even remove the need for mutual trust: When there is opacity, there is uncertainty about the underlying facts. This creates risks.⁵⁴ With full transparency, there would not be any need for trust.⁵⁵ Thus, in a fully transparent tax environment, the losses in efficiency, legality, and equality related to information asymmetry would not exist.⁵⁶

4.3 Overcoming Information Asymmetry

4.3.1 Self: Assessment

To overcome information asymmetry, tax administrations traditionally rely on the taxpayer to file a tax return and submit items of evidence that are subsequently verified and evaluated. In the event of any doubts, the tax administration begins interacting with the taxpayer by requiring further information or additional pieces of evidence before proceeding to the tax assessment. If this was done in every single tax case, the tax administrations' work would involve substantial costs.⁵⁷ With taxation being a mass phenomenon and having constant budget constraints, this type of pre-assessment verification of all submitted tax returns is, and was even in times before digitalization, almost impossible.⁵⁸ With it and with increasing opportunities to standardize taxpayer disclosure obligations along with electronic submission, many states moved to self-assessment⁵⁹ or at least introduced filing procedures similar to it.⁶⁰ In general, under such systems, audits only occur after assessment.⁶¹ Consequently, in many states,

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⁵⁰ OECD, *Trust and Public Policy, How Better governance can help rebuild public trust* (2017) 47 ff; Ambra Brizi/Mauro Giacomantonio/Birga M. Schumpe/Lucia Mannetti, *A Study of the Influence of Personality Factors on the Willingness to Pay Taxes*, *Journal of Economic Psychology*, 2015, Vol 50, 22; see also Erich Kirchler, Erik Hoelzl & Ingrid Wahl, *Enforced Versus Voluntary Tax Compliance: The 'Slippery Slope' Framework*, 29 *J. Econ. Psychol.* 210, 210 (2007), doi: 10.1016/j.joep.2007.05.004; Judith Freedman, *Responsive Regulation, Risk, and Rules: Applying the Theory to Tax Practice*, 44 *UBC L. Rev.* 628, 629 (2011).

⁵¹ Colin F. Camerer & Ernst Fehr, *When Does 'Economic Man' Dominate Social Behavior?*, 311 *Sci. New Series*, 47, 49 et seq. (2006), doi: 10.1126/science.1110600.

⁵² Horizontal equity is one of the general principles of taxation identified by the OECD in its BEPS Action 1, OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report* 21 (OECD Publishing Paris 2015).

⁵³ Thus, already OECD, *Co-operative Tax Compliance* 11 et seq. (OECD Publishing 2016).

⁵⁴ Risks presupposes uncertainty and exposure to loss (Ernst Fehr, *Economics and Biology of Trust*, 7 *J. Eur. Econ. Ass'n*, Proceedings of Twenty-Third Annual Congress of the European Economic Association 235, 235 (2009)).

⁵⁵ Ehrke-Rabel & Gunacker-Slawitsch, *supra* n. 32, at 537.

⁵⁶ For a comparison between the two approaches, see Doran, *supra* n. 44, at 112.

⁵⁷ According to the OECD's *Tax Administration 2017: Comparative Information on OECD and other Advanced and Emerging Economies* 191 (OECD Publishing 2017), most tax administration systems are currently still based on this system.

⁵⁸ See on this Markus Achatz, *Umfang und Grenzen der Offenlegungspflicht im Abgabenverfahren*, in *Die Darlegung der Verfehlung bei der Selbstanzeige nach dem FinStrG* 21, 28 (Roman Leitner & Rudolf Zitta eds 2001); Tina Ehrke-Rabel & Barbara Gunacker-Slawitsch, *Die Bedeutung von Governance im Steuerrecht*, 1 *Austrian L. J.* 99, 99–111 (2014) (20 *Jun.* 2024); Roman Seer, *Steuerrecht*, §21 paras 6 et seq. (Klaus Tipke & Joachim Lang eds 2017)).

⁵⁹ During the tax year, e.g., VAT is self-assessed. Only at the end of the year do taxpayers have to file a tax return. Taxes on wages or on capital income are very often self-assessed.

⁶⁰ In Austria, e.g., income tax is not formally subject to self-assessment, but the functioning of electronic filing in connection with the data-based tax risk management system of the tax administration and the electronic issuance of tax notes is similar to self-assessment (see Tina Ehrke-Rabel, *Rechtskraft im Abgabenverfahren*, in *Korrektur fehlerhafter Entscheidungen* 247, 247 (Michael Holoubek & Michael Lang eds 2017)).

⁶¹ Since the taxpayer is responsible for the information relevant for taxation, he can determine his tax liabilities at a relatively lower cost than the government can. From a government perspective, it thus makes sense to introduce self-assessment.

post-assessment tax audits still constitute the most important tool⁶² to achieve correct taxation.⁶³ Furthermore, regardless of the moment of verification – be it ‘pre’ or ‘post’-assessment, in the case that the tax authority doubts the accuracy of the taxpayer’s declaration, it is generally afforded the opportunity to ask third persons for testimony.

4.3.2 Tax Risk Management

Given the mass of taxpayers, the enormity of taxpayer data necessary for appropriate tax assessment, the European and western American understanding of individual autonomy and the limitation of state resources to enforce the law, tax authorities have always been relying on taxpayer declarations and have never been able to control 100% of the taxpayers.⁶⁴ To find a balance between the obligation to treat all taxpayers equally and the limitation of state resources for full control, tax authorities have been elaborating risk management systems for a long time. They support tax administrations in making better decisions to targeting the risky instead of everyone to channel state resources to where they need to be deployed.⁶⁵

An important part of tax risk management consists of detecting abnormalities in reported taxpayer data to decide whether to audit cases. This is not necessarily the detection of tax fraud. Even in brick-and-mortar times, tax risk management was eased by obligating taxpayers to submit their declarations, e.g., their tax-relevant data – in a structured way by using forms. However, the analysis of these data was executed by human brains, assorted public service agents with distinct experiences, various states of mind, and dissimilar ways of thinking and evaluating data (even though they were all trained the same way). The laws obligated tax agents to proceed rationally and to treat taxpayers equally. In case of severe errors, the tax agents were to be held responsible for their actions.

Besides risk-management, tax authorities would – even in the pre-digitized era – interact with taxpayers by providing assistance in understanding the complexity of tax laws and their application in taxpayers’ lives by providing standardized forms and other types of support.

4.3.3 Digitized Tax Enforcement

AI systems currently support or supplant taxpayer services and risk-management. Tax authorities deploy chatbots to assist taxpayers and eventually collect additional information on them.⁶⁶ They run AI-systems to choose taxpayers for audits⁶⁷ and to segregate them into different groups of compliance.⁶⁸ In tax enforcement, both prescriptive and predictive as well as pre-emptive analytics are already being utilized. Best practice reports published by the OECD show examples from various countries in which tax administrations use big data analytics for different purposes.⁶⁹

AI can support the creation of (new) intrinsic motivation,⁷⁰ e.g., by implementing Behavioural Insights in AI-tools. An interesting example can be found in the OECD report ‘Tax Administration 2022’.⁷¹ In Spain, for example, the tax authorities provide taxpayers with pre-filled tax returns that they can amend. As many modifications are incorrect, the Spanish tax authorities have developed algorithms that classify taxpayers into different categories by analysing existing data from the past. If taxpayers want to make changes that the system identifies as error-prone, they are shown a ‘nudge’ message to reduce incorrect inputs. According to the OECD report, these messages have had a very good effect.

Information asymmetry would be mitigated if tax administration AI was fully embedded into taxpayers’ natural and business environments. It could contribute to at least increase, or eventually create transparency of the taxpayer. According to the OECD, this could be achieved at least for a large group of taxpayers.⁷²

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⁶² This system is generally referred to as one that is based on filing and post assessment cross-checking (OECD, *Tax Administration 2017*, *supra* n. 57, at 190); OECD, *The Changing Tax Environment*, *supra* n. 2, at 24.

⁶³ *Ibid.*, at 36, a tax audit is still the dominant administrative function using just under one third of the staff. However, audit rates are relatively low for the United States, see Leandra Lederman, *supra* n. 47, at 711; for Tina Ehrke-Rabel, *supra* n. 60, at 252; BMF, *Geschäftsbericht der österreichischen Steuer- und Zollverwaltung 57* (2020), https://www.bmf.gv.at/dam/jcr:bbb66fb4-d76c-41c7-9876-d47d5c32669a/Gesch%C3%A4ftsbericht_2020_DE_PDF_UA.pdf (accessed 24 Jun. 2024).

⁶⁴ Roman Seer, in AO §85 Rz 27 (Klaus Tipke & Heinrich W. Kruse eds Jan. 2017); Roman Seer, *Steuervollzug und Rechtsstaat*, 31 DStJG 7, 11 (Werner Widmann eds 2008); Gunacker-Slawitsch, *supra* n. 35, at 546 et seq.

⁶⁵ OECD, *The Changing Tax Compliance Environment*, *supra* n. 2, at 38; European Commission, *Risk Management Guide for Tax Administrations*, Fiscalis Risk Analysis Project Group, Version 1.02 (Feb. 2006), at 2.

⁶⁶ Sarah Domes-Hohl, Tina Ehrke-Rabel & Barbara Gunacker-Slawitsch, *Automatisierung des Steuervollzugs: Finanzverwaltungs-Chatbots*, 6 ÖStZ 145, 147 (2024).

⁶⁷ OECD, *Advanced Analytics for Better Tax Administration*, *supra* n. 2, at 20 et seq.; OECD, *The Changing Tax Compliance Environment*, *supra* n. 2, at 72; Ehrke-Rabel & Gunacker-Slawitsch, *supra* n. 32, at 535.

⁶⁸ European Commission, *supra* n. 81 at 29 et seq.

⁶⁹ For example OECD, *The Changing Tax Compliance Environment*, *supra* n. 2, at 57; OECD, *Tax Administration 2023*, *supra* n. 2, at 91 et seq.; European Commission, *supra* n. 65, at 39 et seq.

⁷⁰ OECD, *Forum on Tax Administration (FTA), Behavioural Insights for Better Tax Administration* (OECD Publishing 2021); OECD, *Tax Administration 2023*, *supra* n. 2, at 83.

⁷¹ OECD, *Tax Administration 2022, Comparative Information on OECD and other Advanced and Emerging Economies* 61 (OECD Publishing 2022).

⁷² OECD, *Towards Seamless Taxation*, *supra* n. 10, at 11 et seq.

By embedding it within taxpayer natural systems, taxpayers would be relieved of their tax reporting obligations and cheating the laws would require active steps whereas AI could support quasi automated taxation (in-built compliance).⁷³ These new tools change tax enforcement and challenge the balance of fundamental rights against the public interest in effective and efficient enforcement. Taxation could shift from voluntary compliance (requiring taxpayers action) to forced compliance (taxation without any active contribution from the taxpayer).⁷⁴

5 WHY TAX ADMINISTRATION AI REQUIRES LEGAL ACTION

5.1 AI Systems and Single Human Brains are not Alike

AI systems are different from the activity of a single human brain. On one hand, they constitute a super-machine with capacities that a single human brain could never deploy. On the other hand, they remain a machine without the singularities of a human brain which are – among others – the ability to find causalities, to understand the physical world, and have real empathy. Only after assessing the differences between a human tax officer's brain and a tax AI system can conclusions be drawn for the legal evaluation of deploying AI systems in tax enforcement.

AI systems are the better statisticians. They differ from a human brain by:

- (1) The volume of data: substantial amounts of data can be processed in a structured way.
- (2) The velocity of data processing: machine-based systems are far quicker in processing vast amounts of data than a single human brain.
- (3) The variety: machine-based systems can process vast variety of data from different sources since the web is not involved, they can automatically accede various (national, European, international) databases and retrieve data from business systems connected to the web (Internet of Things; IoT, e.g., web-based electronic cash registers with real-time connection to the tax authorities). They do not need to simply rely

on the data submitted by taxpayers and third-parties to eventually search for new data sources in the event of doubt.

- (4) Access to data: If properly set up, machine-based systems can rely on a vast amount of data with a likelihood of important validity. This can be achieved, for example, by granting access to various databases via Application Programming Interfaces; APIs⁷⁵ or by commonly storing data using distributed ledger technology.
- (5) Machine-based systems are much more efficient in cross-checking enormous amounts of data:

In another less familiar aspect, any built-in bias produces effects on a larger scale than any bias in a single tax officers' brain.⁷⁶ Moreover, AI can only detect patterns based on correlations, cannot set up causalities, and its works are based on statistics.⁷⁷ Human reflection is not restricted to statistics. This means that tax administration AI is not originally ethically responsible and cannot reflect and question the outcomes. With AI, everything depends on its programming and on its training: it can only act and react to the way that it has been programmed and trained. It cannot evaluate the accuracy of the data it processes and cannot make a difference regarding its origin.

5.2 The Deployment of Tax Administration AI Needs a Clear Framing by Law

Just like anything that the state deploys to fulfil its public tasks, AI must be appropriately framed by law to ensure that it does not increase inequality in tax enforcement. Mindfulness in the context of tax enforcement means that any enforcement tool needs to be based on clear legal rules respecting the core values of society which are equality before the law, more clearly when it comes to tax enforcement; equal treatment of all taxpayers; respect of privacy; and freedom to conduct any business activity.⁷⁸ Taxpayers must certainly not know how AI works in detail, but they must know that tax administrations deploy it to complete their tasks and they must know for which objectives AI is deployed and which data are retrieved from which sources.⁷⁹

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⁷³ OECD, Tax Administration 3.0, *supra* n. 2, at 12; OECD Towards Seamless Taxation, *supra* n. 10, at 15–16.

⁷⁴ Richard. T. Ainsworth & Boryana Madzharova, *Real-Time Collection of the Value-Added Tax: Some Business and Legal Implications*, <http://www.bu.edu/law/faculty/scholarship/workingpapers/2012.html>.

⁷⁵ OECD, *Unlocking the Digital Economy – A Guide to Implementing Application Programming Interfaces in Government* (OECD Publishing 2019); OECD, Towards Seamless Taxation, *supra* n. 10, at 18 et seq.

⁷⁶ Ehrke-Rabel & Gunacker-Slawitsch, *supra* n. 32, at 534.

⁷⁷ AI is the sovereignty of the 'par-coeur' and statistics (Le Monde 20 Aug. 2024), at 11.

⁷⁸ The values on which the European Union is based are anchored in Art. 2 of the Treaty of the European Union, Journal of the EU, C 203/13 (C 203/17).

⁷⁹ Tina Ehrke-Rabel, *Automatisierter Steuervollzug*, 31 JRP 38, 47 et seq. (2023); Barbara Gunacker-Slawitsch, *Algorithmen im Steuerrecht*, in *Algorithmen im Wirtschaftsrecht* 63, 84 ff (Studiengesellschaft für Wirtschaft und Recht 2023).

AI systems are not just another tool to support tax authorities in carrying out their duties. In theory, they can replace a human brain and could make decisions instead of a human. Reportedly, many countries deploy some type of artificial intelligence to choose taxpayers for audits, to check taxpayer data during an audit, or to prefill tax returns.⁸⁰ Moreover, tax administration AI can contribute to segregating taxpayers in different groups and allow micro-targeted action of tax authorities.⁸¹

As no one can look into a human brain to understand the reasoning underlying a decision no one can look into an AI system to perfectly explain its outcome, but contrary to the human brain one cannot ask the AI system. Furthermore, the scale of harm that a wrongful AI system can cause is enormous compared to the one a single human brain can do. Last, the human who has made an erroneous decision (e.g., an illegally discriminating decision) can be held responsible for their wrongdoing.

To effectively address these issues, the deployment of tax administration AI must meet a number of legal prerequisites despite the fact that it might not classify as high-risk AI in the context of the EU AI Act.⁸²

The legal prerequisites relate to the following:

- (1) The source of the data: in a liberal democracy, 'free' web scraping is not allowed, and deploying tax administration AI must not lead to secret surveillance of the taxpayer.⁸³
- (2) The age of the data used: in a liberal democracy, everyone has the inherent capacity of changing their attitude (also) towards the state.⁸⁴ Taxpayer data must not be outdated even if they constitute only a small portion of the entire data set used for evaluation.
- (3) Processing the data: unsupervised machine learning for tax enforcement purposes is unacceptable in a liberal democracy. Supervised machine learning must ensure that the trainers of the machine are familiar with the fundamentals of tax enforcement rules, especially with the fundamental taxpayer rights that underlie the interaction between taxpayers and the tax administration. Due regard

must be given to the training of the machine even when it is conducted by skilled personnel.

- (4) The objective of data processing: tax enforcement must not be equated with crime detection. It fulfils the purpose of uniform tax collection and efficient control. Eventually, it leads to detecting tax offences. As a consequence, tax controls – even if supported by AI – must not be limited to those who are esteemed to be non-compliant. Tax authorities are also obligated to control taxpayers randomly to detect faults or irregularities. As this regularly leads to state interference with the right to privacy, the objective of data processing (and thus the importance of the objective of general interest) and the severity of state interference must be appropriately balanced.⁸⁵ Furthermore, segregating taxpayers according to their presumed level of tax compliance with the effect of treating them differently in the context of 'micro-targeted' tax enforcement must be disclosed. Not only the exercise of segregation must be revealed, but also the parameters used and the consequences related to the different outcomes must be made public. In a liberal democracy, the taxpayer must have the possibility to challenge unequal or disproportionate treatment before the court.⁸⁶
- (5) 'Natural' limitations of deploying AI: AI works statistically, therefore, it can detect patterns and correlations, but it cannot find causalities. It can thus only be utilized when these capacities are needed. Audit selection is one of these cases. To preserve the function of tax controls that consists of uniform and equal tax control (and not solely detecting tax crimes), it must include random controls of non-'abnormal' tax declarations.⁸⁷
- (6) Human intervention and final decision by a human given the limitation of AI to correlation without causality and the biases and noises that can be woven into the systems⁸⁸: A human must be able to intervene when the outcome of the AI's activity is likely to treat taxpayers differently (e.g., subjecting supposedly risk-prone taxpayers to a type of regular

Notes

⁸⁰ OECD, *Tax Administration 2023*, *supra* n. 2, at 46 et seq.

⁸¹ European Commission, *supra* n. 81, at 30; Ehrke-Rabel & Gunacker-Slawitsch, *supra* n. 32, at 533 et seq.

⁸² An evaluation of tax administration AI under the EU AI Act is not the purpose of this article and is thus omitted.

⁸³ According to the ECHR's case law, secret surveillance measures carry the risk of undermining or destroying democracy even if they serve a public interest; *Klass v. Germany*, no. 5.029/71, §49 Eur.Ct.H.R. 1978; *Szabó and Vissy v. Hungary*, no. 37.138/14, Eur.Ct.H.R.1999; in more detail, Gunacker-Slawitsch, *supra* n. 35, at 575 et seq.

⁸⁴ The 'right to be forgotten' as an essential component of a free society is expressed in Art. 17 GDPR, Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 Apr. 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation).

⁸⁵ For many, Case C-817/19, *Ligue des droits humains v. Conseil des ministres* (21 Jun. 2022), ECLI:EU:C:2022:491, at 116.

⁸⁶ Ehrke-Rabel, *supra* n. 79, at 61 s; Gunacker-Slawitsch, *supra* n. 35 at 575; Ehrke-Rabel & Gunacker-Slawitsch, *supra* n. 32, at 537–538.

⁸⁷ According to the German Fiscal Code (*Abgabenordnung*), it must therefore be ensured that, when using risk management systems, a certain number of cases are randomly selected for a comprehensive audit (§88 para. 5 no 1 AO); for more details, see Roman Seer, *Abgabenordnung Kommentar* §88 Abs 5 ref 76, 77 (Klaus Tipke & Heinrich W. Kruse eds 2017).

⁸⁸ O'Neill, *supra* n. 7.

check and not monitoring supposedly risk-averse taxpayers at all). The final decision must be from a human if the tax is assessed differently from the tax return.

Deploying tax administration AI is not just using a tool such as a typewriter to ease tax administrations' duties; it is a new form of tax administration. Therefore, the encoding procedure must be open to judicial control as only that can ensure that the system does not contain inbuilt inequalities.⁸⁹ There must be either transparency on the core functioning of the machine-learning system or, as a supplant, a form of legitimization with a formal procedure that could be audited by a specific independent body.⁹⁰

In societies that rely on the rule of law, there must be clear rules on deploying AI, and there must be safeguards that allow the individual to have the proper functioning of the AI checked by an independent party. Only then does the deployment of government AI confer with the principle of separation of powers that is a core principle of a liberal democracy. The basis for administrations' exercise of power must be stipulated by law. As a consequence, a legal foundation is needed whenever AI supplants or supports governments. The administration is obligated to implement the law, and the normal addressees must be able to have their actions reviewed by the courts. Thereby, the courts ensure the supremacy of the law and thus democracy.⁹¹

If tax Administration AI is deployed in a mindful way, it is likely not only to increase the efficiency of state actions but also equality. As long as AI continues to be used for selecting taxpayers for audits or of running a chatbot to answer easy questions for taxpayers,⁹² the meeting of the outlined legislative needs may render liberal democrats happy.

5.3 Some Tax Administration AI 'Futuristics' May Irremediably Interfere With Personal Autonomy

The OECD's vision and what is already being deployed by states – still in a dispersed manner but proceeding to be more homogeneous – goes much further. To make taxes just happen by embedding tax enforcement into the

taxpayers' natural and business systems means attaching tax enforcement to taxpayers' everyday world which is – to a large extent – connected to the digital world.⁹³ Online and offline are difficult to distinguish and are inseparably interwoven in many areas of human life⁹⁴ much like private lives and business. Private consumption entails tax consequences as do professional activities. If citizens' natural and business systems are connected to the tax administration, even if only via an API that allows retrieving selected information, tax administration becomes an omni-present part of citizens' lives. Embedded systems that make taxes just happen presuppose that real-life events and their tax assessment are clear-cut and unambiguous. As long as legal rules must cover a range of real-life events that are unique in their shape⁹⁵ and as long as legal rules use natural language, there will be ambiguity and a degree of uncertainty that needs to be deliberated and be open to final interpretation by independent bodies. If this cannot be ensured in a seamless tax-life, there is a threat to individual freedom and to democracy as freedom from the non-legitimized exercise of power over people.

6 CONCLUSION

Liberal democracies are based on the concept of the free person who is a rational being capable of understanding their behaviour and taking responsibility for it. The state may only interfere with individual freedom when it has a legal basis, if it is necessary to safeguard the functioning of a democratic society, and to prevent others from harm. Therefore, in liberal democracies, citizens have duties to fulfil and responsibilities to bear. In return, they are not and must not be surveilled by the state. Tax enforcement is built upon this concept.

Tax administration AI – as any other AI – has the potential to change this concept of the free individual with clear duties and responsibilities vis-à-vis the state and the society as well as the state with clearly defined empowerment. Without a clear legal basis for deploying AI by governments, the utilization of governmental AI can endanger the fundamental principles of a liberal democracy. What is technically feasible is not necessarily appropriate for sustaining the fundamental values of a liberal society.

Notes

⁸⁹ Ehrke-Rabel & Gunacker-Slawitsch, *supra* n. 32, at 536–537.

⁹⁰ Tina Ehrke-Rabel, *Die Automatisierung des Verwaltungsverfahrens am Beispiel des Abgabenrechts*, in *Auswirkungen der Digitalisierung auf die Erlassung und Zuordnung behördlicher Entscheidungen* 21, 61 (Nadja Braun Binder, Peter Bußjäger & Mathias Eller eds 2021); Gunacker-Slawitsch, *supra* n. 79, at 84–93.

⁹¹ Gregor Kirchhof, *Die Allgemeinheit des Gesetzes* 300 et seq. (2009).

⁹² However, 'simple questions' may not be simple in their essence, especially when the chatbot provides the answers in plain language (on this topic, see Joshua D. Blank & Leigh Osofsky, *Simplexity: Plain Language and the Tax Law*, 66 Emory L. J. 189, 190 et seq. (2017)); Joshua D. Blank & Leigh Osofsky, *Automated Legal Guidance*, 106 Cornell L. Rev. 179 et seq.

⁹³ OECD, *Tax Administration 3.0*, *supra* n. 2; OECD, *Towards Seamless Taxation*, *supra* n. 10.

⁹⁴ Mireille Hildebrandt & Antoinette Rouvroy, *Law, Human Agency and Autonomic Computing* (2011).

⁹⁵ Kirchhof, *supra* n. 91.

If society wants to uphold the values of liberal democracies, any deployment of tax administration AI must be legally framed with clear rules on the origin of the data, the method of data processing (in general terms, without having to explain the underlying mathematical model in detail), the aim of the data processing, and the possibility of human intervention. Additional legal prerequisites may be necessary depending on the purpose of the use of tax administration AI. If it is deployed in a mindful way, it is likely to increase both the efficiency and the equality of tax enforcement.

However, some available technical possibilities (some tax administration AI ‘futuristics’) may irremediably interfere with the core values of a liberal democracy. These fundamental values would be irretrievably jeopardized if the commencement for shaping the relationship between the state and the citizens is no longer the freedom of the individual person but that of the state’s action if the digital transformation leads to permanent state surveillance to monitor taxpayers’ willingness to cooperate and if the normal addressees have no chance to challenge state action before the court. If tax administration becomes a seamless experience for taxpayers with numerous datapoints connected to each other and allow governments access to a multitude of data available on different online databases without actively involving the taxpayer, the preservation of liberal democratic values seems to become impossible. Legal scholars must openly discuss whether this is an aim to pursue. Additionally, voters have to consciously decide whether this is the life they want to live: No tax cheating anymore for the price of permanent presence by the state. Making the deployment of tax administration just happen is not the way that changes in the core values of a free society should take place.

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Increasing Direct Tax Harmonization and the Role of Tax-Relevant Economic Guarantees in Primary EU Law – a Reflection on a (yet to be Formed) Trend*

Moritz Scherleitner**

The court is showing a tendency towards exposing secondary EU law to a less intensive review under primary EU law than it does for national law. With a potentially large wave of direct tax law harmonization ahead, this has been met with alertness in literature as it may not be adequate for the field of taxation. Against this background, this article elaborates on the development of a direct tax relevant doctrine on the enforcement of economic rights enshrined in primary EU law. The core argument worked out by the author can be summarized as follows. Given the weak democratic legitimization of EU direct tax directives, and having regard to the fact that they are extraordinary difficult to adapt or abolish, the court has an increased responsibility to protect taxpayers' economic rights – particularly when the underlying legislative decision or value is not worth being upheld at the cost of an infringement of such rights.

Keywords: Fundamental rights, economic fundamental rights, charter, EU tax, primary EU law, secondary EU law, harmonisation.

I A CONSTITUTIONAL LEGAL ORDER – HOW SERIOUSLY IS IT TAKEN?

The EU has a constitutional legal order. Thus, primary EU law supersedes secondary EU law, and the latter can only be based on the former.¹ Yet, although this is true in legal terms, in that reality is more nuanced, with literature indicating that the court is showing a tendency towards exposing secondary EU law to a less intensive review under primary EU law than it does for national law.² With a potentially large wave of direct tax law harmonization ahead, this has been met with alertness in literature³ as it may not be adequate for the field of taxation.

In the (natural) absence of a far developed direct tax specific doctrine from the European Court of Justice

(ECJ), this article aims to add to the already rather broad debate on the establishment of a common European constitutional understanding that was already identified twenty-five years ago as the necessary commencement of European tax harmonization.⁴ In an attempt to further generalize considerations brought up in a previous contribution,⁵ the author aims to address the question as to how the court may – and should – uphold taxpayers' economic rights included in primary EU law when reviewing secondary EU direct tax legislation.

Focusing on this issue appears to be of increased relevance given the need to base direct tax harmonization on Article 115 of the Treaty on the Functioning of the European Union

Notes

* The problem this article deals with and expands on has been worked out by Moritz Scherleitner and Noora Mäki, 'The HOT Proposal and Primary EU – An Examination and Suggestions to Address the Tensions' <https://papers.ssrn.com/abstract=4831752> accessed 12 Jun. 2024 under reference to the HOT proposal. The novelty of this article lies in the first mentioned authors being alerted by the problem worked out in *ibid.* aiming to generalize and further develop these thoughts in the context of there being a potential of far reaching harmonization in EU tax law taking place.

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¹ In detail, see e.g., K. E. Sørensen, *Reconciling Secondary Legislation and the Treaty Rights of Free movement*, 3 Eur. L. Rev. 339–361 (2011); P. Syrpis, *The Relationship Between Primary and Secondary Law in the EU*, 52(2) Common Mkt. L. Rev. 461–487 (2015), doi: <https://doi.org/10.54648/COLA2015029>; R. Szudoczky, *The Sources of EU Law and their Relationships: Lessons for the Field of Taxation: Primary Law, Secondary Law, Fundamental Freedoms and State Aid Rules* (IBFD 2014); Rita Szudoczky, *The Relationship Between Primary, Secondary and National Law*, in *Research Handbook on European Union Taxation Law* 93–118 (Edward Elgar Publishing 2020), <https://www.elgaronline.com/edcollchap/edcoll/9781788110839/9781788110839.00011.xml>. See also Caroline Heber, *Enhanced Cooperation and European Tax Law* 218 et seq. (Oxford University Press 2021); Georg Kofler, *Europäischer Grundrechtsschutz Im Steuerrecht, Europäischer Grundrechtsschutz im Steuerrecht* (Verlag Dr Otto Schmidt 2018), <https://www.degruyter.com/document/doi/10.9785/9783504386009-005/html> (accessed 27 Feb. 2024).

² See s. 2.

³ Recently, for instance, Johanna Hey, *Gleichheitssätze im europäischen Steuerrecht*, in *Europäisches Steuerverfassungsrecht* vol 11 (Johanna Hey & Wolfgang Schön eds, Springer Berlin Heidelberg 2023), https://link.springer.com/10.1007/978-3-662-67474-1_7 (accessed 27 Feb. 2024); Paul Felix Lemmen, *Die Bedeutung der EU-Grundrechtecharta für das nationale Steuerrecht: eine Untersuchung am Beispiel des unionsrechtlichen allgemeinen Gleichheitssatzes* (Mohr Siebeck 2022).

⁴ Juliane Kokott, *Das Steuerrecht der Europäischen Union* (CH Beck 2018) s. 4 under reference to; Klaus Tipke, *Europäisches Steuerverfassungsrecht. Eine Rechtsvergleichende Übersicht, in Staaten und Steuern. Festschrift für Klaus Vogel zum 70. Geburtstag* (Paul Kirchhof and others eds, CF Müller 2000).

⁵ Moritz Scherleitner & Noora Mäki, *The HOT Proposal and Primary EU Law – An Examination and Suggestions to Address Possible Validity Concerns*, 16 World Tax J. 3 (2024).

(TFEU) and thus on unanimous decision making in the council. Therefore, once implemented, European direct tax law can only be changed and abolished if every Member State agrees to it.⁶ This is stark contrast to national tax law for which national parliaments, being subject to recurrent re-election, can implement, amend, and abolish tax legislation (usually) based on majority decision making whenever they determine a need for it. If the reader, concurring with the author, is prepared to argue that direct tax law is inherently an area that requires rather constant legislative maintenance, the current EU's institutional setting cannot be regarded as optimal, particularly for direct tax harmonization endeavours that are more complex. One Member State – be it in search of defending a certain interest or after blackmailing the rest of them – is enough to block the initiative thereby risking that it becomes stuck in the past. While this is a well-known problem that Member States are (still) willing to accept,⁷ this article will argue that it poses a special responsibility on the ECJ in enforcing taxpayers' economic rights.

The article will proceed as follows. In section 2, there will be a brief reflection on the tension in which the ECJ is caught when examining secondary EU law in the light of primary EU law. Thereupon, in section 3, it will be argued that direct taxation is a highly sensitive field that is structurally lacking decision making mechanisms that allow it to be adequately maintained and further developed. It therefore requires additional and somewhat different considerations than ordinary secondary EU law aiming at the advancement of the Internal Market. In section 4, the author will then concentrate separately on the three main channels that the court has at its disposal concerning the protection of economic rights. The focus will first be on competence control which protects the community of taxpayers by requiring secondary tax EU law to comply with the principles of subsidiarity and proportionality and to overall advance the internal market (4.2). Thereafter, the author discusses the fundamental freedoms (4.3) as well as Articles 16 and 20 of

the Charter of Fundamental Rights (ChFR) (4.4). In their relevant field of application, these rules grant the right to the individual taxpayer to defend himself against legislation that disadvantages him vis-à-vis other groups provided that it cannot be justified and/or is not proportional.

2 EXAMINING SECONDARY EU LAW UNDER PRIMARY EU LAW – WHY IS THIS SPECIAL?

The court faces a difficult task when examining secondary EU law under primary EU law.⁸ On the one hand, it has a responsibility to protect the guarantees enshrined in primary EU law. These fundamental prerogatives form the constitutional foundation of the European project and upholding them is ultimately a matter of upholding the rule of law.⁹

On the other hand, however, the court must be careful not to upset the institutional balance of the Union by making or overriding decisions that legitimately belong to the secondary EU law legislator.¹⁰ This is also of high practical relevance particularly regarding the difficulties in a supranational law setting – not in the least as the secondary EU law legislator must be granted a certain degree of flexibility in order to react to unforeseen challenges. Furthermore, although reaching a unanimous decision among ministers in the council is less burdensome than creating primary EU law,¹¹ it still remains that it is the same Member States that have signed the treaties that are now giving effect to its abstract and general terms by setting secondary EU law.¹² This more political than legal view calls for broad discretion of the secondary EU law legislator that even tolerates limiting the effect of the general and abstract principles included in primary EU law.¹³

Literature tends to regard the court to solve this dilemma in favour of a more lenient review of secondary EU law under primary EU law.¹⁴ The author shares this

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⁶ See further going, instead of many, Georg Kofler, *EU Power to Tax: Competences in the Area of Direct Taxation*, in *Research Handbook on European Union Taxation Law* (Christiana HJI Panayi, Werner Haslechner & Edoardo Traversa eds, Edward Elgar publishing 2020); Juliane Kokott, *Kompetenzen des Europäischen Steuergesetzgebers*, in *Europäisches Steuerverfassungsrecht* vol 11 (Johanna Hey and Wolfgang Schön eds, Springer Berlin Heidelberg 2023), https://link.springer.com/10.1007/978-3-662-67474-1_3 (accessed 19 Aug. 2024); see for conceptually interesting elaborations on this topic, Wolfgang Schön, *Facilitating Entry by Facilitating Exit: New Paths in EU Tax Legislation*, 46 339 (2018), doi: <https://doi.org/10.54648/TAXI2018033>.

⁷ The commission's initiative proposing a change in decision-making requirements in taxation matters based on the passerelle clause has failed. See European Commission, Communication from the Commission to the European Parliament, the European Council and the Council – Towards a more efficient and democratic decision making in EU tax policy 2019. *European Council*, Outcome of the Council Meeting: 3671st Council meeting Economic and Financial Affairs, 6301/19 (2019).

⁸ In more detail on these and further going arguments, including further references, see e.g., Szudoczky, *supra* n. 1; Szudoczky, *supra* n. 1; Syrpis, *supra* n. 1, at 461; Sørensen, *supra* n. 1, at 339.

⁹ Szudoczky (2020), *supra* n. 1, at 95.

¹⁰ See in this respect particularly Koen Lenaerts, *How the ECJ Thinks: A Study on Judicial Legitimacy*, 36 *Fordham Int'l L. J.* 1302, 1310 (2013).

¹¹ In particular, there is no direct involvement of the national parliaments. See further on the democratic deficit this is giving rise to, F. Vanistendael, *EU Elections and EU Taxation*, *Tax Notes Int'l* 729, 732 (2019).

¹² Szudoczky (2020), *supra* n. 1, at 93 et seq. referring also to; Armin Von Bogdandy, *The European Union as a Human Rights Organization? Human Rights and the Core of the European Union*, 37 *Common Mkt. L. Rev.* 1307, doi: 10.54648/315870.

¹³ Szudoczky (2020), *supra* n. 1, at 93 et seq. referring also to; Von Bogdandy, *supra* n. 12.

¹⁴ See for a broad elaboration, e.g., Szudoczky (2014), *supra* n. 1; Szudoczky (2020), *supra* n. 1; Syrpis, *supra* n. 1; Hey, *supra* n. 3; Jasper JAM Korving, *Article: The European Triangle: On the Relationship Between Primary EU Law, Secondary EU Law and National Law in the Field of Direct Taxation*, 35 *Eur. Bus. L. Rev.* (2024), <https://kluwerlawonline.com/api/Product/CitationPDFURL?file=Journals/EULR/EULR2024008.pdf> (accessed 27 Feb. 2024).

perception. Yet, it is nonetheless important that this is not misunderstood as the court being ignorant of the constitutional relationship enshrined in EU law. To the contrary, the ECJ has, not even rarely, invalidated secondary EU law due to it breaching primary EU law.¹⁵ Furthermore, the court has used other and lighter means to give factual effect to primary EU law guarantees. As explicitly emphasized by its president, the court attempts to uphold secondary EU law by interpreting it 'as far as possible, in such a way as not to affect its validity'¹⁶ and to do 'everything within its jurisdiction to interpret secondary EU law in accordance with primary EU law'.¹⁷ While this has happened through partly truly adventurous interpretations,¹⁸ this softer way of reconciling the will of the secondary EU law legislator with the guarantees of the primary EU law occurs more frequently as the outright invalidation of secondary EU law¹⁹ and underscores the need for a nuanced view of the court's approach in the constitutional review of secondary EU norms. Even more, the court has even been prepared to factually disarm certain (integration unfriendly) exemptions included in primary EU law that it reached through providing interpretations that – although sensible as such – are contrary to the rather obvious will of Member States.²⁰ Nevertheless, such examples of 'pushing the bounds of interpretation to the utmost'²¹

cannot exceed the limits of *contra legem*.²² Hence, if the clear wording of the secondary EU law provision does not allow taking away the conflicting primary EU law through a consistent interpretation, the court will be forced to decide on whether it declares the secondary EU law void or not.²³

3 IS (EUROPEAN) DIRECT TAXATION SPECIAL?

3.1 Too Little Protection by Consent Requiring Stronger Protection by Content?

Taxation is at the core of an area in which central principles of modern constitutionalism are in tension²⁴: On the one hand, states assume responsibility for a wide range of tasks. This has to be funded, and taxation is the predominant source for it. As such, taxation is justified *per se*.²⁵ On the other hand, at least in Western democracies freedom and the private sphere are subject to particular protection with which taxation is interfering.²⁶ Conceptually, balancing these conflicting ideas is for the democratically legitimized parliament through which citizens essentially have the possibility to decide how much tax to impose on themselves.²⁷ This 'protection by consent'²⁸ emphasizes the need for democratic legitimation and control of the tax legislator which is given effect through recurrent elections reconfirming voters' commitment to taxation rules.²⁹ In addition, and although the

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- ¹⁵ For a discussion, see particularly Szudoczky (2014), *supra* n. 1; Szudoczky (2020), *supra* n. 1; Syrpis, *supra* n. 1; Karsten Sorensen, 'Reconciling Secondary Legislation With the Treaty Rights of Free Movement' (2011) 36 European Law Review 347.
- ¹⁶ *Christopher Sturgeon, Gabriel Sturgeon and Alana Sturgeon v. Condor Flugdienst GmbH (C-402/07) and Stefan Bück and Cornelia Lepuschitz v. Air France SA (C-432/07)* [2009] ECJ Joined Cases C-402/07 and C-432/07 [47].
- ¹⁷ Lenaerts, *supra* n. 10, at 1310.
- ¹⁸ Case law shows that this desire of the court has occurred jointly with the boundaries of interpretation being pushed to the utmost. See explicitly, Lenaerts, *supra* n. 10, at 1322. And e.g., *Christopher Sturgeon, Gabriel Sturgeon and Alana Sturgeon v. Condor Flugdienst GmbH (C-402/07) and Stefan Bück and Cornelia Lepuschitz v. Air France SA (C-432/07)* (n. 17) para. 41. According to some, this has occasionally gone *contra legem*. See Szudoczky (2014), *supra* n. 1, s. 7.3.4.
- ¹⁹ Compare, e.g., Syrpis, *supra* n. 1, at 10.
- ²⁰ See s. 3.3.1.
- ²¹ Lenaerts, *supra* n. 10, at 1322.
- ²² *Ibid.*, at 1322.
- ²³ Compare *ibid.*, at 1311.
- ²⁴ Werner Heun, *The Impact of Fundamental Rights on Tax Law*, 55 *Annales Universitatis Scientiarum Budapestinensis de Rolando Eotvos Nominatae: Sectio Iuridica* 33 (2014). Karl Heinrich Friauf, *Verfassungsrechtliche Anforderungen an Die Gesetzgebung Über Die Steuern Vom Einkommen Und Vom Ertrag*, in *Steuerrecht und Verfassungsrecht* (Karl Heinrich Friauf ed., O Schmidt 1989). Fundamentally, see Klaus Vogel, *RECHTFERTIGUNG DER STEUERN: EINE VERGESSENE VORFRAGE: Zugleich Zur "heimlichen Steuerrevolte" Und Zum Dreieck Staat/Wirtschaft/Gesellschaft*, 25 *Der Staat* 481 (1986); the english speaking version was published in Klaus Vogel, *The Justification for Taxation: A Forgotten Question*, 33 *The Am. J. Juris.* 19 (1988), doi: 10.1093/ajj/33.1.19.
- ²⁵ Fundamentally, see Vogel (1988), *supra* n. 24.
- ²⁶ For example, *ibid.*
- ²⁷ Compare, e.g., the sources referred to in *supra* n. 24.
- ²⁸ Wolfgang Schön, *Taxation and Democracy*, 72 *Tax L. Rev.* 235 (2019), doi: 10.59403/9gs0cs.
- ²⁹ As a particularly illustrative example, consider the introduction to the UK Finance Act beginning with: 'Most Gracious Sovereign We, Your Majesty's most dutiful and loyal subjects, the Commons of the United Kingdom in Parliament assembled, towards raising the necessary supplies to defray Your Majesty's public expenses, and making an addition to the public revenue, have freely and voluntarily resolved to give and to grant unto Your Majesty the several duties hereinafter mentioned; and do therefore most humbly beseech Your Majesty that it may be enacted, and be it enacted by the King's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows. Fundamentally and including further references, see e.g., Vogel (1988), *supra* n. 24; Schön, *supra* n. 28; Johan Lindholm, *Squaring the Constitutional Circle: An Overview of EU Fiscal Powers*, in *The Power to Tax in Europe* (Johan Lindholm & Anders Hultqvist eds, 1st edn, Hart Publishing 2023), <http://www.bloomsburycollections.com/book/the-power-to-tax-in-europe/ch2-squaring-the-constitutional-circle-an-overview-of-eu-fiscal-powers/> (accessed 27 Feb. 2023); Ricardo García Antón, *Does the EU Have a Legitimate Power to Enact Direct Taxes?*, in *The Power to Tax in Europe* (Johan Lindholm & Anders Hultqvist eds, 1st edn, Hart Publishing 2023), <http://www.bloomsburycollections.com/book/the-power-to-tax-in-europe/ch3-does-the-eu-have-a-legitimate-power-to-enact-direct-taxes/> (accessed 27 Feb. 2023); François Barreau, *The Legitimacy of the EU's Tax-Based Own Resources*, in *The Power to Tax in Europe* (Johan

extent of this differs between countries, legislators are bound by constitutional principles,³⁰ disallowing them to deprive taxpayers of their fundamental rights.³¹ This 'protection by content'³² sets material constraints on the legislators, ultimately protecting the minority against exploitation by the majority.³³

Assuming there is a need for (1) a certain level of taxpayer protection and (2) assuming that reaching this is a function of protection by consent and content, it can be argued that the lower the protection by consent, the higher the protection by content must be.³⁴ Relying on this as a framework for this article goes hand in hand with the following conceptual implications for reflecting on an EU direct tax constitutional doctrine. Consider, to begin with, that protection by consent in its purest form is characterized by a congruence between voting on tax legislation, paying the tax, and enjoying the expenditures.³⁵ While already in an ideal typical world, such congruence only holds on an aggregate level and not at the individual level (for whom it remains a mandatory taking),³⁶ reality is specifically far from it. It is very typical for states to tax non-citizen residents on their worldwide income and non-residents on what they receive from a jurisdiction. Neither of these groups has a formal say in making tax legislation.

At an EU level, this is even worse. Given that EU secondary direct tax law must be based on Article 115 TFEU, it requires a unanimous council decision to create direct tax directives.³⁷ This not only means that those paying (or bearing)³⁸ the tax do not have a direct say in the process. It also conveys that those rules that have been made by their directly elected

parliaments are set aside by an initiative proposed by a body of civil servants (the commission) and accepted by the executive branch of government (council) with both having no legislative power in the national scene.³⁹

Certainly, representatives of the Member States in the council can be reasonably be expected to represent the will of their respective national parliaments.⁴⁰ However, there is no guarantee that the actual majority is given effect – not even in the moment in which unanimity is achieved as it may have required concessions to make reluctant Member States amenable with the end result being such that it would no longer be supported by the majority.⁴¹ Given that there is no need to reconfirm the unanimous decision via a new one but, to the complete contrary, the requirement being that the once made unanimous decision remains in place as long as there is no unanimous agreement to change or abolish it, the minority begins to control the majority. In the most extreme case, it is one small Member State whose veto keeps the rule in place that has not even enjoyed majoritarian support at its inception and whose abolishment is the will of the majority in the EU and the majorities of the Member States (even in the blocking Member State). Thus, protection by consent is very weak in the current European direct tax law framework.⁴²

Seen from this perspective, protection by content must be especially strong in an EU direct tax setting.⁴³ It goes way beyond the protection of minorities that protection by content is typically concerned with and extends to a need to protect majorities against the spirits called by their predecessors. This

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Lindholm & Anders Hultqvist eds, 1st edn, Hart Publishing 2023), <http://www.bloomsburycollections.com/book/the-power-to-tax-in-europe/ch4-the-legitimacy-of-the-eu-s-tax-based-own-resources/> (accessed 27 Feb. 2023); Jussi Jaakkola, *From the Governance of National Tax Systems to Governing Through European Taxation: A Justification for the EU's Power to Levy Taxes*, in *The Power to Tax in Europe* (Johan Lindholm & Anders Hultqvist eds, 1st edn, Hart Publishing 2023), <http://www.bloomsburycollections.com/book/the-power-to-tax-in-europe/ch5-from-the-governance-of-national-tax-systems-to-governing-through-european-taxation-a-justification-for-the-eu-s-power-to-levy-taxes/> (accessed 27 Feb. 2023); Francesco Farri, *Between Form and Substance: At the Root of the Limits of the EU Taxing Powers*, in *The Power to Tax in Europe* (Johan Lindholm & Anders Hultqvist eds, 1st edn, Hart Publishing 2023), <http://www.bloomsburycollections.com/book/the-power-to-tax-in-europe/ch6-between-form-and-substance-at-the-root-of-the-limits-of-the-eu-taxing-powers/> (accessed 27 Feb. 2023); Cécile Brokelind, *The Power to Tax in International and EU Tax Law: Who Is Sitting Behind the Wheel?*, in *The Power to Tax in Europe* (Johan Lindholm & Anders Hultqvist eds, 1st edn, Hart Publishing 2023), <http://www.bloomsburycollections.com/book/the-power-to-tax-in-europe/ch10-the-power-to-tax-in-international-and-eu-tax-law-who-is-sitting-behind-the-wheel/> (accessed 27 Feb. 2023).

³⁰ See e.g., Schön, *supra* n. 28 who refers to stronger restrictions existing in continental Europe and Latin America while there are less stringent constraints in the United States or the United Kingdom.

³¹ Fundamentally, e.g., Wolfgang Schön, 'Grundrechtsschutz Gegen Den Demokratischen Steuerstaat – Das Steuerfassungsrecht Zwischen Staatsrechtslehre Und Public Economics', in *Jahrbuch des Öffentlichen Rechts* (S. Baer and others eds, Mohr Siebeck 2016); Schön, *supra* n. 28.

³² Schön, *supra* n. 28.

³³ *Ibid.*

³⁴ For a comprehensive elaboration, see *ibid.*

³⁵ See *ibid.*, under reference to; Wallace E. Oates, *Fiscal Federalism* (Harcourt Brace Jovanovich 1972); Charles B. Blankart, *Öffentliche Finanzen in Der Demokratie* (8th edn, Verlag CHBeck 2011).

³⁶ See Schön, *supra* n. 28, under reference to; Richard A. Epstein, *Taxation in a Lockean World*, 4 Social Phil. & Pol'y 49 (1986), doi: 10.1017/S0265052500000431.

³⁷ Kofler, *supra* n. 6.

³⁸ Corporations, of course, cannot vote. Yet, they also only formally pay corporate taxes that are ultimately always borne by an individual who, due to the tax, receives less profit from the corporation or needs to contract inferior terms with it – be it a customer, worker, or supplier. See further going on this incidence of taxation, Michael P. Devereux and others, *Taxing Profit in a Global Economy* (1st edn, Oxford University Press Oxford 2021), <https://academic.oup.com/book/39640> (accessed 20 Mar. 2023).

³⁹ Weiler, *The Transformation of Europe*, 100 The Yale L. J. 2403–2483, at 2466 (1991), doi: 10.2307/796898.

⁴⁰ In some Member States, it is normal for the parliament to bind the minister to a certain mandate.

⁴¹ Compare Lindholm, *supra* n. 29, at 13 referring to; Armin von Bogdandy, *European Democracy: A Reconstruction through Dismantling Misconceptions* 7 <https://papers.ssrn.com/abstract=4014445> (accessed 7 Mar. 2023).

⁴² See for instance, Joachim Englisch, *Gemeinschaftsgrundrechte im harmonisierten Steuerrecht, Zukunftsfragen des deutschen Steuerrechts* 54 (Springer Berlin Heidelberg 2009) https://link.springer.com/10.1007/978-3-642-00258-8_2 (accessed 27 Feb. 2024), who expressed concerns of an inadequate amount of fundamental rights protection being particularly high in the context of the democratic deficit in EU tax legislation.

⁴³ For example, *ibid.*

places an especially high responsibility on the court because taxpayers that are violated in their fundamental rights may factually only be able to rely on the ECJ for receiving protection – and there is, from their perspective, no obvious reason as to why this protection should be less than in a national setting. After all, for the taxpayer as the holder of these rights, it does not make a difference as to whether they are infringed through genuinely national legislation or national legislation implementing an EU directive.

3.2 What Situations Require Particular Attention?

Specifically in the above context, the author urges the court to not be overly zealous in regarding income taxation as merely another field of economic policymaking, in which it is, without further questioning, in place to grant wide discretion to the secondary legislator. To the contrary, taxation is a complex and facet-rich sum of legislative decisions that are inherently sensitive as it, per definition, goes hand in hand with the act of being forced to pay without directly receiving anything in exchange. Behind this is, indirectly at least, always some sort of value decision. However, and this is the point the author intends to make in this section, not every value decision is worth the same protection. Instead, the author posits that some of them may not deserve being upheld against a fundamental right infringement while others precisely need to be defended – occasionally even against the (unintended) effects of the law introducing them.

In this regard, the author stresses that the court – despite frequently expressing the willingness to do so – cannot fully refrain from making value judgments itself. To the contrary, the decision to give preference to the legislators' position already creates a value judgment as it puts the rights of someone else (be it a group or an individual) behind what is assumed to be the legitimate expression of the peoples' will. While the author – as outlined in section 2 – recognized that there are structural arguments that can be invoked to demand the court to step back when examining secondary EU law under primary EU law, it remains a value-based decision for it to attach more weight to legislative flexibility than to the economic rights in question.

Below, the author discusses three instances in which the court may be urged to apply a more cautious approach. While not being in any way a comprehensive or exhaustive list of such instances, they should suffice to make the argument that a nuanced approach to income taxation seems necessary. This is particularly so when building on the assumption that there is

an increased need for taxpayer protection by 'content' in an EU setting when compared to a national setting.⁴⁴

3.2.2 Economic Rights Infringement Through Erroneous Legislation

Making tax legislation is a difficult task. A reasonably simple political intention and overarching aim must be formulated in abstract language that must yield the desired results in all relevant cases whether they are foreseeable or not. The more complex the rules, the harder it may be for the technical experts to anticipate the actual working of the legislation. Furthermore, the politicians that have advanced the initiative through expressing their willingness to support a certain agenda may hardly be able to gain a reasonable understanding of how the law they decide upon works in reality and outside the ideal typical cases they may have in mind.⁴⁵ This is certainly not a new phenomenon nor is it specific to EU law or tax law over all. Legislators often depend on – and are politically accountable for – what experts say.⁴⁶ Yet, as mentioned above, it is much easier for the legislator in a national setting to react to unintended outcomes by changing the law. Instead, when decision making is bound to finding unanimous consensus, the result may be a legislative gridlock – be it due to a missing consensus or merely due to political horse trading. This is a clearly suboptimal setting for a field such as direct tax law that is known for its complexity and constant need for maintenance and further development.

In this context, the author sees good reason for the court to pay increased attention to two crucial questions. First, have the assumptions that are the basis of the legislation or parts of it turned out to be, at least to a reasonable degree, factually true? If not, a piece of legislation that does not necessarily reflect the value that those endowed with political legitimization have meant it to reflect may be at stake. This is certainly not automatically a problem. Reality may be better than what is assumed, or it may be without any relevance that the assumptions do not hold. However, in the event that such law conflicts with primary law guarantees, the author does not see a reason to award special protection to the secondary EU law that is based on false assumptions as the value decision of the legislator does not cover such circumstances. Second and practically maybe more likely, it appears possible that applying the law to certain cases produces outcomes that are actually not in accordance with the original value decision of the legislator. In such cases, applying primary EU law can help to restore the law's function as originally intended and/or protect the taxpayer

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⁴⁴ See s. 3.2.

⁴⁵ Further going on the problems relating to the discrepancy between technical expertise required in tax law creation and the actual knowledge politicians that ultimately endorse the rules, e.g., Linda Sydänmaanlakka, *Article: Power and Expertise in Global Tax Governance*, 52 *Intertax* 190 (2024). See also David Kennedy, *A World of Struggle: How Power, Law, and Expertise Shape Global Political Economy* (NED-New edition, Princeton University Press 2018), <https://www.jstor.org/stable/j.ctt1wf4cz3> (accessed 30 Aug. 2024).

⁴⁶ With further references, e.g., *ibid.*

from having its economic rights infringed by legislation that is inconsistent without there being an acceptable reason for this.

3.2.3 Concern 2: Economic Rights Infringements to Accord with Concessions to Specific Interests of Certain Member States

In a setting of unanimous decision making, Member States can use their veto power. This is neither infrequent nor exceptionally problematic as it is the natural outcome of the political process that is foreseen in Article 115 TFEU. Yet, upon taking a more nuanced view, it could be argued that not every compromise that this political process results in is worth equal protection when balanced against taxpayers' economic rights. While it appears more sensible for the court to respect compromises resulting in harmonization in steps or compromises that genuinely compensate certain Member States for disadvantages, there are fewer reasons to defend, polemically speaking, Member States' attempts to blackmail others for the purpose of achieving concessions serving their special interests.⁴⁷ The latter may especially concern instances of bad compromises that may frustrate the entire initiative⁴⁸ and/or be detrimental for single taxpayers or groups of them. In such situations, the author would see arguments for the court to apply stricter scrutiny particularly as the law, as it stands, may not actually reflect a genuine consensus among Member States but merely be the outcome of political horse trading. The author's position can certainly be very easily opposed by stating that what is of relevance is the law, that is, the final product regardless of how the single elements were derived. This argument certainly has merit, not in the least as it may be very difficult to define what is a good/bad compromise and to what extent this should influence the court in forming a view on its worthiness to be protected. Nevertheless, the author opines that it is legitimate for the court to provide for such considerations. Although they can hardly be decisive on their own, they do affect the balance between the rights of the individual and the (alleged) interest of the legislator. At least to the author, it is very hard to understand why core principles and values of the EU legal framework could unreasonably easily be sacrificed for the sake of ultimately allowing (the Member States

forcing the concession to be introduced) potentially integration-unfriendly rules to prevail.

3.3. Concern 3: Economic Rights Infringements due to Member States Forming 'Tax Cartels'

The third concern that was expressed in literature concerns Member States acting in concert to safeguard legal initiatives that would not withstand primary law scrutiny if they were implemented as national EU law.⁴⁹ While conceptually similar to the second concern referred to above, the issue here is that it is not a single or a few Member States that aim to achieve a special concession that – which is the relevant perspective here – violates taxpayers' economic rights. Rather, it is Member States acting as a whole that count on escaping the consequences of exploiting the court's leniency in reviewing secondary EU law under primary EU law. When Member States act as a 'cartel of fiscal authorities',⁵⁰ so the argument goes, the court should not too readily disregard core EU principles in order to accord with the political agenda.⁵¹

4 A DIRECT TAX SPECIFIC DOCTRINE?

4.1 Three Channels for the Court to Enforce Economic Rights

When searching for possibilities for the ECJ to accommodate the considerations brought forward in section 3, three channels appear to be of increased relevance. The first is competence control for which the ECJ can filter out manifestly inappropriate legislation (4.2). The second are the fundamental freedoms for which the court can address disadvantageous treatment caused by the secondary EU legislation on cross-border transactions (4.3). The third are the fundamental rights (especially Article 16 and/or Article 20 ChFR) for which the court can generally address adverse economic effects of secondary EU law on taxpayers (4.4). Below, the author will discuss of each of these channels by always beginning with an elaboration on the overall role of the legal instrument in question and some reflections on the current doctrine. Thereupon, potential avenues for developing a direct tax specific doctrine will be explored.

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⁴⁷ On the latter, see also Szudoczky (2020), *supra* n. 1, at 95.

⁴⁸ A recent prominent example of this is the Proposal for a COUNCIL DIRECTIVE on Business in Europe: Framework for Income Taxation (BEFIT) 2023 Art. 48(2). See for critique, Pasquale Pistone and others, *Proposal for a Council Directive on BEFIT: An Initial Assessment* (IBFD 2023); Moritz Scherleitner & Edoardo Traversa, *Involving the Corporate Sector in EU Financing – A Two-Tier Model for a Corporate Income Tax Based Own Resource*, Eur. L. Rev. [2024] s. 4.2.2, <https://papers.ssrn.com/abstract=4695242> (accessed 23 Jan. 2024).

⁴⁹ Fundamentally, see Wolfgang Schön, *Interpreting European Law in the Light of the OECD/G20 Base Erosion and Profit Shifting Action Plan*, 74 Bull. for Int'l Tax'n (2020), <https://www.ibfd.org/doi/3202s2r> (accessed 4 Mar. 2024).

⁵⁰ *Ibid.*

⁵¹ *Ibid.*, at 7, s. 6.4.3.

4.2 Safeguarding Economic Rights Through the Competence Function

4.2.1 The role of Competence Control and Brief Reflections on the Current Doctrine

The EU can only legislate to the extent to which Member States have transferred competence to it.⁵² Hence, the EU's action must have a basis in primary EU law which, in direct taxation, is Article 115 TFEU by default.⁵³ This includes a general competence 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'.⁵⁴ This provision can be relied on when differences between Member States' national rules obstruct the exercise of the fundamental freedoms⁵⁵ or cause significant distortions of competition.⁵⁶ Alternatively, recourse to Article 115 TFEU is possible to prevent the emergence of future obstacles to trade resulting from the divergent development of national laws, provided this is likely and the measures in question are designed to prevent it.⁵⁷ On the other hand, merely finding disparities between Member States or the abstract risk of infringements of fundamental freedoms or distortions of competition does not suffice for invoking Article 115 TFEU.⁵⁸

In general terms, the court applies a rather lenient approach in examining the availability of a primary EU law competence.⁵⁹ Yet, in exceptional cases, it has been prepared to strike down secondary EU law as no longer being covered by the (now) Article 114 TFEU.⁶⁰ In this context, the court clarified that secondary EU law must genuinely have the improvement of the conditions for the establishment and functioning of the internal market as its objective (which the directive on tobacco advertising in question in the proceedings did not fulfil).⁶¹ It is ascertained from literature that this requirement is the same for Articles 113 and 115 TFEU.⁶²

Furthermore, Union acts must accord with the principles of subsidiarity included in Article 5(3) TEU. It allows the EU to act only insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States but can be better accomplished at the Union level. While subsidiarity concerns were formally raised by various national parliaments in the course of (both) common consolidated corporate tax base (CCCTB) proposals,^{63,64} subsidiarity is normally not of increased concern in direct taxation.

Moreover, EU acts must comply with the proportionality principle of Article 5(4) TEU. In its 'competence function',⁶⁵ the application of this general principle of EU law⁶⁶ assesses whether the loss in autonomy suffered by the Member States is justified by the greater ability of the

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⁵² 'Consolidated Version of the Treaty on European Union' Art. 5(1). Member States can act, to the extent the EU has not done so.

⁵³ Direct taxation matters affect the Internal Market, of which the establishment is a core goal of the EU. See *Consolidated Version of the Treaty on European Union*, *supra* n. 52, Art. 3(3). Consolidated version of the Treaty on the Functioning of the European Union 2012 (OJ C) Art. 26. See e.g., Peter Behrens, *Der Wettbewerb Im Vertrag von Lissabon*, Europäische Zeitschrift für Wirtschaftsrecht 193 [2008]; Ulrich Becker, *EUV Art. 3 (Ziele)*, in *EU-Kommentar* (Schwarze and others eds, 4th edn 2019) para. 13; Benjamin Straßburger, *Die Dogmatik Der EU-Grundfreiheiten*, vol 70, 7 (1st edn, Mohr Siebeck 2012). Armin Hatje, *AEUV Art. 26 (Binnenmarkt)*, in *EU-Kommentar* (Schwarze and others eds, 4th edn 2019). Korte, *AEUV Art. 26 (Ex-Art. 14 EGV) (Binnenmarkt)*, in *Calliess/Ruffert* (EUV and AEUV eds, 6th edn 2022).

⁵⁴ Consolidated version of the Treaty on the Functioning of the European Union Art. 115. Indirect taxes are dealt with in Consolidated version of the Treaty on the Functioning of the European Union Art. 113. The establishment of the Internal Market – the establishment of which is a core goal of the EU.

⁵⁵ *The Queen, on the application of Vodafone Ltd and Others v. Secretary of State for Business, Enterprise and Regulatory Reform* [2010] ECJ Case C-58/08 [32]; *Federal Republic of Germany v. European Parliament and Council of the European Union* [2006] ECJ Case C-380/03 [37]; Kofler, *supra* n. 6, s. 2.2.

⁵⁶ *The Queen, on the application of Vodafone Ltd and Others*, *supra* n. 55, para. 32. *Federal Republic of Germany*, *supra* n. 55, paras 84 and 106; Kofler, *supra* n. 6, s. 2.2. Nadja Braun Binder & Nadja Braun Binder, *Rechtsangleichung in Der EU Im Bereich Der Direkten Steuern* vol 266, 48–49 (1st edn, Mohr Siebeck 2017).

⁵⁷ *Federal Republic of Germany*, *supra* n. 55, para. 38. *The Queen, on the application of Vodafone Ltd and Others*, *supra* n. 55, para. 33. Kofler, *supra* n. 6, s. 2.2.

⁵⁸ For example, *The Queen, on the application of Vodafone Ltd and Others*, *supra* n. 55, para. 32; Kofler, *supra* n. 6, s. 2.2.

⁵⁹ Kübek & Terhechte, *AEUV Art. 115 (Nationales Recht Mit Unmittelbarer Auswirkung Auf Den Binnenmarkt; Rechtsangleichung)*, in *Frankfurter Kommentar EUV/GRC/AEUV* (Pechstein, Nowak & Häde eds, 2d edn 2023), para. 17; M. Schröder, *AEUV Art. 114 (Rechtsangleichung Im Binnenmarkt)*, in *Streinz* 33 (EUV & AEUV eds, 3d edn 2018).

⁶⁰ *The Queen v. Secretary of State for Health, ex parte British American Tobacco (Investments) Ltd and Imperial Tobacco Ltd* [2002] ECJ Case C-491/01.

⁶¹ *Ibid.*, paras 83 et seq.

⁶² Szudoczky (2020), *supra* n. 1, at 99.

⁶³ This process is known as the yellow card procedure. See further Peter Wattel, *Conceptual Background of CJEU Case Law in Direct Tax Matters*, in *European Tax Law. Volume 1: General Topics and Direct Taxation* / Edited by Sjoerd Douma, Otto Marres, Hein Vermeulen, Dennis Weber (Sjoerd Douma and others eds, Eighth edition, Wolters Kluwer 2019).

⁶⁴ Proposal for a COUNCIL DIRECTIVE on a Common Consolidated Corporate Tax Base (CCCTB) /* COM/2011/0121 final - CNS 2011/0058 */ 2011; Proposal for a COUNCIL DIRECTIVE on a Common Consolidated Corporate Tax Base (CCCTB) 2016.

⁶⁵ Szudoczky (2014), *supra* n. 1, at 120.

⁶⁶ *Opinion of Mr Advocate General Poiras Maduro delivered on 1 October 2009 The Queen, on the application of Vodafone Ltd and Others v. Secretary of State for Business, Enterprise and Regulatory Reform Reference for a preliminary ruling: High Court of Justice (England & Wales), Queen's Bench Division (Administrative Court) – United Kingdom Regulation (EC) No 717/2007 – Roaming on public mobile telephone networks within the Community – Validity – Legal basis – Article 95 EC – Principles of proportionality and subsidiarity Case C-58/08 (ECJ) [4]. Calliess, *EU-Vertrag (Lissabon) Art. 5 (Ex-Art. 5 EGV) (Grundsatz Der Begrenzten Einzelmächtigung, Subsidiarität Und Verhältnismäßigkeit)*, in *Calliess/Ruffert* (EUV and AEUV eds, 6th edn 2022) para. 45; Pache, *EUV Art. 5 (Grundsatz Der Begrenzten Einzelmächtigung, Subsidiaritätsprinzip, Verhältnismäßigkeitsgrundsatz)*, in *Frankfurter Kommentar* (Pechstein, Nowak & Häde eds, 2d edn 2023), para. 153; Georg Lienbacher, *EUV Art. 5 (Subsidiaritätsprinzip)*, in *EU-Kommentar* (Schwarze and others eds, 4th edn 2019), para. 37; Streinz, *EUV Art. 5 (Kompetenzabgrenzung Und Kompetenzausübungsschranken: Prinzip Der Begrenzten Ermächtigung – Subsidiaritätsprinzip – Grundsatz Der Verhältnismäßigkeit)*, in *Streinz* (EUV & AEUV eds, 3rd edn 2018), para. 43; Szudoczky (2014), *supra* n. 1, s. 5.1.3.*

EU to achieve the goals of the legislation.⁶⁷ This requires the EU action to be appropriate for attaining the legitimate objectives pursued by the legislation at issue and not exceed the limits of what is appropriate and necessary in order to achieve them.⁶⁸ In this context, the court reviews proportionality as a matter of suitability, questioning whether the rule genuinely reflects a concern to attain the objective in a consistent and systematic manner.⁶⁹ In addition, it reviews whether recourse can be had to less onerous means for attaining the objectives pursued.⁷⁰ Furthermore, the examination also includes the question of whether the disadvantage stands in adequate relation to the interests pursued (proportionality *stricto sensu*).⁷¹

Nonetheless, under settled jurisprudence, the standard for the review of proportionality used by the court with respect to secondary EU law is lower.⁷² The legality of a measure that is adopted can be affected only if it is 'manifestly inappropriate having regard to the objective which the competent institution is seeking to pursue'.⁷³ *Stricto sensu* proportionality is sometimes not tested at all,⁷⁴ or the elements of necessity and appropriateness are mixed.⁷⁵ Still, some older case law also demonstrates that there could be some leeway for the court to accommodate

somewhat stricter approaches. In *Spain v. Council*, the issue was that the EU legislator did not take into account all of the relevant information in making the law which resulted in poor legislation. Importantly, the court no longer saw this as being encompassed within the discretion awarded to the Union legislator but as constituting a manifest error of assessment.⁷⁶

4.2.2 Reflections on Potential Developments on the Application of Competence Control to Direct Tax Legislation

It is surprisingly frequent that tax literature questions the availability of this legal basis for tax directives.⁷⁷ The argumentation brought forward in this regard may be summarized as follows. If secondary EU law rules cause an increase in taxation or provide for an outcome that is contrary to the ECJ's jurisprudence on the application of the fundamental freedoms on national law, the secondary EU law that is in place cannot be regarded as furthering the internal market.⁷⁸ This resembles especially the third concern listed above since the implementation of the OECD work has been understood to be – at least

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⁶⁷ Opinion of Mr Advocate General Póitres Maduro delivered on 1 October 2009 *The Queen, on the application of Vodafone Ltd and Others v. Secretary of State for Business, Enterprise and Regulatory Reform* Case C-58/08 (An Chúirt Bhreithiúnais) [44]. For a broad elaboration see especially also *Judgment of the Second Senate of 5 May 2020 – 2 BvR 859/15* (Bundesverfassungsgericht) [126].

⁶⁸ *Fédération Charbonnière de Belgique v. High Authority of the European Coal and Steel Community* [1956] ECJ Case 8-55. *The Queen v. Secretary of State for Health, ex parte British American Tobacco (Investments) Ltd and Imperial Tobacco Ltd* [2002] ECJ Case C-491/01 [122]; *Afton Chemical Limited v. Secretary of State for Transport* [2010] ECJ Case C-343/09 [45]. *Sky Österreich GmbH v. Österreichischer Rundfunk* [2013] ECJ Case C-283/11 [50]; *Herbert Schaible v. Land Baden-Württemberg* [2013] ECJ Case C-101/12 [29]. *Digital Rights Ireland Ltd v. Minister for Communications, Marine and Natural Resources and Others and Kärntner Landesregierung and Others* [2014] ECJ Joined Cases C-293/12 and C-594/12 [46]; *Proceedings brought by Heinrich Weiss and Others* [2018] ECJ Case C-493/17 [72].

⁶⁹ *Criminal proceedings against Ernst Engelmann* [2010] ECJ Case C-64/08 [35]. *Marc Michel Janssens v. Burgemeester van Maastricht* [2010] ECJ Case C-137/09 [70]. *European Commission v. Republic of Austria* [2011] ECJ Case C-28/09 [126]; in this context, the CJEU frequently limits its review to whether the relevant measure is manifestly inappropriate having regard to the objective pursued *I Schroeder KG v. the Federal Republic of Germany* [1973] ECJ Case 40-72 [14]; *Hans-Markus Stölting vastaan Hauptzollamt Hamburg-Jonas* [1979] An Chúirt Bhreithiúnais Asia 138/78 [7]. *Hermann Schröder HS Kraftfutter GmbH & Co KG v. Hauptzollamt Gronau* [1989] ECJ Case 265/87 [22]. *Federal Republic of Germany v. Council of the European Union* [1994] ECJ Case C-280/93 [90]. *Federal Republic of Germany v. European Parliament and Council of the European Union* [1997] ECJ Case C-233/94 [55 and 56]. *Emesa Sugar (Free Zone) NV v. Aruba* [2000] ECJ Case C-17/98 [53]. *The Queen, supra* n. 68, para. 123; *The Queen, on the application of Swedish Match AB and Swedish Match UK Ltd v. Secretary of State for Health* [2004] ECJ Case C-210/03 [48]. *Erimine SA v. Secretary of State for Work and Pensions* [2011] ECJ Case C-15/10 [125].

⁷⁰ *Walter Rau Lebensmittelwerke v. De Smedt PVBA* [1982] Euroopa Kohus Kohtuasi 261/81 [17]; *H Jippes, Afdeling Groningen van de Nederlandse Vereniging tot Bescherming van Dieren en Afdeling Assen en omstreken van de Nederlandse Vereniging tot Bescherming van Dieren v. Minister van Landbouw, Natuurbeheer en Visserij* [2001] ECJ Case C-189/01 [81]. *Afton Chemical Limited, supra* n. 68, para. 45. *Bureau d'intervention et de restitution belge v. Beno-Orafi SA* [2011] ECJ Case C-150/10 [75]. *Republic of Poland v. European Parliament and Council of the European Union* [2016] ECJ Case C-358/14 [78].

⁷¹ See e.g., *Philip Morris Brands SARL and Others v. Secretary of State for Health* [2016] ECJ Case C-547/14 [165].

⁷² *Philip Morris Brands SARL and Others, supra* n. 71, para. 166; *Callies, supra* n. 66, para. 45.

⁷³ For example, *The Queen, supra* n. 60, para. 123.

⁷⁴ *Fromançais SA v. Fonds d'orientation et de régularisation des marchés agricoles (FORMA)* [1983] ECJ Case 66/82 [8]; *Affish BV v. Rijksdienst voor de keuring van Vee en Vlees* [1997] ECJ Case C-183/95 [30]; *The Queen, on the application of Vodafone Ltd and Others, supra* n. 55, paras 53 and 54; *Grand Duchy of Luxembourg v. European Parliament and Council of the European Union* [2011] ECJ Case C-176/09 [63]; *Caseificio Cirigliana Srl and Others v. Ministero delle Politiche agricole, alimentari e forestali and Others* [2019] ECJ Case C-569/18 [43].

⁷⁵ See for this and the references of much of the case law quoted in this paragraph, *Judgment of the Second Senate of 5 May 2020 – 2 BvR 859/15, supra* n. 67, para. 126.

⁷⁶ *Kingdom of Spain v. Council of the European Union* [2006] ECJ Case C-310/04 [120 et seq.]; Koen Lenaerts, *Proportionality as a Matrix Principle Promoting the Effectiveness of EU Law and the Legitimacy of EU Action – Keynote Speech – ECB Legal Conference 2021 Continuity and Change – How the Challenges of Today Prepare the Ground for Tomorrow* (2021).

⁷⁷ Arnaud de Graaf & Klaas-Jan Visser, *ATA Directive: Some Observations Regarding Formal Aspects* EC TAX REVIEW. Gianluigi Bizioli, *Taking EU Fundamental Freedoms Seriously: Does the Anti-Tax Avoidance Directive Take Precedence over the Single Market?*, 26 EC Tax Rev. (2017), <https://kluwerlawonline.com/api/Product/CitationPDFURL?file=Journals\ECTA\ECTA2017018.pdf> (accessed 27 Feb. 2024). Sriram Govind & Ivan Lazarov, *Carpet-Bombing Tax Avoidance in Europe: Examining the Validity of the ATAD Under EU Law*, 47 Intertax 852, at 852–868 (2019); Instead, regarding Art. 115 TFEU to be an adequate legal basis see e.g., Braun Binder & Binder, *supra* n. 56, at 92–94; Szudoczky (2020), *supra* n. 1. Szudoczky (2020), *supra* n. 1, at 99.

⁷⁸ To different extents, cf. the references provided in *supra* n. 78.

partly – driven by a desire to minimize the risk of conflict with primary EU law.⁷⁹

The author nevertheless opines that the court is very unlikely to pick up these concerns. This comes because it is ultimately not convincing to argue that the advancement of the internal market demanded by Article 115 TFEU is automatically not occurring when parts of the rules conflict with the case law on national law under the fundamental freedoms. Rather, the advancement of the internal market may just happen through other routes and be positive overall.⁸⁰ In the context of the Anti-Tax Avoidance Directive (ATAD) and in the context of minimum taxation rules, the author feels confident when assuming that such an overall positive effect on the internal market exists. This is because the decrease in distortions caused through under-taxation may contribute more to the improvement of the internal market than the increased compliance costs or occasional violations of the fundamental freedoms create do harm to it.⁸¹

Even if this is incorrect and the rules are overall harmful to the internal market, the court would nevertheless likely accept it as being in accordance with Article 115 TFEU since the harmonization prevents the emergence of future obstacles that non-harmonization would (in addition) create. In colloquial terms, harmonizing the rules makes it the lesser evil than seeing the same rules being implemented without it.⁸² Thus, a successful challenge of tax directives based on the lack of competence in the TFEU does not appear probable. To cut it short, the same is likely true for the subsidiarity principle as it is fair to generalize that harmonization is always better achieved on an EU level than on a national level.

With respect to proportionality, the picture is more nuanced. On the one hand, the court cannot apply an unreasonable strict stance as this may endanger future harmonization endeavours or, what principally may happen as well, could cause part of coordination efforts to take place outside the EU law framework. On the other hand, an overly cautious approach of the court also faces pressure because national constitutional courts may see this as a

reason to deal with the matter themselves. That this is no theoretical problem is best demonstrated by the relatively recent *Weiss* judgment of the Bundesverfassungsgericht (German Constitutional Court) in which the lightweight proportionality review by the ECJ was declared to constitute an *ultra vires* act. This meant that German organs could not participate in the respective action.⁸³ This is certainly an extreme example that was partly met with immense critique.⁸⁴ Yet, it is not the first time that national courts have declared an ECJ judgment *ultra-vires*.⁸⁵

In an attempt to unravel this dilemma, the author suggests that the court respects legitimate legislative choices but is more rigorous when reviewing whether the creation of direct tax law happened based on adequate information. While this can typically be assumed, the law could hardly be argued to be proportionate if that is not the case. As shown above, there is older case law for which the court came to such a conclusion. Of course, the pressing question is what degree of wrong assumptions would be required for the court to intervene. It could be argued that only bluntly and already ex ante absolutely obvious misperceptions maybe should be addressed by the court via declaring the underlying legislation as unproportional. Under this approach, it would factually leave it to the Member States to remedy the deficit. This approach could be praised based on the court insisting and allowing the legislator itself to correct the mistake. On the other hand, it can also be criticized as being too lax given that there is no guarantee that Member States adapt the rules thereby ultimately leaving taxpayers behind with the need to comply with this ill-founded law. Following a stricter approach, the court could seek to reject law that, even in hindsight, is simple based on inadequate information and considerations that make it an inadequate fit for purpose. This is not unproblematic since it would allow the court to make a decision that, after all, does belong to the legislature. However, precisely in a setting requiring unanimity in decision making, this may not be totally inappropriate because the actual majority willing to legislatively address the problem could unreasonably be blocked by a small number of Member States.

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⁷⁹ P. Schmidt, *A General Income Inclusion Rule as a Tool for Improving the International Tax Regime – Challenges Arising from EU Primary Law*, 48 Intertax (2020); C. Brokelind & P. Wattel, *Free Movement and Tax Base Integrity* 655–657 (Deventer 7th Wolters Kluwer 2018), <https://dare.uva.nl/search?identifier=e434781e-847f-4f75-8b6d-bbd2ca4cb79c> (accessed 6 Mar. 2024); L. de Broe & M. Massant, *Are the OECD/G20 Pillar Two GloBE-Rules Compliant with the Fundamental Freedoms?*, EC Tax Rev. 86 [2021]; J. Englisch & J. Becker, *Implementing an International Effective Minimum Tax in the EU* 224 (Arbeiterkammer Wien 2021).

⁸⁰ Apparently in a similar direction, S. Korte, *AEUV Art. 115 (Ex-Art. 94 EGV) (Richtlinien Zur Angleichung von Rechtsvorschriften Für Den Binnenmarkt)*, in Calliess/Ruffert (EUV & AEUV eds, 6th edn 2022), para. 13.

⁸¹ Moritz Scherleitner, *Should the EU Implement a Minimum Corporate Taxation Directive?*, <https://papers.ssrn.com/abstract=3697903> (accessed 2 Jan. 2024).

⁸² See s. 4.2.2.

⁸³ *Judgment of the Second Senate of 5 May 2020 – 2 BvR 859/15*, *supra* n. 67, paras 116 et seq.

⁸⁴ See in this regard also Lenaerts, *supra* n. 77; Koen Lenaerts, *No Member State Is More Equal than Others: The Primacy of EU Law and the Principle of the Equality of the Member States before the Treaties* Verfassungsblog [2020], <https://verfassungsblog.de/no-member-state-is-more-equal-than-others/> (accessed 4 Mar. 2024).

⁸⁵ *Judgment PL ÚS 5/12* [2012] Czech Republic Constitutional Court PL ÚS 5/12, Czech Republic Constitutional Court; Jan Komárek, *Playing With Matches: The Czech Constitutional Court's Ultra Vires Revolution* Verfassungsblog [2012], <https://verfassungsblog.de/playing-matches-czech-constitutional-courts-ultra-vires-revolution/> (accessed 4 Mar. 2024). Marie Landtová v. Česká správa sociálního zabezpečení [2011] ECJ Case C-399/09, see also *Dansk Industri (DI), acting on behalf of Ajos A/S v. Estate of Karsten Eigil Rasmussen* [2016] ECJ Case C-441/14 and *Case 15/2014 Case no 15/2014 Dansk Industri (DI) Acting for Ajos A/S v. The estate left by A* (Danish Supreme Court).

Considered from this perspective, a somewhat more active stance of the court could also give some comfort to the legislator since it knows that correcting its errors is not only dependent on finding unanimity (and potentially at the mercy of some Member States benefitting from the situation) but may effectively also be achieved by the court. Using this approach, the court could contribute to addressing both the first and the third concerns listed in section 3.3 since manifestly erroneous legislation or unmistakably imbalanced tax cartels not benefitting the internal market at all could be declared void by it.

4.3 Safeguarding Economic Rights Through Fundamental Freedoms

4.3.1 The role of the Fundamental Freedoms and Brief Reflections on the Current Doctrine

The fundamental freedoms consist of the free movement of workers,⁸⁶ goods,⁸⁷ and services,⁸⁸ the freedom of establishment,⁸⁹ and the free movement of capital.⁹⁰ They are an integral part of internal market law⁹¹ and prohibit disadvantages that restrict exercising the respective freedom.⁹² A brief review of the general doctrine of applying these freedoms in reviewing secondary EU law demonstrates that the court provides an ultimately relatively sophisticated approach.

First and foremost, the court emphasizes that the prohibition on restrictions on fundamental freedoms applies not only to national measures but also to those adopted by

European Union institutions.⁹³ Although this statement is clear in legal terms, it reiterates the court's commitment to enforce these norms vis-à-vis the secondary EU law legislator, which has not rarely also happened in practice.⁹⁴ Nevertheless, in reviewing secondary EU law, the court is typically regarded as being less strict than when reviewing national law.⁹⁵ This receives principal support in literature due to the inherent territorial application of national law being conceptually more prone to create obstacles to the functioning of the internal market than harmonized EU law.⁹⁶

That stated, there are certain instances in which the court applies a stricter approach. As worked out in literature, this concerns EU law measures that do not apply within the whole Union and that give special treatment to a Member State.⁹⁷ This accords well with the logic outlined above since, to the extent of there not being special rules applying to certain Member States, there is no harmonization and thus no need to treat the situation better than that with national law. The court's accommodating approach towards the distinct nature of secondary EU law is also shown in it being less strict with rules that can only be implemented in secondary EU law, such as coordination rules existing in the field of social security.⁹⁸ These types of provisions are meant to designate what Member State's law applies in a specific situation and, if they are genuinely doing so, the ECJ has accepted them even if the rules cause a disadvantage for a specific cross-border situation.⁹⁹ Yet, again, the court has invalidated secondary EU law coordination rules that take into

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⁸⁶ Consolidated version of the Treaty on the Functioning of the European Union Arts 45–48.

⁸⁷ *Ibid.*, Arts 28–37.

⁸⁸ *Ibid.*, Arts 56–62.

⁸⁹ *Ibid.*, Arts 49–55.

⁹⁰ *Ibid.*, Arts 63–65.

⁹¹ Korte, *supra* n. 81, para. 38.

⁹² Ekkehart Reimer, *Diskriminierungs- Und Beschränkungsverbote Im Direkten Steuerrecht*, in *Europäisches Steuerrecht* (Harald Schaumburg & Joachim Englisch eds, 2., völlig überarbeitete und erweiterte Auflage, Otto Schmidt 2020) para. 7.158. *The Principle of Non-Discrimination in International and European Tax Law* | IBFD, s. 15.2, <https://www.ibfd.org/shop/book/principle-non-discrimination-international-and-european-tax-law> (accessed 28 Feb. 2024).

⁹³ *Ingrid Schmelz v. Finanzamt Waldviertel* [2010] ECJ Case C-97/09 [50]; *Gaston Schul Douane Expéditeur BV v. Inspecteur der Invoerrechten en Accijnzen, Roosendaal* [1982] ECJ Case 15/81 [42]. Most case law dealing with the review of the legality of secondary EU law under the fundamental freedoms includes the free movement of goods. See for an overview, Szudoczky (2014), *supra* n. 1, s. 7.4.4.1.

⁹⁴ *Société Les Commissionnaires Réunis SARL v. Receveur des douanes*; *SARL Les fils de Henri Ramel v. Receveur des douanes* [1978] ECJ Joined Cases 80 and 81/77; *René Lancry SA v. Direction Générale des Douanes and Société Dindar Confort, Christian Ab-Son, Paul Chevasus-Marbe, Société Conforéunion and Société Dindar Autos v. Conseil Régional de la Réunion and Direction Régionale des Douanes de la Réunion* [1994] ECJ Joined Cases C-363/93, C-407/93, C-408/93 C-409/93 C-410/93 C-411/93; *Pietro Pinna v. Caisse d'allocations familiales de la Savoie* [1986] ECJ Case 41/84; *Mario Roviello v. Landesversicherungsanstalt Schwaben* [1988] ECJ Case 20/85.

⁹⁵ See for a detailed analysis, Szudoczky (2014), *supra* n. 1, s. 7.4. Examples include, e.g., *Criminal proceedings against René Kieffer and Romain Thill* [1997] ECJ Case C-114/96; *Meyhui NV v. Schott Zwiesel Glaswerke AG* [1994] ECJ Case C-51/93.

⁹⁶ Szudoczky (2014), *supra* n. 1, at 301.

⁹⁷ On some of these occasions, it declared secondary EU law void. See *Association Belge des Consommateurs Test-Achats ASBL and Others v. Conseil des ministres* [2011] ECJ Case C-236/09 [31–33]; *Mario Roviello*, *supra* n. 96; *Pietro Pinna*, *supra* n. 96; see for a comprehensive discussion, including a reflection on literature dealing with this aspect, Szudoczky (2014), *supra* n. 1, at s. 7.4.2.3.

⁹⁸ See e.g., Council Regulation (EC) No 1408/71 of 14 Jun. 1971 on the application of social security schemes to employed persons, to self-employed persons and to members of their families moving within the Community (8) (9) (10) (11) (Consolidated version – OJ No L 28 of 30 Jan. 1997, at 1) 2010. For a detailed discussion of the cases, cf. Szudoczky (2014), *supra* n. 1, at 292 et seq., discussing *José Allard v. Institut national d'assurances sociales pour travailleurs indépendants (INASTI)* [2005] ECJ Case C-249/04; *Institut national d'assurances sociales pour travailleurs indépendants (Inasti) v. Claude Hervein and Hervillier SA* (C-393/99) and *Guy Lorthiois and Comtexel SA* (C-394/99) [2002] ECJ Joined Cases C-393/99 and C-394/99; *Pietro Pinna*, *supra* n. 95. Szudoczky (2014), *supra* n. 1, at 292 et seq.

⁹⁹ See especially *José Allard*, *supra* n. 99, paras 31 et seq.; Szudoczky (2014), *supra* n. 1, at 293 et seq.

account a Member State's special interest and discriminate against those exercising the freedoms.¹⁰⁰

Moreover, in the context of secondary EU law, the court accepts justifications that are not accepted with respect to national law. Most relevantly, this concerns promoting the internal market¹⁰¹ and, relatedly, the discretion for pursuing harmonization in stages.¹⁰² This is a sensible approach as it allows the court to weigh the positive effects that are achieved for the internal market through the secondary legislation at hand vis-à-vis the effects of striking down the rule due to it infringing the freedoms.

The above considerations suggest that the court accepts the value brought to the internal market through harmonization even if this, seen in isolation, violates the freedoms. This is very much in accordance with the observation made in section 4.2.2, i.e., there are more and different ways to improve the internal market rather than through enforcing the freedoms – and the court leaves the choice to the legislator. This does not, however, extend to situations in which special arrangements for certain Member States create precisely these obstacles that the freedoms are supposed to address.

This line of thought on the court's sensitiveness to the overall effectiveness of internal market law can even be extended to the rare but existing instances in which the court was prepared to factually override primary EU law. For illustration, consider *Verkooijen* (C-35/98), a taxation case in which the court had to deal with now Article 65(1)(a) TFEU stating that the provisions of Article 63 shall be without prejudice to the right of Member States to 'to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested'. Rather obviously, this was included in the treaty to more strongly protect national

tax law measures against being struck down due to violating the free movement of capital.¹⁰³ Yet, the court factually denied this attempt and disarmed this provision through a rather extensive interpretation of Article 65(3) TFEU.¹⁰⁴ This is an ultimately sensible outcome¹⁰⁵ that was apparently guided by the court being unwilling to give effect to the (tainted) will of the Member States, as this would have generated a significant weakening of the free movement of capital that the court perceived as the greater good. As worked out in literature, there are similar cases including Article 21 TFEU with the court neutralizing relevant secondary law restriction even though it is 'subject to the limitations and conditions laid down in the Treaties and by the measures adopted to give them effect'.¹⁰⁶ Again, the court provided an interpretation that was not aligned with the rather clear intention of the Member States.¹⁰⁷ Apparently, the court did not regard it as deserving stronger protection than the citizen whose right to move and reside freely within the territory of the Member States was violated. Both of these cases remarkably show that an overly general assumption towards the structural lethargy of the court towards the EU legislator is not accurate. Rather, as these examples suggest, the court can be very diligent upon seeing a need to do so.

4.3.2 Reflections on Potential Developments of the Fundamental Freedoms to Harmonized Direct Tax Law

In the essential absence of any harmonization, the application of the fundamental freedoms on national tax rules has had a significant impact in shaping EU direct tax systems¹⁰⁸ despite – which is noteworthy – the court (already) applying a special doctrine to national tax rules.¹⁰⁹ In fact, contrary to

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¹⁰⁰ Pietro Pinna, *supra* n. 95.

¹⁰¹ *Criminal proceedings against René Kieffer and Romain Thill*, *supra* n. 96, para. 31.

¹⁰² *Gaz de France – Berliner Investissement SA v. Bundeszentralamt für Steuern* [2009] ECJ Case C-247/08 [52].

¹⁰³ Johanna Hey, *Europäische Steuergesetzgebung Zwischen Binnenmarkt Und Fiskalinteressen*, Europäische Steuergesetzgebung zwischen Binnenmarkt und Fiskalinteressen 26 (Verlag Dr Otto Schmidt 2018), <https://www.degruyter.com/document/doi/10.9785/9783504386009-002/html> (accessed 6 Mar. 2024); Joachim Englisch, *Rechtfertigungsgründe*, in *Europäisches Steuerrecht* (Harald Schaumburg & Joachim Englisch eds, 2., völlig überarbeitete und erweiterte Auflage, Otto Schmidt 2020), para. 7.201; Moritz Scherleitner, *The Imported Mismatch Rule in Light of the Fundamental Freedoms*, 49 *Intertax* (2021), s. 3.1, <https://kluerlawonline.com/api/Product/CitationPDFURL?file=Journals/TAXI\TAXI2021039.pdf> (accessed 6 Mar. 2024).

¹⁰⁴ *Staatssecretaris van Financiën v. BGM Verkooijen* [2000] ECJ Case C-35/98 [37 et seq.].

¹⁰⁵ Hey, *supra* n. 104, at 26.

¹⁰⁶ Consolidated version of the Treaty on the Functioning of the European Union – PART TWO: NON-DISCRIMINATION AND CITIZENSHIP OF THE UNION – Art. 21 (ex Art. 18 TEC) 1957 (OJ C).

¹⁰⁷ Szudoczky (2014), *supra* n. 1, at 111 et seq.; Syrpis, *supra* n. 1. See for case law, especially, *Baumbast and R v. Secretary of State for the Home Department* [2002] ECJ Case C-413/99 [90 et seq.]; *Rudy Grzelczyk v. Centre public d'aide sociale d'Ottignies-Louvain-la-Neuve* [2001] ECJ Case C-184/99; *The Queen, on the application of Dany Bidar v. London Borough of Ealing and Secretary of State for Education and Skills* [2005] ECJ Case C-209/03; *Athanasios Vatsouras (C-22/08)* and *Josif Koupatantze (C-23/08) v. Arbeitsgemeinschaft (ARGE) Nürnberg 900* [2009] ECJ Joined cases C-22/08 and C-23/08.

¹⁰⁸ Marjaana Helminen, *EU Tax Law: Direct Taxation 2* (2022 edition, IBFD 2022). Niels Bammens, *The Principle of Non-Discrimination in International and European Tax Law* (IBFD Publ 2012); Joachim Englisch, *Grundfreiheiten: Vergleichbarkeit, Rechtfertigung Und Verhältnismäßigkeit*, in *Europäisches Steuerrecht* (Michael Lang ed., DStJG Tagungsband 2018); Frans Vanistendael, *The Functioning of Fundamental Freedoms and Tax Neutrality in the Internal Market*, Research Handbook on European Union Taxation Law (Edward Elgar Publishing 2020), <https://www.elgaronline.com/edcollchap/edcoll/9781788110839/9781788110839.00013.xml> (accessed 7 Mar. 2024); Wattel, *supra* n. 65.

¹⁰⁹ Opinion of Advocate General Juliane Kokott in Case C-385/12 *Hervis Sport- és Divatkereskedelmi Kft. v. Nemzeti Adó- és Vámhivatal Közép-dunántúli Regionális Adó Főigazgatósága*, EU:C:2014:47, para. 84. Kokott, *supra* n. 4, Ch. 3.

general internal market law that is dominated by the (non-discriminatory) restriction approach, the ECJ case law on direct tax law follows a (less strict) non-discrimination approach.¹¹⁰ This is sensible as taxes have per se a restrictive effect meaning that, upon the application of the (non-discriminatory) restriction approach, every tax could have to be justified and tested for proportionality.¹¹¹ As such, and to borrow the famous words of the deceased doyen of European Taxation, Frans Vanistendael, ‘The European tax landscape is no big snooker table that spans the whole internal market on which all balls are meant to run smoothly. Rather, it is a room containing twenty-seven different snooker tables that should be accessible in a non-discriminatory manner’.¹¹²

Direct tax harmonization would not conceptually change the above situation as long as the compartmentalization of tax systems remains. It would, to add to the above metaphor, only mean that rules governing the games on each of the twenty-seven different snooker tables would be harmonized and make it easier to expand and play on other tables as well.¹¹³ Prima facie, the task of the fundamental freedoms in such a setting is not different than one in a national setting since it remains that cross-border transactions must not be discriminated against unless there is an acceptable reason and the rules are proportionate. Yet, as outlined in section 4.3.1, the application of the freedoms to harmonized EU law happens in a setting that is crucially different than what is the case for national law. After all, upon harmonization, the rule under examination is valid in the entire EU and not just in a certain Member State like it is in the unharmonized setting. Should the secondary EU direct tax law rule in question pass competence control,¹¹⁴ it can be assumed – for the purposes of applying the freedoms – that there will be an overall advancement of the internal market. Notably, this can mean both that the secondary EU law rules genuinely make the applicable tax law more integration friendly or by harmonizing integration unfriendly rules that would otherwise remain unharmonized and thus even worse.¹¹⁵

What remains at this stage is an (assumed) overall benefit for the internal market that is to be weighed against the downsides brought by the partial restrictions of the fundamental freedoms. In striking this balance, the court already applies a relatively nuanced doctrine that focuses on the general situation. It grants leeway to the legislator as to how the internal market should be improved while it nevertheless also demonstrates a remarkable readiness to interfere with the secondary EU legislator upon it perceiving that there is a need for doing so.¹¹⁶

In further forming its doctrine on how to apply the fundamental freedoms to harmonized direct tax law, the court should – and likely will – continue to take a critical stance on special arrangements granted to certain Member States that face strict scrutiny if they violate the freedoms. Should it do so, it would address the second concern listed above. In addition, the court should be sensitive about not upholding rules violating the freedoms if they are simply not worth it (concern 1). This requires the court to enter into a sufficiently rigorous analysis of the tax rule in question in light of the broader, and per se legitimate, legislative initiative of which it is a part. In this role as a piece in a larger mosaic, the court should form a view on the benefits brought by the provision in question upon which they should be weighed against the disadvantages suffered by the individual. If a legitimate and consistent legislative decision from the EU legislator is in question, the odds for this rule to withstand scrutiny should be higher than with rules that incoherently and/or unproportionately restrict the freedoms of taxpayers without yielding a benefit sufficiently justifying it.

4.4 Fundamental Rights

4.4.1 The role of Fundamental Rights and Brief Reflections on the Current Doctrine

As EU law supersedes national constitutional law,¹¹⁷ a system of European fundamental rights control is necessary

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¹¹⁰ Literature complains about the confusion that the ECJ creates by using the term ‘restriction’ in an undifferentiated manner. See e.g., J. Englisch, in *Europäisches Steuerrecht* 280 (M. Lang ed.) ; Opinion of Advocate General Michal Bobek in Case C-382/16 *Hornbach-Baumarkt*, EU:C:2017:974, paras 39–40. For a more comprehensive elaboration, see Bammens, *supra* n. 109, s. 13.4.3; J. Snell, *Non-discriminatory Tax Obstacles in Community Law*, 56 *Int’l & Comp. L. Q.* 365–366 (2007); K. Banks, *The Application of the Fundamental Freedoms to Member State Tax Measures: Guarding Against Protectionism or Second-Guessing National Policy Choices?*, 33 *Eur. L. Rev.* (2008); J. A. M. Korving, *Internal Market Neutrality*, at 85 et seq.

¹¹¹ Going back to F. Vanistendael, *The Compatibility of the Basic Economic Freedoms with the Sovereign National Tax Systems of the Member States*, 12 *EC Tax Rev.* 141 et seq. (2003).

¹¹² Similarly used in, e.g., Schön, *infra* n. 114, s. 3.7.

¹¹³ See for further going conceptual remarks, W Schön, *Neutrality and Territoriality – Competing or Converging Concepts in European Tax Law?*, 69 *Bulletin for International Taxation* (2015), <https://www.ibfd.org/doi/28ef6by> (accessed 16 Feb. 2024).

¹¹⁴ See s. 4.2.

¹¹⁵ See s. 4.2.1.

¹¹⁶ See s. 4.3.1.

¹¹⁷ *Internationale Handelsgesellschaft mbH v. Einfuhr- und Vorratsstelle für Getreide und Futtermittel* [1970] ECJ Case 11-70.; *Erich Stauder v. City of Ulm – Sozialamt* [1969] ECJ Case 29-69 [7].

in order to avoid a constitutional gap.¹¹⁸ Through the Treaty of Lisbon, the longstanding ECJ case law based on the constitutional traditions common to the Member States and the European Convention of Human Rights (ECHR)¹¹⁹ was codified into Article 6(3) TEU.¹²⁰ Furthermore, based on Article 6(1) TEU, the EU recognizes the ChFR and grants it the same legal value as primary EU law.¹²¹ This leads to EU law being governed by a written and unwritten catalogue of fundamental rights.¹²² EU law in breach of it is void.

Being the 'shadow of EU law',¹²³ the relevance of EU fundamental rights control has been increasing steadily with the growing of direct taxation harmonization.¹²⁴ Yet, and particularly when compared to national constitutional traditions,¹²⁵ a direct tax specific EU fundamental rights doctrine is still in its inception. While this is the natural result of the court not having had the chance to develop this,¹²⁶ it is nevertheless an issue of rather high relevance. This is because – as quoted in the introduction of this article – the development of, or at least the debate

about, a European tax constitutional law understanding is important for promoting the chances of harmonization.¹²⁷ Given the wideness of the subject, the author's general reflections on the current doctrine shall already be limited to what seems to be relevant for taxation.

First of all, it is worth stressing that the court in a fundamental rights setting also applies a nuanced method and differs in scrutiny depending on what type of rights are at stake. In broad terms, the court appears to apply a stricter standard vis-à-vis personal fundamental rights. This can be deduced from the general case law and from the already emerging taxation case law.¹²⁸ Literature, so it appears, seems to express a positive stance towards this approach.¹²⁹

On the other hand, the situation is different for economic fundamental rights for which the case law suggests that the court conducts a rather light assessment. In an indirect tax context, the court also emphasized that it grants broad discretion to the secondary EU legislator when it is called upon to make political, economic, and

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¹¹⁸ See in more detail, e.g., Pasquale Pistone, *EU Charter of Fundamental Rights in General Principles of EU Law and Taxation*, in *European Tax Law*, vol 1 (Peter Wattel and others eds, Wolters Kluwer 2018); Katerina Perrou, *Fundamental Rights in EU Tax Law*, in *Research Handbook on European Union Taxation Law* (Christina HJI Panayi and others eds, Edward Elgar Publishing 2020); Katerina Perrou, *Case Law Note: The Application of the EU Charter of Fundamental Rights to Tax Procedures: Trends in the Case Law of the Court of Justice*, 49 *Intertax* 853 (2021); Kofler, *supra* n. 2; Lemmen, *supra* n. 3. For an overview of the German approach, see e.g., Johanna Hey, *Entwicklungslinien Und Zukunftsfragen Des Steuerverfassungsrechts*, *Driien*, Klaus-Dieter Hey, Johanna/Mellinghoff, Rudolf (Hrsg.), vol 100 (2018); Michael Eichberger, *Verfassungsrechtliche Rahmenbedingungen*, <https://publikationen.uni-tuebingen.de/xmlui/handle/10900/73491> (accessed 27 Feb. 2024). More general on the phenomenon, see e.g., Juliane Kokott & Pasquale Pistone, *Taxpayers in International Law: International Minimum Standards for the Protection of Taxpayers' Rights* (Hart 2022).

¹¹⁹ *J Nold, Kohlen- und Baustoffgroßhandlung v. Commission of the European Communities* [1974] ECJ Case 4–73 [12–14]; and, *Liselotte Hauer v. Land Rheinland-Pfalz* [1979] An Chüirt Bhreithiúnais Case 44/79 [15]. 'European Convention on Human Rights'. 4.XI.1950.

¹²⁰ In more detail, see e.g., Pache, *EUV Art. 6 (Grundrechte-Charta Und EMRK)*, in *Frankfurter Kommentar* (Pechstein, Nowak & Häde eds, 2d edn 2023); Kingreen, *EU-Vertrag (Lissabon) Art. 6 (Ex-Art. 6 EUV) (Grundrechte-Charta Und EMRK)*, in *Callies/Ruffert* (EUV & AEUV eds, 6th edn 2022); Armin Hatje, *EUV Art. 6 (Charta Der Grundrechte; EMRK)*, in *EU-Kommentar* (Schwarze and others eds, 4th edn 2019); Schorkopf, *EUV Art. 6 Grundrechte-Charta Und EMRK*, *Das Recht der Europäischen Union* (80th edn 2023).

¹²¹ *Consolidated Version of the Treaty on European Union*, *supra* n. 52 Art. 6(1). In more detail, see e.g., Schorkopf, *supra* n. 121; Pache, *EUV Art. 6 (Grundrechte-Charta Und EMRK)*, *supra* n. 121. Schorkopf, *Art. 6 EUV*, in *Das Recht der Europäischen Union* (Grabitz, Hilf & Nettesheim eds, Beck 2019).

¹²² On the relation between *Consolidated Version of the Treaty on European Union*, *supra* n. 52, Art. 6(1) and 6(3) and in favour of the primacy of the Charter of Fundamental Rights of the European Union 2012 (OJ C), see e.g., Kingreen, *supra* n. 121, paras 15–18. Schorkopf, *supra* n. 107, para. 56. See the latter, at paras 50 et seq. for an overview of the discussion on the role of *Consolidated Version of the Treaty on European Union*, *supra* n. 52, Art. 6(3). Charter of Fundamental Rights of the European Union.

¹²³ Koenraad Lenaerts & José Antonio Gutiérrez-Fons, *The Place of the Charter in the European Legal Space*, in *The EU Charter of Fundamental Rights – A Commentary (Second Edition)* (Hart Publishing 2021).

¹²⁴ Council Directive (EU) 2016/1164 of 12 Jul. 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market 2016; Council Directive (EU) 2022/2523 of 15 Dec. 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union 2022; Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries 2017; Proposal for a COUNCIL DIRECTIVE laying down rules to prevent the misuse of shell entities for tax purposes and amending Directive 2011/16/EU 2021; Proposal for a COUNCIL DIRECTIVE on laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes 2022; Proposal for a COUNCIL DIRECTIVE on Business in Europe: Framework for Income Taxation (BEFIT), *supra* n. 48; Proposal for a COUNCIL DIRECTIVE on transfer pricing 2023.

¹²⁵ See for instance, the German literature on the topic such as, and with further references, Lemmen, *supra* n. 3; Hanno Kube, *Europäisches versus nationales Steuerverfassungsrecht*, in *Europäisches Steuerverfassungsrecht*, vol 11 (Johanna Hey & Wolfgang Schön eds, Springer Berlin Heidelberg 2023), https://link.springer.com/10.1007/978-3-662-67474-1_2 (accessed 27 Feb. 2024); Hey, *supra* n. 3; Kokott, *supra* n. 4, s. 3; Englisch, *supra* n. 42; Friederike Engler, *Steuerverfassungsrecht im Mehrebenensystem: ein Vergleich des Schutzes vor Besteuerung durch EMRK, Grundrechtecharta und die nationale Grundrechtsordnung* (1. Aufl, Nomos 2014).

¹²⁶ Hey, *supra* n. 3, at 176.

¹²⁷ See s. 1.

¹²⁸ Marta Papis-Almansa, *Case Law Trend: The End Does Not Justify the Means: On How the Secondary EU Law Infringes the Primary EU Law in the Light of the Recent Judgments of the CJEU*, 51 *Intertax* (2023), <https://kluwerlawonline.com/api/Product/CitationPDFURL?file=Journals/TAXI/TAXI2023055.pdf> (accessed 27 Feb. 2024); Michael Stöber, *The Charter of Fundamental Rights and EU Tax Directives*, 32 *EC Tax Rev.* 203 (2023); Yassin Abdullab Kadi and Al Barakaat International Foundation v. Council of the European Union and Commission of the European Communities [2008] ECJ Joined Cases C-402/05 P and C-415/05 P; Association Belge des Consommateurs Test-Achats ASBL and Others v. Conseil des ministres [2011] ECJ Case C-236/09; Maximilian Schrems v. Data Protection Commissioner [2015] ECJ Case C-362/14; Data Protection Commissioner v. Facebook Ireland Limited and Maximilian Schrems [2020] ECJ Case C-311/18; Orde van Vlaamse Balies and Others v. Vlaamse Regering [2022] ECJ Case C-694/20; Volker und Markus Schecke GbR (C-92/09) and Hartmut Eifert (C-93/09) v. Land Hessen [2010] ECJ Joined Cases C-92/09 and C-93/09; W/M and Sovim SA v. Luxembourg Business Registers [2022] ECJ Joined Cases C-37/20 and C-601/20.

¹²⁹ Stöber, *supra* n. 129; Papis-Almansa, *supra* n. 129.

social choices and to rank divergent interests or undertake complex assessments.¹³⁰ In this respect, tax literature is more critical.¹³¹

The two most relevant economic fundamental rights concerning direct taxation are Article 16 ChFR and Article 20 ChFR; Noting that these rules can be applied in parallel or alone,¹³² the author will elaborate on them separately. The first rule, Article 16 ChFR, protects the freedom to provide business.¹³³ Keeping in mind the EU's commitment to a social market economy in accordance with the requirements of an open market economy with free competition,¹³⁴ the relevance of this 'fundamental legal principle'¹³⁵ is 'not to be underestimated'¹³⁶ and 'of extraordinary importance'.¹³⁷ It protects the freedom to exercise an economic or commercial activity, the freedom of contract, and free competition.¹³⁸ The second rule, Article 20 ChFR, includes the general equality principle. It demands treating equals alike and non-equals differently.¹³⁹ It is applicable subsidiarily to other more special equality principles (such as the fundamental freedoms).¹⁴⁰

4.4.2 Reflections on Potential Developments of Applying Selected Economic Fundamental Rights to Secondary EU Tax Law

4.4.2.1 Article 16 and the Freedom to Provide Business

Traditionally, questions related to applying the freedom to provide business (and their national counterparts)¹⁴¹

have typically been related to taxation that is unreasonably high and thereby unduly impact a taxpayer's freedom to provide business.¹⁴² This also extends to financial obligations that are related to a tax. For instance, in the VAT case *BB construct*, the court regarded deposits that can be unreasonably high and cause companies to declare bankruptcy to be in breach of Article 16 ChFR.¹⁴³

Although it requires some fantasy, it is not impossible to expand on this towards suspecting that, in a direct taxation context, similar questions could emerge regarding compliance costs that are related to fulfilling direct tax obligations. This is certainly most unlikely as, in the counterfactual scenario of no harmonization, compliance costs could be much higher. Furthermore, even if such a breach was ascertained, it would plausibly be justifiable. After all, paying tax based on a business' own calculation is the starting point of most tax systems and, although rules like the Minimum Taxation Directive¹⁴⁴ are complex and create high compliance costs, they cannot be argued to per se endanger the freedom to provide business, especially not to such an extent that they demand action from the court. Nonetheless, it cannot be ruled out that single rules could raise concerns if the cost of properly complying with them would be manifestly out of proportion particularly when considering the nature of the business covered by the rules. With much less fantasy, the author could imagine such issues to concern, for instance, the imported mismatch rule included in the

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¹³⁰ *Proceedings brought by Rzecznik Praw Obywatelskich (RPO)* [2017] ECJ Case C-390/15 [54].

¹³¹ Hey, *supra* n. 3, at 172.

¹³² *Herbert Schaible v. Land Baden-Württemberg* [2013] ECJ Case C-101/12; *UAB 'Spika' and Others v. Žuvininkystės tarnyba prie Lietuvos Respublikos žemės ūkio ministerijos* [2018] ECJ Case C-540/16. *Herbert Schaible v. Land Baden-Württemberg*; *UAB 'Spika' and Others v. Žuvininkystės tarnyba prie Lietuvos Respublikos žemės ūkio ministerijos*.

¹³³ See fundamentally, *J Nold, Koblen- und Baustoffgroßhandlung v. Commission of the European Communities* [1974] ECJ Case 4-73. Mayer, *Nach Art. 6 EUV Grundrechtsschutz Und Rechtsstaatliche Grundsätze*, *Das Recht der Europäischen Union* (80th edn 2023); Nowak, § 35 *Unternehmerische Freiheit Und Wettbewerbsfreiheit*, in *Handbuch der Europäischen Grundrechte* (Heselerhaus & Nowak eds, 2d edn 2020); Ulf Brühmann, *AEUV Art. 16 (Ex-Artikel 286 EGV) (Datenschutz)*, in *Europäisches Unionsrecht* (von der Groeben, Schwarze & Hatje eds, 7th edn 2015).

¹³⁴ *Opinion of Advocate General Kokott, Samira Achbita and Centrum voor gelijkheid van kansen en voor racismebestrijding v. G4S Secure Solutions NV*, Case C-157/15 (ECJ) [134]; Treaty on European Union Art. 3(3); Treaty on the Functioning of the European Union (OJ C) Arts 119(1) and 120. See also Convent, *Explanations Relating to the Charter of Fundamental Rights of the European Union*, CHARTE 4473/00.

¹³⁵ *Order of the President of the Court of 13 November 2000 'Invest' Import und Export GmbH and Invest Commerce v. Commission of the European Communities Case C-317/00 P(R)* (ECJ) [57].

¹³⁶ Case C-157/15, *supra* n. 135, para. 134.

¹³⁷ Nowak, *supra* n. 134, para. 1. Nowak, *supra* n. 134, para. 1.

¹³⁸ Compare, e.g., *Herbert Schaible*, *supra* n. 68, para. 24; *Romonta GmbH v. European Commission* [2014] GC Case T-614/13 [56]. *Sky Österreich GmbH*, *supra* n. 68, para. 42. *Pillbox 38 (UK) Limited, trading as Totally Wicked v. Secretary of State for Health* [2016] ECJ Case C-477/14 [155]. *Anonymi Geniki Etairia Tsimenton Iraklis (AGET Iraklis) v. Ypourgos Ergasias, Koinonikis Asfalisis kai Koinonikis Allilengyis* [2016] ECJ Case C-201/15 [67]; *Finančné riaditeľstvo Slovenskej republiky v. BB construct sro* [2017] ECJ Case C-534/16 [35]. *Polkomtel sp z oo v. Prezes Urzędu Komunikacji Elektronicznej* [2017] ECJ Case C-277/16 [50]; *UAB 'Spika' and Others v. Žuvininkystės tarnyba prie Lietuvos Respublikos žemės ūkio ministerijos* [2018] ECJ Case C-540/16 [34].

¹³⁹ Generally and instead of many, see e.g., Heselerhaus, *GRC Art. 20 Gleichheit Vor Dem Gesetz*, in *Frankfurter Kommentar* (Pechstein, Nowak & Häde eds, 2d edn 2023); from a direct tax perspective, including further references, see e.g., Lemmen, *supra* n. 3; Hey, *supra* n. 3.

¹⁴⁰ See *Ingrid Schmeltz v. Finanzamt Waldviertel*, *supra* n. 94, paras 74 et seq. Note, however, that the availability of a more special principle does not automatically rule out the applicability of the general principle. See Heselerhaus, *supra* n. 140, para. 15.

¹⁴¹ Recently in Finland, see *Perustuslakivaliokunta, Valiokunnan lausunto PeVL 9/2023 vp*.

¹⁴² See for a broader elaboration, Kokott, *supra* n. 4, at 193.

¹⁴³ *Finančné riaditeľstvo Slovenskej republiky v. BB construct sro* [2017] ECJ Case C-534/16 [38 et seq.]; see further, Kokott, *supra* n. 4, at 193.

¹⁴⁴ Minimum Tax Directive (2020/2523).

ATAD.¹⁴⁵ While being justified per se, this rule can occasionally be of outrageous complexity thereby making the literal compliance with the rules either impossible or prohibitively expensive, especially for smaller businesses.¹⁴⁶

In addition and as recently posited by the author on a separate occasion,¹⁴⁷ it is possible that an EU tax rule gives an advantage to certain businesses that are in scope of the measure which can adversely affect the competitive position of another taxpayer. Although this is a complex discussion,¹⁴⁸ there are instances in case law suggesting that Article 16 ChFR could be concerned with such a situation¹⁴⁹ potentially in combination with the equality principle included in Article 20 ChFR.¹⁵⁰ It clearly exceeds the scope of this article to establish any comprehensive suggestions as to how a direct tax specific doctrine should be developed in this regard. Yet, in taking on this fascinating intellectual challenge at a later stage in time, there is one question the author is eager to find an answer to: Given the inapplicability of the state aid provisions in Article 107 TFEU to secondary EU law (due to the lack of attributability of the aid to the Member State),¹⁵¹ can (and should) Article 16 ChFR take over the task of protecting those that economically suffer from not being entitled to an advantage that its competitor receives? To the author, at least, the answer to this question is ambiguous. On the one hand, it is true that the risk for tainted state aid is undoubtedly lower when concerning EU measures. On the other hand, however, secondary EU direct tax law may – and be it unintentionally – nonetheless create similar effects. For those being detrimentally affected by the legislation exerting a competitive disadvantage on them, it is of no avail whether the underlying rule is national law or EU law. Although the examination schemes for Article 107 TFEU and Article 16 ChFR are different, it still remains that the former has provided protection to an economic actor that would be weakened unless it is essentially ultimately safeguarded by applying

Article 16 ChFR (and potentially Article 20 ChFR). It is not clear upfront to the author why this should be acceptable and, in fact, whether this would even be in the interest of the legislator that may not have wanted such an outcome but that can be prevented by a small minority from changing it due to the burdensome process.

4.4.2.2 The Equality Principle of Article 20 ChFR

4.4.2.2.1 Overview

Equality is a very, if not the most relevant, constitutional principle for the field of taxation considering that the equal sharing of tax burdens is a matter of general acceptance and justification of taxation per se.¹⁵² Yet, thus far, a direct tax specific doctrine on the application of the equality principle does not exist.¹⁵³ For the purposes of this article it is, of course, not possible to provide elaborations that adequately reflect the legal, political, and social questions that are related to the development of a direct tax-specific understanding of the EU equality principle.¹⁵⁴ However, the author intends to raise three issues that seem to be particularly interesting and worth focusing on in the anticipation of a development of such a doctrine.

The first one is of a conceptual nature and focuses on the difficult task for the court to embed its direct tax relevant jurisprudence into a setting in which Member States' constitutional traditions are, in part, very widely developed. This becomes even more difficult to the extent that secondary EU law is only punctually harmonized, meaning that its application is also building on national law (which is again not covered by the EU equality law (4.4.2.2.2)). Second and third, the author intends to outline some important choices that the court must make in developing a direct tax-specific equality doctrine. In this regard, the author intends to split the discussion into tax related rules, non-fiscal rules (to which the ability to pay

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¹⁴⁵ Council Directive (EU) 2016/1164 of 12 Jul. 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, *supra* n. 125, Art. 9(3).

¹⁴⁶ See on the issue, including further references, e.g., Moritz Scherleitner, *Addressing Tax Arbitrage with Hybrid Financial Instrument* | IBFD, Ch. 5.4.5, <https://www.ibfd.org/shop/book/addressing-tax-arbitrage-hybrid-financial-instrument?v=686> (accessed 23 Feb. 2023).

¹⁴⁷ Scherleitner & Mäki, *supra* n. 1.

¹⁴⁸ Based on which parts of literature have concluded that there is a subjective dimension to the principle of free competition. This is, however, a broader discussion. See on this, e.g., Nowak, *supra* n. 134, para. 35; Kühling & Drechsler, *GRC Art. 16 {Unternehmerische Freiheit}*, in *Frankfurter Kommentar* (Pechstein, Nowak & Häde eds, 2d edn 2023), para. 17. Jarass, *EU-Grundrechte-Charta Art. 16 Unternehmerische Freiheit*, in *Jarass (Charta der Grundrechte der EU ed., 4th edn 2021)*, para. 2.

¹⁴⁹ *Federal Republic of Germany v. Council of the European Union* [1994] ECJ Case C-280/93 [81].

¹⁵⁰ *UAB 'Spika' and Others v. Žuvininkystės tarnyba prie Lietuvos Respublikos žemės ūkio ministerijos*, *supra* n. 133, paras 25 et seq.

¹⁵¹ *Deutsche Bahn AG v. Commission of the European Communities* [2006] GC Case T-351/02 101 et seq.; see more broadly Raymond HC Luja, *The Attribution of State Aid to Member States in the Exercising of Options in Directives: Annotation on the Judgment of the General Court of 21 March 2012 in Joined Cases T-50/06 RENV, T-56/06 RENV, T-60/06 RENV, T-62/06 RENV and T-69/06 RENV, Alumina II*, 12 Eur. State Aid L. Q. 119 (2013).

¹⁵² Hey, *supra* n. 3, at 157.

¹⁵³ *Ibid.*

¹⁵⁴ For broader elaborations, see for instance, *ibid.*; Kokott, *supra* n. 4, Ch. 3; Englisch, *supra* n. 42; Lemmen, *supra* n. 3.

principle does not apply), and fiscal rules (to which the same principle may apply) (4.3.3.3.2-4.3.3.3.2).

4.4.2.2.2 Conceptual remarks on embedding EU direct tax equality doctrines into (far developed) national traditions.

The equality principle is at the core of the legal systems of all EU Member States and a core principle of the EU.¹⁵⁵ Nevertheless, while it seems intuitive and clear that persons need to be treated equally, it remains of extraordinary difficulty to say *when* they need to be treated in the same way or differently.¹⁵⁶ This is because the answer to this question often includes values and perceptions.¹⁵⁷ For courts that are called upon to give life to the abstract equality principle, this is a delicate task since they must balance the need to respect value decisions made by the legislature with that of protecting the taxpayers against arbitrary law making.¹⁵⁸

In a national context, courts have been confronted with these questions for a long time. As a result, constitutional traditions in the field of direct tax have emerged in each Member State. These national doctrines are again to be taken into account by the ECJ as sources of interpretation (but not as direct sources of law).^{159,160} Conceptually, this is well founded as it approximates fundamental rights protection at the national and European levels.¹⁶¹ Yet, these constitutional traditions are not uniform and differ in part considerably from each other.¹⁶² This is exacer-

bated by the fact that national doctrines also change over time.¹⁶³ Thus, it is difficult to predict how exactly national constitutional traditions will influence the ECJ case law. Nevertheless, it is worth stressing that taking these into account is not an exercise of finding the lowest common denominator.¹⁶⁴ Rather, the interpretation should achieve a high standard of protection that is adequate for Union law.¹⁶⁵ This is achieved through an 'evaluative approach',¹⁶⁶ at the end of which the court 'chooses from each of the Member States those solutions which, having regard to the objectives of the Treat[ies], appear [to] be the best'.¹⁶⁷ Importantly, this can include relying on concepts that are used only in a minority of Member States.¹⁶⁸ Furthermore, the court does not have to precisely adhere to the chosen national tradition but can also further develop it.¹⁶⁹

Another possibility would be for the court not to, or not to always, aim towards building up a European tax equality understanding but to apply Article 20 ChFR in close connection with specific national constitutional traditions. This would not be fully unknown to EU law¹⁷⁰ and could, when extrapolated to direct taxation, also mean that there will be room left for (potentially diverging) national values within the application of the equality principle. The ultimate result could be a partly non-uniform application of Article 20 ChFR to tax law which is a sacrifice made in favour of paying stronger respect to

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¹⁵⁵ Convent, *supra* n. 137, Art. 20; see further on Art. 20 ChFR, e.g., Jarass, *EU-Grundrechte-Charta Art. 20 Gleichheit Vor Dem Gesetz*, in Jarass (Charta der Grundrechte der EU ed., 4th edn 2021); Rossi, *EU-GRCharta Art. 20 Gleichheit Vor Dem Gesetz*, in Calliess/Ruffert (EUV & AEUV eds, 6th edn 2022); Heselhaus, *supra* n. 142; Noting that the principle is not explicitly enshrined in all constitutions of Members States while nevertheless being a core part of the common constitutional traditions, Streinz, *GR-Charta Art. 20 Gleichheit Vor Dem Gesetz*, in Streinz (EUV & AEUV eds, 3d edn 2018), para. 2; Mark Bell, *Article 20 - Equality Before the Law*, in *The EU charter of Fundamental Rights: A Commentary* (Steve Peers and others eds, Second edition, Hart 2021); For elaborations from a tax perspective, see for instance, Hey, *supra* n. 3; Juliane Kokott & Lars Dobratz, *Der unionsrechtliche allgemeine Gleichheitssatz im Europäischen Steuerrecht*, in *Grundfragen des Europäischen Steuerrechts* (Wolfgang Schön & Caroline Heber eds, Springer 2015), https://doi.org/10.1007/978-3-662-47465-5_2 (accessed 12 Feb. 2024); Lemmen, *supra* n. 3.

¹⁵⁶ Bell, *supra* n. 156.

¹⁵⁷ Bell verweis sharpston.

¹⁵⁸ The latter being the core of equality as a constitutional principle. See further, e.g., Elise Muir, *The Essence of the Fundamental Right to Equal Treatment: Back to the Origins*, 20 Ger. L. J. 817 (2019).

¹⁵⁹ See e.g., Kingreen, *supra* n. 123, paras 19 et seq., 39 et seq.; Pache, *GRC Art. 52 Tragweite Und Auslegung Der Rechte Und Grundsätze*, in *Frankfurter Kommentar EUV/GRC/AEUV* (Pechstein, Nowak & Häde eds, 2d edn 2023), paras 44 et seq.

¹⁶⁰ Note that, based on the Charter of Fundamental Rights of the European Union 2012 (OJ C) 52(3), it is necessary to also take the ECHR into account. That being said, a direct tax specific doctrine has not yet been developed in this convention which is unlikely to change given that the ECHR has not been expected to have a noticeable effect on tax legislation. See further, Lemmen, *supra* n. 3, at 153 et seq.

¹⁶¹ For example, Lemmen, *supra* n. 3, at 175.

¹⁶² For an elaboration, see for instance, Lemmen, *supra* n. 3, at 186 et seq.; Englisch, *supra* n. 43. For a direct comparison of the German to the Austrian and Italian equality doctrine, see Lemmen, *supra* n. 3, at 175–280; M. Bourgeois, *Constitutional Framework of the Different Types of Income*, in *The Concept of Tax*, vol 3 (B. Peeters ed., EATLP International Tax Series 2005).

¹⁶³ Observing such a tendency towards stricter constitutional control in direct taxation focusing on Austria and Germany, see Lemmen, *supra* n. 3, at 193 et seq., 343.

¹⁶⁴ Convent, *supra* n. 135, Art. 52(4).

¹⁶⁵ *Ibid.*

¹⁶⁶ Koen Lenaerts, *The European Court of Justice and the Comparative Law Method*, 25 Eur. Rev. Priv. L. (2017), <https://kluwerlawonline.com/api/Product/CitationPDFURL?file=Journals/ERPL/ERPL2017022.pdf> (accessed 15 Aug. 2024).

¹⁶⁷ Under reference to Lenaerts, *supra* n. 169, at 304; *Opinion of Mr Advocate General Lagrange delivered on 4 June 1962 Koninklijke Nederlandsche Hoogovens en Staalfabrieken NV v. High Authority of the European Coal and Steel Community Case 14/61 (ECJ)*; see also e.g., Lemmen, *supra* n. 3, at 180.

¹⁶⁸ With further references Lemmen, *supra* n. 3, at 181.

¹⁶⁹ *Ibid.*

¹⁷⁰ *Case C-157/15*, *supra* n. 135, at 125.

national identities.^{171,172} Whether this is a sensible approach, however, can be doubted as it would be rather detrimental to integration.

This leaves the court in a very difficult situation. Powerful voices in literature urge it to understand that it needs to make a transition from an integration court to a constitutional court¹⁷³; otherwise, there is a risk for national constitutional courts to intervene and provide fundamental rights protection themselves.¹⁷⁴ Furthermore, literature draws the court's attention to the fact that, in some jurisdictions at least, there is tendency towards applying a stricter stance by constitutional courts vis-à-vis the legislator.¹⁷⁵ The court, so the argument goes, should not allow those obstacles to emerge that national constitutional courts had to overcome in a long process. Rather, it should develop a direct tax specific fundamental rights doctrine that communicates to the legislator that it is not immune to fundamental rights control.¹⁷⁶ Given the larger need for 'protection by content' in an EU setting, the author fully endorses these positions. After all, and different than in a national setting, the legislator may well be unable to adapt the law which creates situations in which the taxpayer subject to unequal treatment cannot do anything else but depend on the court to uphold its rights. Nonetheless, it is particularly important in this regard to stress that the court faces certain restrictions that can hinder it – especially in a setting of lower harmonization – in giving full effect to these demands even if it was fully committed to do so.

In fact, and noting that an issue broader than what can be reflected here is at stake,¹⁷⁷ an EU equality principle may not cover all legal norms that are relevant regarding the equality of situations. Rather, they apply only to the extent that EU law is a factor. This means that, in examining unequal treatment for the purposes of Article 20 ChFR, only situations that are explicitly or implicitly covered by secondary EU law may be

considered in the application of a comparability analysis.¹⁷⁸ As a result, unequal tax treatment that results from Member States being able to keep their national law (in the absence of harmonization covering this situation) is, from an EU perspective, to be accepted even if it would not be allowed under full harmonization.¹⁷⁹ This essentially means that Article 20 ChFR does not obligate (or enable) the European legislator to remedy the unequal treatment emerging in such a situation.¹⁸⁰ Rather, it is national constitutional law that may or may not force the national legislator to align national law with secondary EU law with a view to eliminate the unequal treatment.¹⁸¹ This means that, especially in an environment of very little harmonization, the court cannot (even) ensure factual equality alone.

4.4.2.2.3 The application of Article 20 ChFR to tax related non-fiscal rules

In discussing the application of Article 20 ChFR, the author will first focus on tax related non-fiscal rules, that is, initiatives that ease the application of tax rules but that are not, or at least not directly, actual fiscal rules that themselves demand the implementation of rules creating a tax liability. As an example, consider the commission's proposal for a head office tax system for micro, small, and medium-sized enterprises (HOT proposal) under which eligible companies would be able to calculate their EU permanent establishments' profits pursuant to the tax base rules of the head office state while the tax rate of the source state.¹⁸² In these cases, the question is not about whether the court will apply a direct tax specific equality concept – like the ability to pay principle which will be discussed below (4.4.2.2.3). It is rather about ordinary equality control targeted at preventing that taxpayers unjustifiably and disproportionately suffering from arbitrary law making.

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¹⁷¹ Which is also enshrined in the consolidated version of the Treaty on European Union – TITLE I COMMON PROVISIONS – Art. 4 2012 (OJ C) para. 2; see in this regard also Lemmen, *supra* n. 3, at 334 et seq.

¹⁷² For a brief review of the fascinating discussions that may revolve around this issue, see for instance, Sigrid Hemels, *Fairness: A Legal Principle in EU Tax Law?*, in *Principles of Law: Function, Status and Impact in EU Tax Law* (C. Brokelind ed. 2014), <http://www.ibfd.org/IBFD-Products/Principles-Law-Function-Status-and-Impact-EU-Tax-Law> (accessed 15 Aug. 2024).

¹⁷³ Hey, *supra* n. 3, at 172.

¹⁷⁴ *Ibid.*, at 185.

¹⁷⁵ Regarding Austria and Germany, see Lemmen, *supra* n. 3, at 193 et seq., 343. In more detail on the German doctrine i.e., understood to be particularly strict towards the legislator. For an elaboration, including further references, see instead of many, e.g., Lemmen, *supra* n. 3, at 186 et seq.; Englisch, *supra* n. 42.

¹⁷⁶ Lemmen, *supra* n. 3, at 344.

¹⁷⁷ See in more detail on this issue, Caroline Heber, *Zwingende Gleichheit? Die Einflussnahme des Europarechts auf rein nationale Sachverhalte (Teil 1)*, 33 Europäische Zeitschrift für Wirtschaftsrecht 53 (2022); Caroline Heber, *Zwingende Gleichheit? Die Einflussnahme des Europarechts auf rein nationale Sachverhalte (Teil 2)*, 33 Europäische Zeitschrift für Wirtschaftsrecht 107 (2022); Caroline Heber, *The Interest Limitation Rule in the Light of European Constitutional Law*, 31 EC Tax Rev. 72 (2022); Englisch, *supra* n. 42, at 67.

¹⁷⁸ *Åklagaren v. Hans Åkerberg Fransson* [2013] ECJ Case C-617/10 [19 et seq.]; see for further references, Heber, *supra* n. 178, at 76.

¹⁷⁹ Englisch, *supra* n. 42, at 67 including further references to; *Administration de l'enregistrement et des domaines v. Eurodent Sàrl* [2006] ECJ Case C-240/05; *Idéal tourisme SA v. Belgian State* [2000] ECJ Case C-36/99 [34].

¹⁸⁰ In more detail and with further references, see Englisch, *supra* n. 42, at 67; Heber, *supra* n. 178, at 77.

¹⁸¹ See in more detail, Heber, *supra* n. 178; Heber, *supra* n. 178; Heber, *supra* n. 178, at 77.

¹⁸² See Proposal for a COUNCIL DIRECTIVE establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU 2023.

7Continuing, for illustration purposes, with the above mentioned HOT proposal, consider that the rules provide for a significant simplification for SMEs in scope.¹⁸³ At the same time, however, it also includes extremely broad and blunt anti-abuse rules.¹⁸⁴ Without aiming to delve into the technical details it should suffice to say that the current mechanism aimed at preventing companies from enjoying the benefits if they are not meant to do so, can easily lead to situations in which companies that should be able to benefit from the rules cannot do so since they are assumed to act abusively. As the clearest of various other examples, consider startups that must wait two years before being able to receive the benefit¹⁸⁵ regardless of any abuse motivation and regardless of whether it was established in a jurisdiction with tax base rules that are more favourable.¹⁸⁶ While the author accepts that the reader may regard this as collateral damage resulting from a legitimate interest to simplify the legislation, it remains that the SME in question could suffer a competitive disadvantage vis-à-vis others eligible to the rules if its non-startup competitors can rely on the HOT simplification. This can very well make a difference because, if A Co. (the start-up) and B Co. (a company eligible for the simplification) compete for a project abroad for which it is assumed that it would require creating a PE, then B Co. would be able to more easily outbid A Co. due to its lower compliance costs. The latter may then invoke Article 20 ChFR arguing that this differentiation violates its right to equal treatment.

Below, the author discusses different approaches that, prima facie, the court could follow to resolve this issue which – in the view of A Co. at least, forms an example of the first concern outlined in section 3.2 that is allegedly a poorly founded and inconsistent rule that violates a taxpayer's right to equal treatment.

The first option to be considered is an attempt by the court to avoid a conflict between the secondary EU law with the equality principle via using a consistent interpretation of the concerned law in order to adhere to the demands of primary EU law. Although the court, as emphasized in section 2, has been prepared to push the limits of interpretation to the utmost with a view of achieving this result, it would not be a possibility here. This is because the criteria of a two-year

holding period would clearly read in the law meaning that such an interpretation would be contra legem and hence not allowed.

Another possible option for the court lies in the simple acceptance of the legislative choice. Stated differently, if the legislator decides to treat A Co. differently than B Co., then this is acceptable because the legislator wanted that. Although this logic sounds – and factually is – self-defeating, it can be found in various occasions in case law, for instance, in the *Jetair* case. In it, the court upheld the validity of a provision of the VAT directive based on the argument that the two situations in question were not comparable since the legislator wanted to treat them differently.¹⁸⁷ The author himself does not show much sympathy towards this approach as it deprives A Co. of its rights through – without any reasoning – accepting the legislative decision that should actually be scrutinized. However, it can be argued that this de-facto absent restriction of the legislator is just what may be required – at least sometimes. Such an argument would be difficult to fend off completely as sometimes a legitimate legislative value judgment may be at stake that the court does not want to replace. Nonetheless, the victim of the alleged arbitrary legislative decision, i.e., A Co., has a legitimate interest in being presented an acceptable reason explaining why it has to suffer the disadvantage.

Alternatively, and with regard to the existing doctrine most likely, the court may engage in balancing the interests in question. This means that the legislative decision is exposed to a comparability analysis in light of the object and purpose of the concerned rules. In the underlying example, it would have to be asked whether, considering the goal of the HOT rules to promote cross-border expansion of SMEs, A Co. is in a comparable situation to B Co.¹⁸⁸ As argued in more detail elsewhere, this will most likely be the case as both companies are equally in a situation in which the proposal is meant to apply (promote cross-border expansions by providing for a tax benefit that should ease this process). Thereupon, it must be asked whether there is a justification for the different treatment. For this purpose, the above-mentioned reasoning of the need to prevent the abuse of the system has to be considered

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¹⁸³ *Ibid.*, at 1.

¹⁸⁴ In more detail, see Scherleitner & Mäki, *supra* n. 1.

¹⁸⁵ Proposal for a COUNCIL DIRECTIVE establishing a Head Office Tax system for micro, small and medium sized enterprises, and amending Directive 2011/16/EU, *supra* n. 183, Art. 4(1)(b).

¹⁸⁶ Scherleitner & Mäki, *supra* n. 1.

¹⁸⁷ *Jetair NV and BTW-eenheid BTWE Travel4you v. FOD Financiën*, Case C-599/12 (ECJ 13 Mar. 2014), <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:62012CJ0599>, para. 55. Furthermore, in some direct tax case law on the fundamental freedoms, the court used a self-defeating narrow benchmark for comparability. See *Pensioenfonds Metaal en Techniek v. Skatteverkeet*, Case C-252/14 (ECJ 2 Jun. 2016), <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:62014CJ0252>, paras 52 et seq. For critique on the judgment, see e.g., Scherleitner, *The Fundamental Freedoms and the Taxation of Dividends Received by Non-resident Investment Funds: Some Thoughts on Non-discrimination With a Special Focus on Recent ECJ Case Law*, 50(6) Intertax 484–498 (2022), <https://kluwerlawonline-com.libproxy.aalto.fi/journalarticle/Intertax/50/6/TAXI2022046>, at 493 et seq.; H. Vermeulen, *Cross-Border Dividend Taxation*. In *European Tax Law* 828 (P. Wattel, O. Marres, & H. Vermeulen eds, Wolters Kluwer 2019). See also however, *JBG T Miljoen and Others v. Staatssecretaris van Financiën*, Joined Cases C-10/14, C-14/14, C-17/14 (ECJ 17 Sep. 2015), <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:62014CJ0010>.

¹⁸⁸ See further going on this example, including an analysis of other approaches to comparability in such a case, Scherleitner & Mäki, *supra* n. 1, at 3.4.

acceptable – which it most likely is. The more thrilling part happens now: Is it again just left as such – which would resemble the *Jetair* approach with the slight difference of there being some reason that was brought forward? Or, would the Court apply choose a stricter approach? Case law may indeed more strongly point in this direction. While the RPO case is often invoked to emphasize the court's willingness to grant broad discretion to the secondary EU legislator in making political, economic, and social choices,¹⁸⁹ the actual judgment gives less of a carte blanche to the legislator than this statement suggests.¹⁹⁰ Similarly, in *Arcelor Atlantique et Lorraine* dealing with a different exposure of competing sectors to the Emissions Trading System,¹⁹¹ the court provided a rather detailed analysis of the equality principle. While a violation of this principle was not found, this was mainly because the court accepted that the legislator is taking a step-by-step approach.¹⁹² Stricter approaches are also seen, for instance, when applying Article 20 ChFR to workers¹⁹³ interestingly including case law that was about the entitlement to certain compensation for dismissals and thus, ultimately, economic advantages.¹⁹⁴ As such, it seems possible – and in the author's view also sensible – that the court provides for a stricto sensu proportionality analysis. If that happened, the author posits – as expressed elsewhere¹⁹⁵ – that the provision at stake must be invalidated since the rule is neither suitable to reach its goal (e.g., the same problem exists after a two-year waiting time; empty companies that exist for two years may be purchased) nor is the rule not exceeding what it should to achieve the abuse it wants to prevent. To the contrary, it deprives all start-ups from the tax benefit even though there is no reason for doing so because (1) genuine start-ups should, per the rationale of the law, also be supported, and (2) anti-abuse rules like Article 6 of the ATAD are meant to address these abusive cases.

Last, the court may follow an approach that is relied on in the German constitutional tradition, that is, scrutinizing the consistency of the legislation towards demanding the legislator to consequently follow the value decisions it implemented in the law. Although the author is well aware that such 'Folgerichtigkeitsprinzip' (consistency principle)¹⁹⁶ has been explicitly rejected by non-German constitutional courts,¹⁹⁷ it nevertheless remains that this principle has clear advantages, particularly in lower stages of harmonization.¹⁹⁸ After all, it remains that the legislator can make its value judgments. The court only holds it accountable on them. The often criticized disadvantage of the consistency principle to unduly restrict law making¹⁹⁹ does not appear convincing, especially in situations when single policy decisions (such as the HOT proposal overall) are concerned. All that can tell us the value added by such an initiative is the legislator itself – and by demanding consistency, the first concern outlined in section 3.2 would be very well resolvable. Furthermore, it must not be forgotten that deviations from the overarching value decision (here, the promotion of cross-border expansion of SMEs) will continue to be allowed as long as there is a good reason for them. In the authors view, this does not exist for the disadvantageous treatment of A Co.,²⁰⁰ but it may well be evidenced in other circumstances.

While a consistency principle comparable to the German tradition does not currently exist (and possibly never will) in the doctrine,²⁰¹ its core idea is not at all alien to EU law. To the contrary, the ECJ has turned down (national) legislation due to not pursuing 'stated objectives in a consistent and systematic manner'.²⁰² A conceivable way to more strongly include the logic in the doctrine would be to accept AG Kokott's definition of a 'manifest error' as being law that cannot be plausibly explained to a third party.²⁰³ This again requires a convincing reason that adheres well the overall logic of the

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¹⁸⁹ *Proceedings brought by Rzecznik Praw Obywatelskich (RPO)* (2017), para. 54. *Proceedings brought by Rzecznik Praw Obywatelskich (RPO)* (2017), para. 54.

¹⁹⁰ See already, Scherleitner & Mäki, *supra* n. 1, at 3.4.

¹⁹¹ Directive 2003/87/EC of the European Parliament and of the Council of 13 Oct. 2003 establishing a system for greenhouse gas emission allowance trading within the Union and amending Council Directive 96/61/EC (Text with EEA relevance) (2018), <http://data.europa.eu/eli/dir/2003/87/2018-04-08/eng>.

¹⁹² J. Kokott, & L. Dobratz, *Der unionsrechtliche allgemeine Gleichheitssatz im Europäischen Steuerrecht*, in *Grundfragen des Europäischen Steuerrechts* 25–40 (Wolfgang Schön & C. Heber Eds, Springer 2015), https://doi.org/10.1007/978-3-662-47465-5_2; *Société Arcelor Atlantique et Lorraine and Others v. Premier ministre, Ministre de l'Écologie et du Développement durable and Ministre de l'Économie, des Finances et de l'Industrie* (2008b), para. 69.

¹⁹³ Bell, *supra* n. 156, at 609.

¹⁹⁴ *Anacleto Cordero Alonso v. Fondo de Garantía Salarial (Fogasa)* [2006] ECJ Case C-81/05.

¹⁹⁵ Scherleitner Mäki, *supra* n. 1.

¹⁹⁶ Kokott, *supra* n. 4, at 103. In more detail and for a discussion of the beginnings of an EU consistency principle in light of the much further developed Folgerichtigkeitsgebot, see also Lemmen, *supra* n. 3, at 324 et seq.

¹⁹⁷ LEMMEN – VERWEIS AUF VFGH.

¹⁹⁸ Similarly, see e.g., Kube, *supra* n. 128, at 25; similarly, also Kokott, *supra* n. 4, para. 3.46.

¹⁹⁹ See for a broader discussion, Schön, *supra* n. 32; Lemmen, *supra* n. 3, at 324 et seq.

²⁰⁰ Scherleitner & Mäki, *supra* n. 1.

²⁰¹ Lemmen, *supra* n. 3, at 324 et seq.

²⁰² *Hartlauer Handelsgesellschaft mbH v. Wiener Landesregierung und Oberösterreichische Landesregierung*, Case C-169/07 (ECJ 10 Mar. 2009), <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:62007CJ0169>, para. 55.

²⁰³ *Grand Duchy of Luxembourg and Others v. European Commission*, Joined Cases C-451/21 P and C-454/21 P (ECJ 5 Dec. 2023), para. 92.

system. A general exclusion of start-ups from the HOT regime does not exist – at least not to the author.²⁰⁴

4.3.3.3 The application of Article 20 ChFR to fiscal rules

The analysis shall now focus on the application of the equality principle to fiscal provisions. These provisions are understood here as secondary EU law that is directly and primarily concerned with influencing tax liability.²⁰⁵ These rules can, for instance, be tax exemptions granted by EU law²⁰⁶ or, as has recently been more frequent, EU rules that increase the tax liability under certain circumstances.²⁰⁷ In these situations, the question emerges as to whether there is an EU ability to pay principle that can – similarly as in a large number of Member States – restrict the EU secondary legislator.²⁰⁸

While the court has not yet had a chance to decide on the issue, it should not be surprising that this decisive question has been subject to nuanced elaborations in tax literature.²⁰⁹ In an attempt to reflect upon the essential elements of this discussion, the author first points towards scholars that have argued that, as long that there is no European tax system from which a European ability to pay principle can be deduced, such a principle does not exist.²¹⁰ Stated differently, the existence of the ability to pay principle in EU tax law must have more than some sporadically harmonized tax rules as its basis. Instead, it needs EU legislation on the taxable event and tax base to build up such a principle.²¹¹ In

its absence, an equality examination of EU tax measures must be conducted in light of their relevant object and purpose.²¹² Although this is a defensible position, this problem should disappear with ongoing harmonization.

On the other hand, some scholars have also argued that an EU ability pay principle (already) exists.²¹³ This argument rests on the fact that it is explicitly guaranteed as a direct tax relevant constitutional equality standard in many Member States²¹⁴ and, apart from that, factually dominates the discussion on tax equality on a worldwide basis.²¹⁵ Given that Member States' constitutional traditions are to be taken into account by the ECJ in the interpretation of Article 20 ChFR, there are strong reasons to argue in favour of such a principle existing.²¹⁶ Furthermore, all of the 'ingredients'²¹⁷ for the ability to pay principle are included in primary EU law.²¹⁸ In addition to the equality principle from which the principle is to be deduced, primary EU law includes, for instance, references to solidarity,²¹⁹ social justice,²²⁰ human dignity,²²¹ and the right to property²²² of which all are essential pillars of it.²²³ In this context, it seems rather certain that the ECJ would demand the EU legislator to adhere to the ability to pay principle in making secondary EU tax law making.²²⁴ Although this would have greater ramifications in the (unlikely event of) harmonization of the taxation of individuals, it also extends to corporate taxation demanding, essentially, that business

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²⁰⁴ Scherleitner & Mäki, *supra* n. 1.

²⁰⁵ In the above example of the HOT proposal, the immediate aim is to influence administrative ease with which tax rules are applied. Their impact on tax liability is a side effect of these rules.

²⁰⁶ Especially, Council Directive 2011/96/EU of 30 Nov. 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (recast) 2015; Council Directive 2003/49/EC of 3 Jun. 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States 2013.

²⁰⁷ Minimum Tax Directive (2020/2523); Council Directive (EU) 2016/1164 of 12 Jul. 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, *supra* n. 125.

²⁰⁸ For broader elaborations on the topic, see Hey, *supra* n. 3; Lemmen, *supra* n. 3; Heber, *supra* n. 178; Englisch, *supra* n. 42; Kokott, *supra* n. 4, ss 3.48 et seq.

²⁰⁹ Hey, *supra* n. 3; Lemmen, *supra* n. 3; Heber, *supra* n. 178; Englisch, *supra* n. 42; Kokott, *supra* n. 4, ss 3.48 et seq.

²¹⁰ Heber, *supra* n. 178, s. 4.2.

²¹¹ *Ibid.*

²¹² *Ibid.*

²¹³ See in significant detail, including further references, Lemmen, *supra* n. 3; see further, e.g., Chiara Bordini, *The Ability to Pay in the European Market: An Impossible Sudoku for the ECJ*, 38 Intertax 2 (2010); Kokott, *supra* n. 4, s. 3.75; Joachim Englisch, *Ability to Pay*, in *Principles of Law: Function, Status and Impact in EU Tax Law* (Cécile Brokelind ed., IBFD 2014).

²¹⁴ See here in particular, Englisch, *Ability to Pay*, n. 217, at 451 et seq.; Lemmen, *supra* n. 3; Kokott, *supra* n. 4, ss 3.52 et seq.

²¹⁵ Kokott, *supra* n. 4, s. 3.52; Wolfgang Schön, *International Tax Coordination for a Second-Best World (Part I)*, 1 World tax J. (2009): WtJ s. 2.2.1.1; J. C. Jr. Fleming, R. J. Peroni & S. E. Shay, *The Ability-to-Pay Case for Taxing Worldwide Income*, 5 Florida Tax Rev. 306 (2001); F Vanistendael, *Legal Framework for Taxation*, in *Tax Law Design and Drafting*, vol 1, at 8 (V. Thuronyi ed., International Monetary Fund 1996); S. Utz, *Ability to Pay*, 23 Whittier L. Rev. 867 (2002).

²¹⁶ For instance, Lemmen, *supra* n. 3, at 307; Englisch, *supra* n. 217.

²¹⁷ Hey, *supra* n. 159.

²¹⁸ Hey, *supra* n. 159, at 160; Englisch, *supra* n. 215, at 484 et seq.; Lemmen, *supra* n. 3; Kokott, *supra* n. 4, ss 3.50 et seq.

²¹⁹ See the preamble of the Charter of Fundamental Rights of the European Union 2012 (OJ C); *Consolidated Version of the Treaty on European Union*, n. 52, Art. 2.

²²⁰ *Consolidated Version of the Treaty on European Union*, *supra* n. 52, Art. 3(3).

²²¹ Charter of Fundamental Rights of the European Union Art. 1.

²²² Charter of Fundamental Rights of the European Union 2012 (OJ C) Art. 17.

²²³ See e.g., Englisch, *supra* n. 215, at 446 et seq. providing also an elaboration on the influence of the Art. 16 of the European Social Charter demanding the protection of family life, inter alia, through fiscal arrangements.

²²⁴ E.g., Kokott, *supra* n. 4, 3.75; Lemmen, *supra* n. 3.

expenses are deductible.²²⁵ While the legislator may – and recently also often has²²⁶ – deviated from this principle, this has to happen for a good reason and withstand a proportionality test.²²⁷ What this exactly means will have to developed by the court upon it indeed finally confirming the expectations of establishing a European ability to pay principle based on Article 20.

5 CONCLUSION

This article has elaborated on the development of a direct tax relevant doctrine on the enforcement of economic rights enshrined in primary EU law. This is perceived to be a relevant discussion that is to be initiated ahead of far-reaching harmonization of EU direct tax law rules. The core argument worked out by the author can be summarized as follows. Given the weak democratic legitimization of EU direct tax directives, and having regard to the fact that they are extraordinary difficult to adapt or abolish, the court has an increased responsibility to protect taxpayers' economic rights – particularly when the underlying legislative decision or value is not worth being upheld at the cost of an infringement of such rights. This calls for the court to accept that direct taxation is not merely a further area of economic policymaking that does not require more than a very lightweight review to determine its consistency with primary EU law. Instead, it is a highly sensitive field that not only demands that the legislator is given respect but also that the legitimate interests of those economically suffering from its decisions are appreciated. Contrary to what is the case in a national setting in which laws can easily be changed, in an EU setting, the taxpayer may more easily be left in a situation in which it is only the court that can give effect to the rights that have been shaping the EU thus far.

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Notes

²²⁵ Englisch, *supra* n. 215, at 461.

²²⁶ For example, Council Directive (EU) 2016/1164 of 12 Jul. 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, *supra* n. 127, Arts 4 and 9.

²²⁷ Englisch, *supra* n. 215, at 461.

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DEBRA: When Unstoppable Aspirations for Debt-Equity Parity Meet Immovable Tax Systems

Domenico Imparato*

Achieving debt-equity parity in corporate taxation has long been a sought-after holy grail in the quest for capital structure neutrality; however, the latter does not always align with the former. The United States devoted significant thought on how to reach both, especially in the 1990s, but eventually did not achieve either with its tax reforms at the dawn of the twenty-first century.

Now, it is Europe's turn to try. This is what the European Commission aims to accomplish with its Directive Proposal for a Debt Equity Bias Reduction Allowance (DEBRA). It would introduce a notional interest deduction on increases in a firm's equity and a dual-limiting rule that would cap deductible interest at 85% of exceeding borrowing costs (interest paid minus interest received) in addition to interest deductibility already being restricted to 30% of a firm's earnings before interest, taxes, depreciation, and amortization (EBITDA).

This article shows that DEBRA fails to achieve capital structure neutrality and does not ensure debt-equity parity. It skews the tax treatment of debt without promoting greater diversification in the portfolio choice of financing sources for corporate Europe as European companies remain heavily reliant on bank lending compared to their American counterparts.

Last, the article suggests that the risk of debt-financing outsourcing as a potential consequence of DEBRA could inadvertently impact direct investments between Europe and some of its main trading partners, including the United States and the United Kingdom. This process is already underway in America with more anti-abuse provisions emerging in its tax treaties and federal tax regulations for the cross-border payment of interest and dividends.

Keywords: Debt-equity parity, tax bias, capital structure neutrality, allowance on corporate equity (ACE), DEBRA, ATAD, double-dip financing structures, qualifying asset holding companies (QAHCs), dividends-received deduction (DRD), tax treaties.

I INTRICATE WATERS TO NAVIGATE

In general, all companies have only three sources of funding: retained profits, capital efficiency improvements, or someone else's money. Companies typically procure the last one through either equity finance via a shareholder capital injection such as debt (e.g., market-based finance or bank funding) or, as in much private equity, a mix of the two.

The capital theory shows that capital structure does not change performance in perfect markets.¹ However, the traditional view in corporate finance suggests that companies are (more) inclined to rely on debt rather than raise equity which is a phenomenon known as 'debt-equity bias' that is said to

be rooted in an historical trait of the tax system referred to as 'tax bias'.² Because interest payments can be deducted from corporate tax bills, whereas costs related to equity financing (e.g., dividend payments) cannot, de facto the tax system incentivizes companies' directors to borrow.

The reasoning goes on to posit that this tax bias will have the potential to hinder economic growth and stability. The conjecture that follows in economic terms is that the subsidization of borrowing through tax deductibility might lead to companies becoming excessively indebted and thereby heighten their vulnerability to financial downturns.³ The susceptibility of heavily leveraged companies to economic downturns could subsequently

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¹ F. Modigliani & M. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 Am. Econ. Rev. 261 (1958); and, F. Modigliani & M. Miller, *Corporate Income Taxes and the Cost of Capital: A Correction*, 52 Am. Econ. Rev. 433 (1963).

² S. Fatica, T. Hemmelgarn & G. Nicodème, *The Debt-Equity Tax Bias: Consequences and Solutions*, European Commission's Directorate-General for Taxation and Customs Union, Taxation Papers, Working Paper No. 33 (2012).

³ J. Bianchi, *Overborrowing and Systemic Externalities in the Business Cycle*, 101(7) Am. Econ. Rev. 3400 (2011), doi: 10.1257/aer.101.7.3400. Also Centre for European Economic Research (ZEW), *The Effects of Tax Reforms to Address the Debt-Equity Bias on the Cost of Capital and on Effective Tax Rates* (2016).

exacerbate the impact of recessions, possibly effectuating a cascading effect on employment, investment, and overall economic wellbeing. In such a scenario, the tax bias would affect a swathe of firms from small, unlisted businesses to the world's largest public companies as extensive debt loads can potentially amplify the exposure of any entity to economic shocks.

Other critics argue that this tax bias would be contrary to the 'principle of neutrality in the source of finance' and distort incentives in the use of capital.⁴ The high recourse to debt financing may even amplify returns to shareholders and potentially distort the true economic value of firms and investments, especially in certain industries such as private equity.⁵

Realistically, taxation is not the sole determinant in shaping the structure of corporate debt. For example, low interest rates, particularly during periods like the aftermath of the 2007–2009 financial crisis and the peak of the Covid-19 pandemic, encourage the uptake of cheap debt. When this market-induced dynamic aligns with robust corporate profits, it creates an opportunity to secure long-term fixed-rate debts as today's cash-rich firms can signal and convey confidence in their ability to meet interest obligations that will mature in the future.⁶

Still, acknowledging that taxation can also impact business behaviour – from investment levels⁷ and entrepreneurial risk taking⁸ to the initial incorporation location⁹ and including financing choices¹⁰ – assume, if only momentarily, that the debt-equity bias is entirely tax-driven. As corporate taxes rise, it would intensify (the higher the headline tax rate, the greater that the deduction for interest payments would be for the same amount of debt) and effectively narrow the tax base due to less corporate income being available to be taxed.

Building on the consideration that a potential tax-generated debt-equity bias is actually an area of concern, the European Commission of the European Union (EU

Commission) is mulling a debt-equity bias reduction allowance. This initiative is encapsulated within the newly-proposed Debt Equity Bias Reduction Act (DEBRA).¹¹ DEBRA is a directive proposal that seeks to level the playing field between debt and equity financing by intervening in both directions as it envisions a deductible allowance on firms' capital increases (DEBRA ACE) along with a supposed-to-be equivalent limitation on interest deductibility. The latter would particularly consist of a new interest limitation rule (DEBRA ILR) to be applied on top of the one already in place under Article 4 of the Anti-Tax Avoidance Directive (ATAD Directive)¹² in order to curb the purportedly excessive tax advantages associated with debt financing (ATAD ILR).

While the DEBRA proposal represents a commendable effort, it is essential to assess the potential challenges it faces as its effectiveness may be contingent on various factors, including unintended consequences. Hence, this article explores these challenges and offers a nuanced understanding of DEBRA's shortcomings both domestically within the single market and internationally in the context of potential tax repercussions between the EU on one hand and the United Kingdom and the United States on the other.

The article proceeds as follows. Part I delves into the mechanics of the debt-equity bias by providing a brief review of options that are available to address the tax bias beginning with the simplest approach involving eliminating interest deductibility. The analysis then explores more complex proposals that have been made over time to achieve some form of corporate-shareholder tax integration. They encompass a full dividend exclusion, imputation, dividend deduction, a comprehensive business income tax (CBIT), an allowance for corporate capital (ACC), and a corporate cash-flow tax, although some of them have actually gone nowhere (e.g., CBIT, dividend deduction) and, even when adopted, others have not

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⁴ A. Weichenrieder & T. Klautke, *Taxes and the Efficiency Costs of Capital Distortions*, CESifo Working Paper, No. 2431 (2008), Centre for Economic Studies and Ifo Institute (CESifo), Munich. Also P. Sorensen, *Taxation and the Optimal Constraint on Corporate Debt Finance*, Working Paper no. 5101 (2014), CESifo, Munich.

⁵ On the effects of borrowing on amplifying returns, see J. Gilligan & M. Wright, *Private Equity Demystified: An Explanatory Guide* 17 (Oxford University Press, 4th ed. 2020). For insights on leverage as a potential 'precondition for there [in the private equity industry] being any deal at all', see D. Davies, *Keeping the powder dry. Tyranny of the IRR*, Financial Times (20 Jan. 2023).

⁶ The above assertion needs to make a preliminary distinction between bond finance that generally has a fixed interest rate and bank credit (i.e., loans) i.e., generally a floating rate. Bond markets are typically tapped by large corporations. Thus, when credit is cheap, these firms tend to lengthen the maturity of their debt and issue bonds at fixed interest rates (F. Bräuning, G. Joaquim & H. Stein, *Interest Expenses, Coverage Ratio, and Firm Distress*, Federal Reserve Bank of Boston – Current Policy Perspectives Paper (29 Aug. 2023)). It is therefore not surprising that, according to Goldman Sachs, as of Aug. 2023, USD 7.6tn out of the USD ninety US corporate credit market was in fixed-rate and long-duration debt with only a quarter set to mature in the next three years (Goldman Sachs, *Corporate Credit Concerns*, 121 Global Macro Research Paper (10 Aug. 2023)). During the same period, The Economist noted that several non-financial listed firms in America and Europe reported higher-than-expected profits with their EBITDAs being '32% higher in the final quarter of 2022 than in the same period in 2019' (The Economist, *Businesses are in for a Mighty Debt Hangover* (16 May 2023)).

⁷ L. Dimitrova & S. Eswar, *Capital Gains Tax, Venture Capital, and Innovation in Start-Ups*, 27.4 Rev. Fin. etc. ..., doi: 10.1093/rof/rfac057.

⁸ J. Cullen & R. Gordon, *Taxes and entrepreneurial risk-taking: Theory and Evidence for the U.S.*, 91 J. Pub. Econ. 1479 (2007), doi: 10.1016/j.jpubeco.2006.12.001.

⁹ S. Morse, *Startup Ltd.: Tax Planning and Initial Incorporation Location*, 14 Florida Tax Rev. 319 (2013), doi: 10.5744/ft.2013.1408.

¹⁰ J. MacKie-Mason, *Do Taxes Affect Corporate Financing Decisions?*, 45 The J. Fin. 1471 (1990), doi: 10.2307/2328746. Also J. Graham, *Taxes and Corporate Finance*, in *Handbook of Empirical Corporate Finance* (B. Eckbo ed., Elsevier Science, Amsterdam 2008).

¹¹ COM(2022) 216 final, Proposal for a Council Directive on laying down rules on a debt-equity bias reduction allowance and on limiting the deductibility of interest for corporate income tax purposes.

¹² Council Directive (EU) 2016/1164 of 12 Jul. 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

effectively addressed the tax bias against equity (e.g., imputation, dividend exemption). Last, it considers the alternative of keeping interest deductibility while making the notional cost of equity finance tax deductible (known as allowance for corporate equity or ACE), which is the approach that DEBRA partially adopts.

Part II explores DEBRA in greater detail and examines its potential impact on firm financing. It also analyses how its new DEBRA ILR would interact with the earnings-stripping rule of ATAD ILR's Article 4 that already limits yearly interest deductibility to 30% of a company's EBITDA (defined as earnings before interest, taxes, depreciation, and amortization). This examination concludes that the complex regime of DEBRA, partially overlapping with ATAD (which is set to remain in place), fails to achieve tax neutrality between equity capital and debt for EU companies, particularly by tilting the tax treatment of debt.

Then, Part III transitions from the single market level to an international tax perspective. In doing so, it places a spotlight on two of the EU's primary trading partners, the United Kingdom and the United States, aiming to understand how DEBRA might position itself within the existing cross-border tax frameworks between the EU and these two countries. This is done in light of the UK's 2022-introduced Qualifying Asset Holding Company (QAHC) regime, the 2016 US Model Income Tax Convention, and the US tax code's dividend received deduction provision. It concludes that, respectively, DEBRA could potentially: (1) trigger countermeasures in London to prevent the outsourcing of debt-financing (with interest deductions), not least through QAHC-related double-dip structures from the EU to the United Kingdom; (2) have tax treaty repercussions on intra-group financing, especially when an EU parent company lends to a US subsidiary; and (3) unsettle US corporate shareholders due to the risk of losing a full domestic deduction when receiving dividends from EU corporations in which they have invested. Interactions between DEBRA and the EU Global Minimum Tax¹³ are beyond the scope of this article.

In Part IV, the analysis broadens its scope to evaluate whether the presumed tax bias is as significant as assumed at the DEBRA level. Even if deemed substantial, the section questions whether taxation, in general, is the optimal means to mitigate a potential debt-equity bias. Furthermore, it delves into exploring potential adjustments to DEBRA with the aim of fostering financial

diversification for European companies given that bank lending remains the primary source of debt financing in the EU despite the increase in the importance of market-based finance since the 2007–2009 financial crisis.

Part V concludes by noting that, if the goal is to strengthen the balance sheets and financial position of a country's corporations to fund more investments, incentivizing their supply of equity capital seems largely reasonable. However, taxation should prioritize encouraging virtuous behaviours over imposing complex regulations that can hinder growth. This entails facilitating companies' access to capital markets, anticipating cross-border tax consequences with main trading partners, and considering the tax burden on shareholders to ensure tax neutrality. As these crucial aspects are unfortunately still absent in DEBRA, the article offers broadly applicable insights that can be valuable not only in Europe but also beyond.

2 TAX PROTOTYPES IN THE PURSUIT OF CAPITAL STRUCTURE NEUTRALITY AND THE ROADS NOT TAKEN

The debt-equity tax bias is commonly perceived to operate at the company level, tilting towards debt and deterring new equity financing. This is rooted in the classical tax system of taxing shareholders on their after-tax profits while debtholders are taxed on the pre-tax returns of a firm's investments owing to the deductibility of interest but not of equity returns.¹⁴

However, the corporate tax rate and the tax savings from deducting interest from the corporation's taxable income are not the sole factor influencing a firm's decision-making process regarding its capital structure. It is often overlooked that a company's chosen mix of debt and equity can also be influenced by the applicable tax system as a whole which includes tax rates on investors and business owners. For instance, if debt, which allows for interest deductions, was held by exempt taxpayers, it would result in a lower effective aggregate tax rate on corporate earnings as the deduction at the source would not be offset by taxation on the recipient. If equity was held by high-bracket taxpayers and the company did not pay out dividends, this would contribute to a lower effective aggregate tax rate on the firm's unrealized economic income (e.g., appreciation in corporate assets)¹⁵ as the latter is not taxed until a sale occurs.¹⁶

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¹³ Council Directive (EU) 2022/2523 of 14 Dec. 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union.

¹⁴ C. H. Johnson, *Is an Interest Deduction Inevitable*, 6(1) Va. Tax Rev. 123 (1986) <https://law.utexas.edu/faculty/calvinjohnson/is-an-interest-deduction-inevitable-1986.pdf>.

¹⁵ H. J. Schlunk, *The Zen of Corporate Capital Structure Neutrality*, 99(2) Mich. L. Rev. 410 (2000) <https://scholarship.law.vanderbilt.edu/faculty-publications/442/>.

¹⁶ This principle holds true in practice, but it is still worth noting that, theoretically under the 'put-call parity theorem' which suggests that stocks, bonds, puts, and calls are interchangeable financial instruments whose value can be calculated relative to one another, taxable investors could still purchase stocks and utilize derivatives to replicate a bond investment. See A. C. Warren, *U.S. Income Taxation of New Financial Products*, 88 J. Pub. Econ. 899 (2004), doi: 10.1016/S0047-2727(03)00042-2.

Hence, the effectiveness of taxation in generating revenue may be compromised when the tax system fails to maintain capital structure neutrality, de facto allowing for manipulation of tax liability based on a firm's capital structure preferences. It has even been proposed that non-neutrality in capital structure can influence investment choices as tax shields may incentivize corporations to opt for less risky projects with lower returns but more favourable tax rates over projects with higher risk (and potentially higher returns).¹⁷

A solution to ensure capital structure neutrality is to 'integrate' corporate taxation with taxation on investors into a unified tax scheme.¹⁸ 'Integration' would levy taxes only once on the pre-tax return and after-tax profits of an investment regardless of whether it occurs at the corporate or investor level and whether this involves shareholders or debtholders.

Yet, tax authorities currently claim entitlement to earnings at the corporate level and then once again upon their distribution to shareholders thereby resulting in double taxation of the same income. This encourages shareholders to endorse management's reinvestment of earnings into the business. Essentially, if the tax rate on immediate reinvestment that is achieved by retaining corporate earnings is lower than the tax rate on first disbursing after-tax profits followed by their reinvestment in the same business, a tax incentive to retain corporate earnings materializes.

However, not all tax systems that preserve capital structure neutrality are integrated and vice versa. Equity instruments can offer their holders the option of elective deferral that is known as the 'realization requirement' for which their increase in value is only taxed upon disposal at the point of sale. Furthermore, most equity instruments enable holders to turn business income into capital gains that are subject to lower tax rates compared to dividends

and ordinary income. This creates a bias among various classes of equity holders as not all shareholders have equal discretion between selling and holding out.¹⁹

Moreover, even if the tax rate on dividends was equal to that on capital gains, some investors may still prefer transactions resulting in capital gains due to their ability to offset tax basis (i.e., the original cost of acquisition).²⁰

Over time, various proposals or 'prototypes', each with its own pros and cons, have been proposed to allegedly pursue integration or at least achieve debt-equity parity although they are not equally capable of waning capital structure choices off of tax considerations.

Among the various proposals, one of the simplest is to prevent companies from deducting interest payments from their taxable income; this is a prototype known as a 'full non-deduction of interest' (NDI). Implementing an NDI system could not only result in a significant increase in tax revenue but also help reduce administrative and compliance costs and thereby enable governments to lower headline tax rates while expanding the tax base.²¹ However, there are both theoretical and practical hurdles linked to this approach. Some might support the idea of allowing interest deductions because lenders are taxed on the interest they earn. In an ideal scenario in which both lenders and borrowers are subject to the same tax rate, the cost of investing would be consistent regardless of how the investment is financed.

This concept resonates with the principles of a genuine Haig-Simons income tax for which income is defined as consumption plus or minus changes in net worth. From this perspective, debt that is a negative asset would contribute to a decrease (*minus* paid interest) in net worth.²² Stated differently, the total tax owed should not change whether the lender invests directly into an asset or borrows to invest in an identical-risk asset. Any loss in revenue would then come from variations in tax rates

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¹⁷ Michael Knoll, *Taxing Prometheus: How the Corporate Interest Deduction Discourages Innovation and Risk-Taking*, 38 Vill. L. Rev. 1461 (1993) https://scholarship.law.upenn.edu/faculty_scholarship/1150/.

¹⁸ For a critique of the concept of 'integration' as a vital objective for the income tax system, see R. S. Avi-Yonah, *Taxation With Realization After Moore*, (115) Tax Notes Int'l 25 (2024). The author emphasizes the distinction between entity-level taxes and shareholder/partner taxes, positing that their purposes diverge: entity-level taxes would function as a regulatory tool for firms while shareholder/partner taxes would aim to achieve progressivity within the tax system for redistribution purposes among individuals.

¹⁹ If every shareholder sold proportionally, it is true that the relative ownership positions of shareholders would remain unchanged. However, in practice, individuals in weaker economic positions, such as retailers, may require liquidity for consumption and therefore prefer dividend payments over share buyback plans. Nevertheless, if dividends are not declared for an extended period, these shareholders may face pressure to sell and eventually need to liquidate their stake. Corporate buybacks can then be viewed as a situation in which minority partners are waiting for profit distributions that do not materialize and are bought out by majority partners who can afford to wait, do not require cash, and have influence over management. See S. Stein, *Taxes, Dividends, and Distortions*, Policy Review, Hoover Institution Press 59 (2002).

²⁰ To illustrate an investor's potential preference for capital gains over dividends, consider an investee venture, X, in which shareholder Y has an equity investment worth 100, establishing their tax basis. After one year, X generates after-tax profits of N of which 200 will be paid to Y. X has two main options for distributing this amount either as dividends or through a share buyback. Assuming a constant tax rate of 20% for both capital gains and dividends:

- if X opts for a dividend distribution of 200, Y would receive 160 after tax ($= 200 \times (1 - 0.20)$) while Y's initial investment of 100 remains tied up in X;
- alternatively, if X engages in a share buyback for 200, Y would receive 180 consisting of the initial investment (100) i.e., returned and the capital gain net of tax ($= (200 - 100) \times (1 - 0.20)$). The same outcome would occur if Y was to unload its equity share to a third-party buyer and realize a capital gain from the sale.

²¹ Some commentators suggest that the additional tax revenues do not have to be balanced out by reducing headline tax rates. Instead, they could be invested in initiatives that support business growth and innovation (e.g., boosting funding for R&D programs). See B. Michel & L. Millán, *The EU DEBRA Proposal – an Undesirable ACE Up the EU Commission's Sleeve*, Tax Justice Network 1–22 (2023).

²² H. Simons, *Personal Income Taxation: The definition of Income as a problem of Fiscal Policy* 283 (University of Chicago Press, Chicago 1938). However, it could be argued that this rationale might not apply to corporations that are legal entities not engaged in consumption or own wealth in the same way that individuals do. Instead, their wealth would serve as a reserve against the claims of various capital providers who have a stake in the corporation's assets.

such as lower rates or exemptions for lenders compared to the highest rates for corporate borrowers.²³

Transitioning away from interest deductibility would also pose practical hurdles, especially during the adjustment phase. Companies that have arranged their finances around the possibility of deducting interest might strongly resist any changes (e.g., in private equity where profits may largely derive from leveraging portfolio investments).²⁴ Even a move to only eliminate deductibility for new debt could meet significant opposition.

The second prototype is referred to as a ‘dividend exclusion’ and aims to tax corporate profits only once by applying corporate tax rates to dividends, enabling shareholders to exclude them from their total income whereas interest income is taxed at the rates applicable to those holding debt. However, executing a complete dividend exclusion can be both expensive and politically challenging, particularly if the corporate tax rate is lower than those applied to labour income. This is because this would result in effectively subsidizing capital income for shareholders who are high-bracket taxpayers.

Despite its potential downsides, several countries have adopted a *partial* dividend exclusion over the last two decades following a reform in the United States known as the ‘Jobs and Growth Tax Relief Reconciliation Act of 2003’ (JGTRRA) which significantly reduced taxes on dividends to rates lower than those on ordinary income.²⁵ Still, a partial dividend exclusion can result in a misallocation of capital between corporate and noncorporate sectors. This is because the lower tax rate for dividends is not contingent on actual corporate tax payments. Consequently, if corporate tax payments can be minimized (e.g., shielded), a bias is created in favour of corporate investment over noncorporate investment that is subject to individual-level tax rates due to its pass-through treatment.

The third prototype is referred to as a ‘dividend deduction’ and proposes that companies should have the option to deduct dividend payments, much like the deduction of

interest payments, to ensure earnings are only taxed once. Shareholders would pay taxes on dividends at their own rates while debtholders would pay taxes on interest at their respective rates. Yet, if shareholders are foreign, the source country may be unable to tax them (or tax them in full).²⁶ However, it has been noted that several jurisdictions already permit domestic deductions on outbound interest and royalty payments without demanding tax withholdings or with reduced withholdings under tax treaties. This implies that comparable provisions could potentially be applied to dividend payments made to foreign shareholders.²⁷

Nevertheless, a core concern with the ‘dividend deduction’ prototype is that equity and debt are fundamentally distinct from a legal standpoint. Although the line between interest as a clear cost of conducting business and equity returns as a source of business income can blur in economic terms since both payments represent a return to capital,²⁸ the distinction still holds legally for at least two reasons.

First, setting aside the case of hybrid instruments (e.g., financial derivatives) blending characteristics of debt and equity²⁹ that may pose challenges to the tax system (e.g., by seeking double deductions countered by anti-avoidance regulations), debt still entails an obligation to repay money at fixed times and rates whereas dividends are largely discretionary for a firm.

Second, considering dividends as a business expense could inadvertently weaken the perception of shareholders as business owners. While this might be consistent with the standardized separation between ownership and control in public companies across Anglophone countries,³⁰ it might not apply as strongly to large firms in continental Europe³¹ or even less so to small and medium-sized (SME) limited liability companies for which shareholders usually have a more direct ownership stake.

The different prototype of the ‘shareholder allocation’ would shift the taxation of equity income to the shareholder level. By dividing a corporation’s income among its

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²³ A. Auerbach, *Should Interest Deductions Be Limited?*, in *Uneasy Compromise: Problems of a Hybrid Income-Consumption Tax* (H. Aaron, H. Galper, & J. Pechman eds, Washington, D.C.: The Brookings Institution 1988).

²⁴ D. Imparato, *The Skewed Playing Field between Private Equity and Family Ownership Hemmed in by Intra- and Inter-Country Tax Non-neutralities*, 16(1) *World Tax J.* 177–242 (2024), doi: 10.59403/emtrqd.

²⁵ R. Avi-Yonah, *The Pitfalls of International Integration: A Comment on the Bush Proposal and its Aftermath*, 12(1) *Int’l Tax & Pub. Fin.* 87 (Springer 2005).

²⁶ Globalization pressures, the principle of free movement of capital, or both may restrict some source states from domestically taxing foreign recipients on outbound dividends. Additionally, at the international level, taxing rights for dividends are often primarily assigned to the recipient’s resident state. Most tax treaties permit source states to tax only a portion of the gross dividend amount, typically between 5% and 15%; however, these rates are generally lower than the corporate income tax rates applied in developed countries. As a consequence, a tax prototype supporting dividend deductions in the source state could easily be viewed by that state as a loss to its corporate tax base.

²⁷ R. Avi-Yonah & A. Chenchinski, *The Case for Dividend Deduction*, *American Bar Association*, 65(1) *Tax lawyer* 3–14 (2011).

²⁸ R. De Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, IMF Staff Discussion Note (2011).

²⁹ W. Schön, T. Beuchert, A. Roesener, A. Gerten, M. Haag, S. Heidenbauer, C. Hohmann, D. Kornack, N. Lagdali, L. Mueller, C. Osterloh-Konrad, C. Pohlhausen, P. Redeker & E. Röder, *Debt and Equity: What’s the Difference? A Comparative View*, Max Planck Institute for Intellectual Property, Competition & Tax Law, Research Paper No. 09–09 (2009).

³⁰ A. Berle & G. Means, *The Modern Corporation and Private Property*, New York: The Mac-Millan Company (1932).

³¹ M. Faccio, *The Ultimate Ownership of Western European Corporations*, 65 *J. Fin. Econ.* 365 (2002), doi: 10.1016/S0304-405X(02)00146-0. Also A. Medina et al., *Corporate Ownership and Concentration*, OECD Corporate Governance Working Paper No. 27 (OECD Publishing, Paris 2022).

equity owners, the shareholders would incorporate allocated amounts into their taxable income, receive a credit for corporate taxes paid, and adjust the basis in their shares by the allocated income after subtracting the credit amount. Ultimately, distributions would be treated as a return of capital. However, implementing such a system is bound to pose administrative challenges. For example, corporations would need to maintain capital accounts akin to partnerships, and shareholders engaging in short-term stock transactions would be required to fulfil reporting duties thereby increasing compliance costs.

Additionally, the US Treasury Department proposed a further prototype in 1992 known as the CBIT. Its purpose was to establish a single level of tax on capital income by disallowing deductions for both dividends and interest paid by corporations while also excluding those received by shareholders and debtholders from their taxable income. The removal of the deduction for business interest simplifies tax rules and eliminates the need for provisions aimed at preventing excessive interest deductions.³²

Allowing for immediate expensing of investments (in lieu of accounting depreciation) would transform the CBIT into a 'corporate cash-flow tax' with equal potential for addressing the debt-equity distinction at the corporate level. Borrowing could be made taxable when funds are borrowed but are deductible when repaid thereby mirroring the tax treatment of equity that is not taxed upon issuance and not deductible when dividends are paid.³³ However, a similar change in the taxation of corporate borrowing might impact the international movement of capital by encouraging multinational corporations to borrow from subsidiaries located in jurisdictions with lower tax rates. To address this concern, a corporate cash-flow tax would need to transition from a territorial approach to a destination-based one, limiting its application to domestic transactions exclusively (e.g., disregarding borrowing and interest payments involving foreign entities) which would pose challenges during implementation.³⁴

Further, under the ACC prototype, the deduction for effectively paid interest would be replaced with a notional deduction for both debt and equity.³⁵ The deduction rate would be based on market interest rates for medium-term government securities and thereby represent a fixed fraction

of the cost of a firm's entire capital finance.³⁶ This model would impose a single levy on the normal rate of return on debt and equity (which is the opportunity cost of an investment compensating investors for the time value of money) by taxing it at the investors' and shareholders' rates. Additionally, it would tax profits exceeding the normal rate of return on debt and equity twice and subject them to taxation at both the corporate and investor levels.³⁷

As anticipated, while aimed at reducing incentives for heavily leveraged corporate capital structures, some of these tax prototypes do not entirely remove tax considerations from corporate financial decisions. For instance, the NDI system could replace the tax-driven motivation to issue debt with a significant incentive to keep profits within the company and delay taxes for investors.

Likewise, the prototypes of dividend exclusion and shareholder allocation still factor tax implications into decisions regarding capital structure despite diminishing the tax advantages of leveraging. This is because they either tax profits (dividends) at the corporate level and interest at the lender level or tax corporate profits at shareholders' rates and interest at lenders' rates, respectively. Therefore, in both scenarios, achieving a balance between debt and equity would necessitate uncommon situations in which all of these tax rates precisely coincide.

Similarly, the dividend deduction prototype might shift the bias from retaining earnings towards favouring dividend distributions. This could lead to encouraging immediate payouts even when corporations could benefit from retaining more liquidity for future investments.

The ACC prototype might not completely eradicate distortions in capital structure, particularly if investors are tax-exempt or subject to preferential tax rates or if they are foreign investors subject to different tax treatment(s).

On the contrary, the CBIT regime would equalize how debt and equity are treated and remove tax preferences or deferrals as neither dividends nor interest would be taxable income for recipients. However, this approach has a significant drawback: without factoring in investors' rates into tax calculations on business income, high-bracket shareholders receiving dividends might face a CBIT flat rate lower than the tax rate on labour income. This jeopardizes the progressivity of the entire tax system.³⁸

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³² The Department of the US Treasury, *Integration of The Individual and Corporate Tax Systems – Taxing Business Income Once* 1–275 (Jan. 1992).

³³ A. Auerbach, *A Modern Corporate Tax*, The Center for American Progress/The Hamilton Project (2010).

³⁴ By focusing solely on domestic transactions, a similar destination-based tax would align with what is known as the 'principle of origin' (which traces the cause of income, and thus the power to tax, to the jurisdiction where the income is created) at least for borrowing activities confined to the territory where the debtor is located as interest will be taxable only in that state, i.e., the debtor's state. See E. C. M. Kemmeren, *Taxing Interest in the Debtor State as an Alternative to DEBRA*, 32(2) EC Tax Rev. 44–55 (2023), doi: 10.54648/ECTA2023010.

³⁵ E. D. Kleinbard, *Beyond Good and Evil Debt (and Debt Hedges): A Cost of Capital Allowance System*, 67 Taxes, 943 (1989) https://gould.usc.edu/assets/docs/Beyond_Good.pdf.

³⁶ In other words, this notional deduction would reflect the nominal cost of all financing of both equity and debt. See R. Boadway & N. Bruce, *A General Proposition on the Design of a Neutral Business Tax*, 24 J. Pub. Econ. 231 (1984), doi: 10.1016/0047-2727(84)90026-4.

³⁷ K. Pratt, *The Debt-Equity Distinction in a Second-Best World*, 53 Vand. L. Rev. 1055 (2000) <https://scholarship.law.vanderbilt.edu/vlr/vol53/iss4/1/>.

³⁸ The reference here pertains to the entire internal tax ecosystem of a single jurisdiction. Implementing progressive income taxation globally to achieve a fair distribution of economic resources between countries presents a greater challenge than at the national level. This difficulty stems from countries' tendency to use their tax authority to

As perhaps expected, the DEBRA proposal diverges from all of these paths and embarks on a distinct road. It retains, albeit with limitations, interest deductibility while also allowing the notional cost of equity finance to be tax deductible. As the notional deduction applies to equity only, it is termed as an ‘allowance for corporate equity’, or ACE, which sets it apart from the ACC.

There are *ex ante* concerns associated with a similar approach. One is that it could potentially diminish tax revenue and narrow the tax base. The cost of ACE may vary depending on whether it applies solely to new corporate equity or also to the existing capital accumulated over time. The implementation of ACE relief for equity finance reportedly led to Croatia losing up to a third of its corporate tax base³⁹ and, more generally, even ACE schemes limited to increases in equity capital have been reported to be expensive to maintain.⁴⁰ Offsetting this loss by raising headline corporation tax rates can prove to be challenging. Furthermore, raising headline tax rates to compensate for revenue shortfalls may exacerbate distortions caused by corporate taxes.

Therefore, understanding how the DEBRA proposal confronts such concerns and alleviates potential drawbacks becomes imperative, thus, Part II will now delve into it to examine its mechanisms for attempting to address these challenges.

3 WHEN A DEBT-EQUITY BIAS MEETS A DEBRA

The DEBRA proposal applies to all taxpayers subject to corporate income tax in one or more EU Member States with the exception of financial enterprises. It consists of two distinct components or measures:

- an ACE deduction based on capital increases (DEBRA ACE); and
- a new limitation on the deductibility of passive interest (DEBRA ILR) that would apply in addition to the ATAD ILR.

3.1 The DEBRA ACE Component

Beginning with the ACE deduction, this allowance on equity would be calculated by multiplying an ‘allowance base’ by a ‘notional interest rate’, or NIR ($ACE = Allowance\ Base \times NIR$).

The allowance base represents the year-on-year increase in net equity derived from the difference between net equity at the end of the current tax year and that at the end of the previous tax year. It includes the corporate taxable entity’s paid-up capital, share premium accounts, revaluation reserve, other reserves, and carried-forward profits or losses adjusted by subtracting the tax value of the taxpayer’s participation in associated enterprises’ capital and any holdings of the taxpayer’s own shares.

Stated differently, faced with the choice between granting an ACE to all equity – both old and new (sometimes referred to as a ‘full’ or ‘hard’ ACE) – or only to new equity (dubbed ‘soft’ ACE), the EU Commission chooses the latter primarily on the grounds that a hard ACE would result in excessively high fiscal costs.⁴¹ The concept that the goal of long-term corporate de-leveraging could be better served by providing equal tax treatment for both new and existing investments is not given much consideration, though. Yet, the EU Commission is likely correct: implementing a full ACE deduction at present would not address any past bias against old equity contributions and would effectively result in a windfall for businesses that would benefit shareholders.⁴²

Regarding the NIR, this would be determined based on a ten-year risk-free interest rate with an additional risk premium to account for the higher interest rates typically faced by private borrowers compared to risk-free borrowers. This risk premium is set at 1% for large companies, while SME enterprises are assigned a higher rate of 1.5% reflecting the assumption that they encounter greater hurdles in securing equity financing and contend with elevated financing costs.⁴³

The EU Commission proposes capping the annual allowance on equity at 30% of the taxpayer’s EBITDA with any excess allowance capacity – meaning the portion

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benefit their own citizens, potentially leaving fewer resources and taxing rights for poorer nations. For an analysis of global distributive justice and the concept of global progressivity, refer to A. Kern, *Progressive Taxation for the World*, Tax Law Review, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4746523. At the national level, putting aside considerations of justice and fairness, the economic justification for progressive taxation rests on the diminishing marginal utility of income. This principle indicates that, as a taxpayer’s income increases, the additional benefit (utility) received from each extra dollar diminishes compared to the utility received from previous dollars. Simply stated, each additional untaxed dollar or dollar from a government transfer (e.g., payments to low-income households) provides a greater benefit to lower-income taxpayers than the benefit that a higher-income taxpayer loses from each additional dollar paid in taxes to government revenue; see M. S. Stein, *Diminishing Marginal Utility of Income and Progressive Taxation: A Critique of The Uneasy Case*, 12(2) N. Ill. U. L. Rev. 373 (1992) <https://huskiecommons.lib.niu.edu/niu/vol12/iss2/3/>.

³⁹ M. Keen & J. King, *The Croatian Profit Tax: An ACE in Practice*, 23(3) Fiscal Stud. 401 (2002), doi: 10.1111/j.1475-5890.2002.tb00066.x. Also International Monetary Fund, *Debt Bias and Other Distortions: Crisis-Related Issues in Tax Policy* (Jun. 2009), Washington D.C.

⁴⁰ A notable example is Italy which introduced an ACE regime in 2011 providing tax relief on a portion of income proportional to increases in net corporate equity. However, the Italian ACE scheme was abolished in 2024. The accompanying report to Legislative Decree No. 216 of 2023 that repealed the scheme explicitly cited its high cost as one of the primary reasons for its discontinuation, estimating that abolishing ACE would generate additional tax revenue of EUR 4.8 billion in 2025 and EUR 2.8 billion annually thereafter.

⁴¹ EU Commission Staff Working Document, *Debra Impact Assessment Report*, Brussels, 11 May 2022 SWD(2022) 145 final, at 54.

⁴² American Law Institute, *Federal Income Tax Project, Reporter’s Study Draft, Subchapter C (Supplemental Study)*, Philadelphia 92 (1989).

⁴³ In detail, to factor in inflation and central bank policy, for each tax year, the relevant interest rate will be determined based on the ten-year maturity risk-free rate published in Dec. of the prior tax year by the European Insurance and Occupational Pensions Authority. See EU Commission Staff Working Document, (*ibid.*), at 57.

of the equity allowance that exceeds 30% of EBITDA in a given tax period – being eligible for carryforward for up to five (5) years.⁴⁴

If a taxpayer experiences an increase in equity but still incurs losses or has meager profits, any unused portion of the equity allowance due to insufficient net taxable income (stated otherwise, any ACE portion higher than the corporation's net taxable income in a given tax year) could be carried forward indefinitely with no time limit.⁴⁵

3.2 The DEBRA ILR Component, on Top of the ATAD ILR

The DEBRA proposal offers a new regulation for consideration that limits deductible interest to 85% of 'exceeding borrowing costs' that are defined as interest paid minus interest received. This DEBRA ILR is designed to operate alongside the ATAD ILR. However, while the latter includes a safe harbour to reduce compliance burdens for situations deemed less prone to tax evasion – allowing net borrowing costs to be deductible up to EUR three million with only amounts exceeding this limit being subject to the 30% maximum threshold of the taxpayer's EBITDA⁴⁶ – the DEBRA ILR does not incorporate any *de minimis* rule.

Since both ILRs would apply in parallel, companies would need to calculate their allowable deductions under both the new DEBRA ILR and Article 4 of ATAD with the former required to be applied first. A key aspect of the interaction between these two rules is represented by Article 6 of the DEBRA proposal which that carryforward and carryback opportunities only in cases when the deductible amount under the DEBRA ILR is higher than that under the ATAD ILR and not vice versa.

As a result, if the non-deductible amount for a given year is lower under the DEBRA ILR (e.g., fifteen) compared to the ATAD ILR (e.g., twenty), the difference between the two (e.g., –5 in this scenario: = 15–20) can be carried forward or back under Article 4 of the ATAD

rules thereby reducing future tax liability or resulting in a tax refund.

However, the opposite scenario does not apply: when the deductible amount is higher under the ATAD ILR resulting in a lower non-deductible amount under the ATAD (e.g., ten) than under the DEBRA ILR (e.g., fifteen), the excess non-deductible interest (e.g., five: = 15–10) becomes permanently disallowed under Article 6 of the DEBRA proposal with no possibility of future recovery.

The matrix below offers a visual representation of this complex interplay between higher/lower deductible and non-deductible amounts under DEBRA and ATAD.

Scenario	DEBRA ILR (Constant)	ATAD ILR (1)	ATAD ILR (2)	Carryforward/ Carryback
Deductible	85	80	90	
Non-deductible (1)	15	20	-	5
Non-deductible (2)	15	-	10	nil

Clearly, this detaches the DEBRA ILR from what can merely be a temporary non-deductibility under the ATAD ILR. Otherwise stated, under Article 4 of ATAD, the idea is that companies have an incentive to enhance their financial performance to avoid losing previously non-deductible interest expenses and generate enough future EBITDA to offset them. However, this is no longer always valid under the DEBRA ILR as, depending on the circumstances, potential excess non-deductible interest expenses may be immediately lost and no longer recoverable.

To provide a practical example, assume a situation with a constant EBITDA of 100, a debt-to-EBITDA ratio (which measures a company's liabilities relative to its

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⁴⁴ According to Art. 4, para. 1, of the DEBRA directive, the ACE would be deductible for ten consecutive tax periods. This means that the allowance on equity could be proportionally deducted in the relevant year and spread across the following nine years. The EU Commission suggests that doing so would mirror the average maturity of debt and limit the fiscal cost; see EU Commission Staff Working Document, (*ibid.*), at 28.

⁴⁵ The DEBRA proposal includes a recapture rule to prevent taxpayers from injecting equity solely to benefit from the ACE allowance and subsequently withdrawing the capital. If a taxpayer who has benefitted from an ACE deduction experiences an equity decrease in a given tax period, a proportionate amount will become taxable over the next ten tax periods up to the total net equity increase for which the allowance was obtained. The recapture rule does not apply if the taxpayer proves the decrease is due to incurred losses or a legal obligation. However, this disparity in tax treatment – for which losses can avoid recapture while equity increases always trigger ACE deductions (up to the 30% EBITDA limit) – could lead to unintended tax-planning strategies for businesses that fluctuate between losses and profits as noted by R. Ismer, *Editorial: A Zebra or a Donkey? The European Commission's Proposal for a Debt-Equity Bias Reduction Allowance (DEBRA)* 31(4) EC Tax Rev. 164 (2022), doi: 10.54648/ECTA2022017.

⁴⁶ The EU's ATAD ILR and the US ILR share some similarities and diverge in key aspects. Both utilize a 30% deductible ceiling as outlined in the EU's ATAD Directive and s. 163(j) of the US Tax Code. However, the US ILR applies this 30% deductible ceiling only to 'business interest' (i.e., interest paid or accrued on indebtedness properly allocable to a trade or business). Meanwhile, 'investment interest' (interest paid or accrued on indebtedness properly allocable to property held for investment) falls under its own set of limitations outlined in s. 163(d) of the US Tax Code. In contrast, the EU's ATAD ILR treats all interest expenses equally regardless of whether they are for business or investment purposes. Another key difference lies in the calculation method. While the EU's ATAD ILR uses the EBITDA, the US ILR has employed 'adjusted taxable income' as of 2022 that excludes depreciation and amortization and effectively lowers the 30% ceiling and tightens the deduction limits for business interest. See N. D. R. Miano, *Debt vs. Equity Financing and Business Taxation in a Post-BEPS/Anti-Tax Avoidance Directive/Corona World*, International Journal (BNA) 1–30 (2022).

cash flow) ranging from 2–5 and market interest rates varying from 1% to 11% and then consider three scenarios.

Under Scenario No. 1, with a net debt-to-EBITDA ratio of five, the company is highly leveraged and pays a 10% interest rate on its debt, resulting in annual interest expenses of fifty (Table 1). This translates into a deductible amount of 42.5 under the DEBRA ILR and thirty under the ATAD ILR. Since only the lower amount is deductible (Table 2), twenty would be disallowed (=50 – 30; Table 3). However, because the amount computed under the DEBRA is higher than that under the ATAD (42.5 > 30), the difference of 12.5 can be carried forward or back.

Under Scenario No. 2, with a net debt-to-EBITDA ratio of 3.5, the company is in a better financial situation and pays a 7% interest rate on its debt, resulting in annual interest expenses of 24.5 (Table 1). This translates into a deductible amount of 20.8 under the DEBRA ILR and thirty under the ATAD ILR. Since only the lower amount is deductible (Table 2), 3.7 would be disallowed

(= 24.5–20.8; Table 3). However, the situation is reversed in this case: since the amount computed under DEBRA is now lower than that under the ATAD (20.8 < 30), the difference between the two – that is, the excess non-deductible interest of 9.2 – cannot be carried forward or back.

Last, under Scenario No. 3, with a net debt-to-EBITDA ratio of two, the company is in a solid financial position and can serve its debt at a lower interest rate of 5%, resulting in overall annual interest expenses of just ten (Table 1). The deductible amount is 8.5 under the DEBRA ILR and thirty under the ATAD ILR. Since only the lower amount is deductible (Table 2), 1.5 would be disallowed (= 10–8.5; Table 3). Again, because the amount computed under DEBRA is much lower than that under the ATAD (8.5 < 30), the excess non-deductible interest – equal to the difference of 21.5 – cannot be carried forward or back.

The computations for all three scenarios are summarized in Table 4.

Table 1 Payable Interest

Payable Interest		EBITDA x						
Interest Rate		2	2.5	3	3.5	4	4.5	5
	1.0%	2.0	2.5	3.0	3.5	4.0	4.5	5.0
	2.0%	4.0	5.0	6.0	7.0	8.0	9.0	10.0
	3.0%	6.0	7.5	9.0	10.5	12.0	13.5	15.0
	4.0%	8.0	10.0	12.0	14.0	16.0	18.0	20.0
	5.0%	10.0	12.5	15.0	17.5	20.0	22.5	25.0
	6.0%	12.0	15.0	18.0	21.0	24.0	27.0	30.0
	7.0%	14.0	17.5	21.0	24.5	28.0	31.5	35.0
	8.0%	16.0	20.0	24.0	28.0	32.0	36.0	40.0
	9.0%	18.0	22.5	27.0	31.5	36.0	40.5	45.0
	10.0%	20.0	25.0	30.0	35.0	40.0	45.0	50.0
	11.0%	22.0	27.5	33.0	38.5	44.0	49.5	55.0

Table 2 Allowable Interest

Allowable (Lowest)		EBITDA x						
Interest Rate		2	2.5	3	3.5	4	4.5	5
	1.0%	1.7	2.1	2.6	3.0	3.4	3.8	4.3
	2.0%	3.4	4.3	5.1	6.0	6.8	7.7	8.5
	3.0%	5.1	6.4	7.7	8.9	10.2	11.5	12.8
	4.0%	6.8	8.5	10.2	11.9	13.6	15.3	17.0
	5.0%	8.5	10.6	12.8	14.9	17.0	19.1	21.3
	6.0%	10.2	12.8	15.3	17.9	20.4	23.0	25.5
	7.0%	11.9	14.9	17.9	20.8	23.8	26.8	29.8
	8.0%	13.6	17.0	20.4	23.8	27.2	30.0	30.0
	9.0%	15.3	19.1	23.0	26.8	30.0	30.0	30.0
	10.0%	17.0	21.3	25.5	29.8	30.0	30.0	30.0
	11.0%	18.7	23.4	28.1	30.0	30.0	30.0	30.0

Table 3 Disallowed Interest

Disallowed	Interest Rate	EBITDA x						
		2	2.5	3	3.5	4	4.5	5
	1.0%	0.3	0.4	0.5	0.5	0.6	0.7	0.8
	2.0%	0.6	0.8	0.9	1.1	1.2	1.4	1.5
	3.0%	0.9	1.1	1.4	1.6	1.8	2.0	2.3
	4.0%	1.2	1.5	1.8	2.1	2.4	2.7	3.0
	5.0%	1.5	1.9	2.3	2.6	3.0	3.4	3.8
	6.0%	1.8	2.3	2.7	3.2	3.6	4.1	4.5
	7.0%	2.1	2.6	3.2	3.7	4.2	4.7	5.3
	8.0%	2.4	3.0	3.6	4.2	4.8	6.0	10.0
	9.0%	2.7	3.4	4.1	4.7	6.0	10.5	15.0
	10.0%	3.0	3.8	4.5	5.3	10.0	15.0	20.0
	11.0%	3.3	4.1	5.0	8.5	14.0	19.5	25.0

Table 4 Computations

	Scenario No. 1	Scenario No. 2	Scenario No. 3
EBITDA	100	100	100
Debt x	5	3.5	2
Total Debt	500	350	200
Interest Rate	10%	7%	5%
Interest Payable	50	24.5	10
DEBRA ILR (85% Allowable)	85%	85%	85%
ATAD ILR (30% Threshold)	30%	30%	30%
Interest Allowable under DEBRA ILR	42.5	20.8	8.5
Interest Allowable under ATAD ILR	30	30.0	30
Threshold to apply	30	20.8	8.5
Interest Disallowed in the Relevant Year	-20	-3.7	-1.5
Interest Carried Forward or Back	12.5	-	-
Lost Interest (not Carried Forward or Back)	-	-9.2	-21.5

The practical analysis above prompts two considerations. First, DEBRA could inadvertently restrict debt financing even for firms with low debt-to-EBITDA ratios and ample cash (and cash equivalents) to secure favourable interest rates when borrowing and potentially lead to an increase in their financing costs.

Second, because whether the difference in calculation between DEBRA and ATAD is permanently disallowed inappropriately depends on whether the deductible amount calculated under the former is lower than the latter, a paradox emerges. With all else being equal, companies with higher leverage, thus paying higher interest, may find themselves with greater opportunities to carry forward their interest expenses compared to companies with lower levels of net debt and lower interest rates.

As these inconsistencies are revealed, even further concerns arise when the two components of the DEBRA proposal and the ATAD ILR are assessed together considering their interaction.

3.3 A Three-Headed Hydra: The Interplay Among DEBRA ACE, DEBRA ILR, and ATAD ILR

Before delving into the intricacies of how these measures interact, it is worth first discussing the proposed exclusion of all financial enterprises from the DEBRA regulations. According to the EU Commission's preparatory work, this exclusion is justified as financial companies, often subject to capitalization regulations, typically receive more interest than they pay. Consequently, the DEBRA ILR would seldom apply to financial enterprises that could instead benefit from the allowance on equity effectively subsidized by non-financial companies (NFCs) caught by the DEBRA ILR's net.⁴⁷

While it is true that many financial companies (e.g., banks) must legally meet minimum capital requirements, it is essential to acknowledge that raising regulatory capital incurs a cost. The appeal of investing in this sector compared to others affects the financing costs borne by financial companies that can subsequently influence the availability of financing for the entire economy.

Moreover, it remains somewhat ambiguous to what extent capital requirements can reduce the responsiveness

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⁴⁷ EU Commission Staff Working Document, (*ibid.*), at 34.

of financial firms to changes in taxation. On the one hand, there is the argument that regulatory minimum reserve levels could restrict financial companies' ability to adjust debt-to-equity ratios compared to NFCs.⁴⁸ Some studies indicate that tighter regulations and increased supervisory scrutiny in the aftermath of the 2007–2009 financial crisis combined with market pressure on bank buffers likely contributed to leaving large banks with less ability to let tax considerations influence their leverage decisions.⁴⁹ On the other hand, some alternative perspectives suggest different views either to (1) argue that regulatory buffers and minimum capital-to-assets requirements may not be as crucial as commonly believed in determining the capital structure of most banks (including large, publicly traded ones),⁵⁰ to (2) emphasize that small banks might be even more responsive to tax incentives than the average non-bank,⁵¹ or (3) recall that segments of the financial sector, such as shadow banking entities, possess financial engineering skills that can be exploited in order to engage in debt-equity arbitrage and potentially displace or defer tax liabilities.⁵² Hence, the EU Commission's decision to exclude all financial companies from the scope of DEBRA does not appear to be entirely supported by scientific data regarding their allegedly lower exposure to debt bias.

Equally uncertain is whether the DEBRA proposal might actually achieve another goal endorsed by the EU Commission, i.e., supporting start-ups and scale-ups.⁵³ At one end of the spectrum, providing a higher notional interest rate for SMEs (1.5% NIR instead of the standard 1%) may seem supportive. However, fast-growing innovative companies requiring rounds of equity injections often need long time horizons before churning profits. Consequently, they might accumulate ACE for years while experiencing recurring losses. If the scale-up proves successful, they could suddenly generate (very) positive EBITDAs, but this would abruptly cap annual deductions at 30% and restrict carried-forward deductions to five (5) years. Additionally, while the EUR three million safe harbour under the ATAD ILR de facto prevents start-ups, scale-ups, and numerous SMEs from falling under the scope of Article 4 of the ATAD easing their compliance duties, the absence of any *de minimis* rule under the DEBRA umbrella implies that these firms

will be directly affected by the DEBRA ILR and potentially increase their compliance burdens.

Moving on to the core criteria for evaluating the measures intertwined in DEBRA, the key question is whether they can fulfil the main task of removing tax planning considerations from corporate financing decisions across Europe. Notably, the answer is negative partly because the EU Commission's reasoning is based on the insufficient premise that achieving capital structure neutrality depends exclusively on equalizing the tax treatment of interest and equity returns – that once equity returns become as deductible (via the ACE) as interest, a level playing field for firms' capital structure preferences would follow.

Nonetheless, this only tells part of the story as it assumes that the choice between equity and debt is essentially a firm's decision between raising new funds from shareholders and using someone else's funds. However, it overlooks that accumulating corporate earnings rather than distributing them is one of the simplest ways to finance a business.

The idea becomes more salient when contrasting two alternatives: (1) internal reinvestment of profits by the corporation itself *versus* (2) distribution of those profits for external reinvestment by individual shareholders.

Accumulated and reinvested corporate earnings by the corporation itself are pre-tax earnings for its shareholders deferring their personal income tax. This effectively creates a deduction for the investor if their aggregate tax rate – consisting of the corporate income tax on the reinvestment return plus the dividend tax rate on future distributions – is lower than the sum of individual tax rates applied twice when corporate earnings are immediately distributed, invested directly by the shareholder as an individual, and the return is earned by the shareholder personally.⁵⁴

The DEBRA prototype might actually exacerbate this situation: since the ACE reduces the taxable base income, there would be more profits available for either reinvestment or distribution to shareholders. Thus, if these profits are retained internally at the firm level, there would be one layer of taxation at the corporate rate (on the reinvestment return) and another at individual rates (on future distributions) minus the ACE deduction (= + ACE deduction – CIT – PIT). However, if the funds were

Notes

⁴⁸ B. Andrade, *Comments submitted by The International Bureau of Fiscal Documentation on the European Commission Consultation on debt-equity Bias Reduction Allowance (DEBRA)*, Task Force on EU Law, Amsterdam (24 Sep. 2021).

⁴⁹ L. Oana & A. F. Tieman, *Financial Sector Debt Bias*, 107 J. Banking & Fin. 105597 (2019), doi: 10.1016/j.jbankfin.2019.07.017.

⁵⁰ R. Gropp & F. Heider, *The Determinants of Bank Capital Structure*, 14.4 Rev. Fin. 587 (2010), doi: 10.1093/rof/rfp030.

⁵¹ J. H. Heckemeyer & R. A. de Mooij, *Taxation and Corporate Debt: Are Banks any Different?*, 70(1) Nat'l Tax J. 53 (2017), doi: 10.17310/ntj.2017.1.02.

⁵² R. Palan & D. Wigan, *The Economy of Deferral and Displacement: Finance, Shadow Banking and Fiscal Arbitrage*, in *Shadow Banking* 202–216 (United States: Routledge 1st ed. 2018).

⁵³ EU Commission Staff Working Document, (*ibid.*), at 8.

⁵⁴ W. D. Andrews, *Tax Neutrality between Equity Capital and Debt*, 30(3) Wayne L. Rev. 1057 (1984) <https://heinonline-org.libproxy.berkeley.edu/HOL/Page?handle=hein.journals/waynlr30&id=1067&collection=journals&index=>.

distributed and then invested (not into a business venture) by the shareholder directly, there would be two rounds of taxation at individual rates and no ACE deduction ($= -\text{PIT} - \text{PIT}$).

To give a numerical example, consider a firm with 1,000 in after-tax funds available for either investment (first scenario) or distribution as a dividend (second scenario). Suppose there is only one investment opportunity that pays a 10% return in one year, a corporate tax rate of 21%, and only one shareholder.

In the first scenario, assuming a 5% NIR, if the firm retains the funds internally as a source of equity finance and makes the investment, it would have a pre-tax return of 100 but a taxable base of 50 ($= 1,000 \times 10\% - \text{ACE}$; where $\text{ACE} = 1,000 \times 5\%$). Therefore, the firm would have 89 in after-tax annual profits available for distribution to its shareholder ($= (50 \times (1-21\%)) + 50 \text{ ACE}$). A shareholder in a UK-like dividend tax bracket of 39.3% would end up with 54 after paying their own tax ($= 89 \times (1-39.3\%)$).

In the second scenario, if 1,000 had been distributed, there would have been a tax payment of 393 on the distribution, leaving the shareholder with 607 to invest ($= 1,000 \times (1-39.3\%)$). This would generate a pre-tax return of approximately sixty-one, leaving the investor with thirty-seven after individual tax ($= 61 \times (1-39.3\%)$) which is less than the fifty-four the shareholder would have had if the investment had been made within the firm.

The difference is clearly due to the ACE: by making more dividends available for distribution at the company level, all other things being equal, the return for the shareholder will also be larger. This can be easily confirmed by noting that, if the individual tax rate is held constant at 39.3% in the first scenario but is reduced to a US-like dividend tax rate of 15% in the second scenario, the shareholder taxpayer would end up with 72.25 ($= 1000 \times ((1-15\%)^2 \times 10\%)$). This is more ($72.25 > 54$) than if the investment had benefited from ACE but was subject to higher individual tax rates on the distribution (e.g., 39.3% versus 15%).

Put it another way, whereas the advantage for debt can be measured against corporate income tax, it can be measured against the investors' tax rates for equity earnings. It is also not surprising that the allowance on equity might eventually resemble a form of a dividend deduction system as it has been suggested that, to achieve full neutrality, the ACE system would require

transforming the personal income tax into a personal consumption tax, exempting the normal return to capital.⁵⁵

Moreover, while one component of the NIR (i.e., the ten-year risk-free interest rate) can be adjusted to reflect market interest rates, its second component (risk premium) is fixed by regulation (1% or 1.5%) regardless of the different risk characteristics of the individual firm or the market sector in which it trades. Hence, while the ACE applies to a notional return, debt relief (interest deductions) still applies to actual interest payments, and the effective interest rate of the latter might differ from the nominal interest rates on which the ACE rate is based.

Even if actual interest payments for debt relief and nominal interest rates for ACE relief remained constant and identical, the overlapping regulations between the ATAD and the two-component DEBRA scheme pose challenges in securing tax neutrality between equity and debt choices.

As previously mentioned, the deductibility of ACE under DEBRA is limited to 30% of a corporation's EBITDA, and this deductible allowance on equity can be carried forward indefinitely or for up to five tax periods if, respectively, it exceeds the taxpayer's net taxable income or 30% of its EBITDA, but it cannot be carried back.

The Interest Limitation Rule bifurcates between DEBRA and the ATAD with the 30% EBITDA maximum threshold under the latter mirroring the upper limit for ACE relief under the former.

However, Article 4 of the ATAD also allows deductible borrowing costs exceeding taxable interest revenues and other similar taxable revenues to be carried back for up to three (3) years whereas no carry-back is provided for the deductibility of the allowance on equity under DEBRA which potentially results in time misalignments in the tax treatment between debt relief and ACE relief. There is also no quantitative alignment between the two reliefs as the 30% EBITDA upper limit under the ATAD applies alongside the cap that would limit deductible interest to 85% of exceeding borrowing costs under the new DEBRA ILR whereas the ACE relief would face only the 30% EBITDA threshold.

Predicting the practical consequences of the temporal and quantitative misalignments between the two reliefs is not straightforward. Still, considering the potential significance of the quantitative misalignment, it is likely

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⁵⁵ S. Cnossen, *Corporation Taxes in the European Union: Slowly Moving Toward Comprehensive Business Income Taxation?*, 25(3) Int'l Tax & Pub. Fin. 808 (2018), doi: 10.1007/s10797-017-9471-2. This type of reform was indeed one of the proposals of what is referred to as the 'Mirrlees Report' combining an ACE treatment of business investment with a rate-of-return allowance (RRA) treatment of savings. The idea was to exempt the component of income and capital gains earned on savings that corresponds to a risk-free or 'normal' rate of return from taxation (e.g., the rate paid on medium-term government bonds) and to provide an RRA for substantial holdings of risky assets (e.g., equities) with higher returns. See J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles & J. Poterba, *The Mirrlees Review: Conclusions and Recommendations for Reform*, 32(3) Fiscal Stud. – The J. Applied Pub. Econ. 331 (2011), doi: 10.1111/j.1475-5890.2011.00140.x.

that the array of rules introduced by DEBRA could tilt the bias towards equity; however, substituting a bias (in favour of debt) with potentially another bias (in favour of equity) is not equivalent to attaining tax neutrality in the treatment of debt and equity.

It can be deduced that the combination of the allowance on equity and the ILR proposed under DEBRA fails to achieve comprehensive debt-equity parity. Moreover, it does not ensure full capital structure neutrality as it does not eliminate potential tax arbitrage from a firm's decisions regarding its capital structure. With these consequences being relevant for the European internal market, the need to analyse its broader cross-border implications remains, particularly in relation to direct investment flows with the United States and the United Kingdom; this will be the focus of the next section.

4 DEBRA BEYOND THE PILLARS OF HERCULES: POTENTIAL TAX SPILLOVER EFFECTS ON DIRECT INVESTMENTS ACROSS THE ATLANTIC AND THE ENGLISH CHANNEL

From an international tax perspective, it is noteworthy that, in many respects, while originally designed for the single market, the widespread implementation of DEBRA across the European Union could have unforeseen implications for the tax treatment of cross-border financing planning and direct investment with its key trading partners. This section examines some of these consequences with a focus on two countries: the United Kingdom and the United States.

4.1 Double-Dip Financing Structures: The Case Between Europe and the United Kingdom

From the British perspective, the primary concern with the current EU-wide DEBRA proposal is the risk it carries of potentially instigating outsourcing of debt-financing and enabling double deductions through 'double-dip financing structures' for which conglomerates would benefit from ACE deductions in Europe while also deducting passive interest in the United Kingdom.

Double-dip structures can be described as tax-efficient arrangements that enjoy concurrent tax deductions in more than one jurisdiction (e.g., one in the source state

and the other one in the residence country) by either taking advantage of different countries' approaches to financial instrument characterization (e.g., hybrid mismatches) or by routing debt through nominee-entity intermediaries.⁵⁶

To curb aggressive tax planning, Article 5 of the DEBRA proposal includes a specific anti-avoidance rule aimed at preventing the inclusion of any equity increases resulting from intra-group loans – that is, between associated enterprises – in the DEBRA ACE's base (specific anti-avoidance rule or SAAR). An 'associated enterprise' is defined as an entity directly or indirectly holding economic rights or a voting interest exceeding 25% of another party's subscribed capital or voting rights ('25% qualifying interest').

To illustrate how this SAAR would work, the EU Commission provides an example. Suppose company A in Member State A receives a genuine equity injection that is subsequently used to grant a loan to associated company B in Member State B. Company B, in turn, uses the loan principal to inject equity into associated company C in Member State C. Since there has been only one genuine equity increase at the group level, the SAAR should lead to a denial of the allowance on equity in Member State C to prevent a duplication of deductible ACE – specifically, in both Member States A and C.

Hence, a similar SAAR appears reasonable, but it seems to lack comprehensiveness. While it can thwart cascading multiplications of ACE deductions, it fails to prevent the duplication of tax reliefs through simultaneous deductions for both equity allowance and interest expenses.

In the context of the EU–UK relationship, consider two scenarios. In the first, equity is injected by an unrelated party into a European parent company. The parent then uses this fresh capital to lend to a UK subsidiary. The EU parent would deduct the ACE under DEBRA while the UK subsidiary would claim deductions for the paid interest.⁵⁷

The problem of double deduction is exacerbated if no tax withholding is applied on the cross-border interest payments. This situation is not impossible to achieve, by exploiting the existing network of international double tax conventions (DTCs). For instance, payments could be routed through Luxembourg. Under Article 11(1) of the 2022 DTC between the United Kingdom and Luxembourg, interest payments are taxable only in the resident country (where the lender is based) with essentially no taxing rights for the source state except for specific and limited circumstances (e.g., income to be

Notes

⁵⁶ A. R. Lanthier & J. M. Mintz, *Seeking More Coherent Approach to Interest Deductibility*, 55(3) Can. Tax J. 629 (2007) <https://ssrn.com/abstract=1273171>.

⁵⁷ Despite the initial equity injection forming the basis for both the ACE deduction at the EU parent's level and the interest deductions at the UK subsidiary's level, it could be counterargued that the tax paid on the interest received by the EU parent would offset the deductions claimed in the United Kingdom. However, it is important to note that the interest received by the EU parent might go untaxed (or be taxed at a lower rate than the CIT deductions in the United Kingdom) depending on the Member State's tax rules, resulting in an (almost) full double-deduction benefit. Even if this was not the case (i.e., if the interest is taxed in the recipient's Member State), the ACE deduction might still offset the taxation on the received interest (or most of it) and allow the multinational group to claim interest deductions in the United Kingdom with little to no taxation on the corresponding payments in the EU.

regarded as dividends instead of interest or the beneficial owner of the interest conducting business in the source state through a permanent establishment).⁵⁸ Another available option could be going through the Netherlands.

A second scenario follows the reverse order whereby the parent company is established in the United Kingdom, takes out a loan from an unrelated party, and deducts interest on it. It then uses the loan principal to inject equity into a subsidiary based in Europe that would deduct the ACE under DEBRA.

In either scenario, although Article 6 of the ATAD Directive includes a general anti-abuse rule (GAAR) aimed at disregarding arrangements lacking valid commercial reasons reflecting economic reality other than securing a tax advantage, it seems improbable that Member States would deploy the GAAR under a EU Directive (ATAD) to neutralize the effects of ACE deductions sought under a different EU Directive (DEBRA) to offset negative spillovers (interest deductions) occurring outside the European Union, such as in the United Kingdom.

Even if both of these scenarios were caught by the SAAR, which seems improbable at best, there might be others that would not be particularly because cross-border investments between Europe and the United Kingdom could achieve tax advantages even without involving associated enterprises but instead by using preferential tax regimes such as the QAHC scheme.

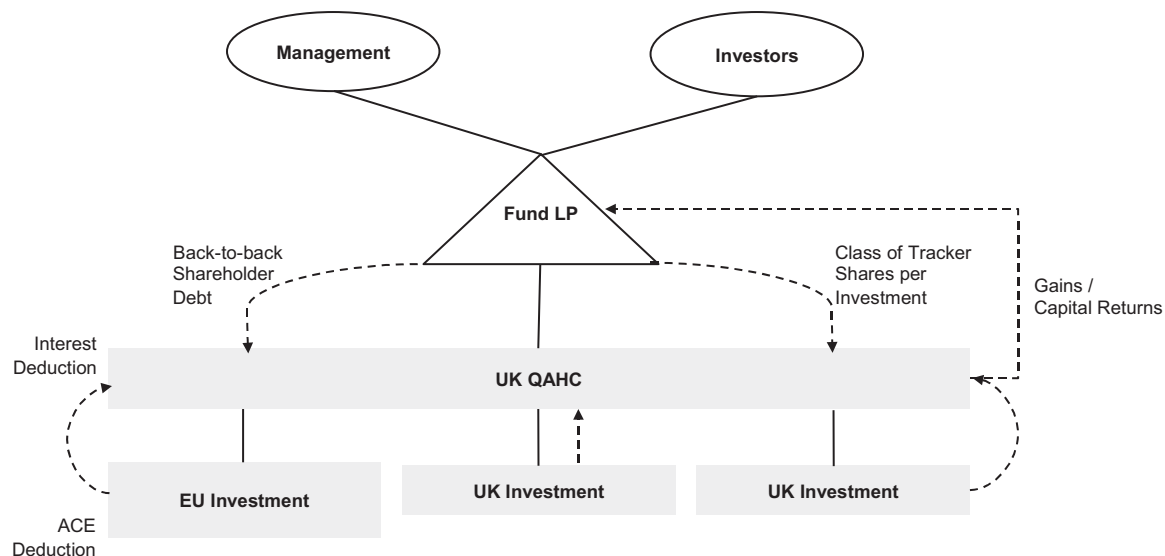
Introduced to enhance the UK's competitiveness as a location for asset management and investment funds, a QAHC is a standard company largely owned by investors

deemed 'qualified' for regulatory purposes (e.g., collective investment schemes, alternative investment funds, pension schemes, life insurance companies), but the QAHC regime switches off certain regulations of the UK tax system that would otherwise be applicable. Notably, it allows interest deductions on an accrual basis and introduces a full exemption for QAHCs from withholding tax on interest paid on any debt in addition to the standard domestic rule of no withholding tax on dividends or other distributions.

Moreover, taxation of a QAHC's business income at standard rates effectively applies only to the margins between its borrowing and lending with deductions permitted for profit-related interest given its full tax exemption on received dividends (excluding those from listed or traded equity securities) and gains from shares (except shares in UK property-rich companies with at least 75% of their value derived from UK land). The QAHC regime also facilitates capital returns to investors by disapplying tax rules that would treat premiums on redemption, repayment, or repurchase of shares as income distributions and allowing distributed profits to be returned as capital gains and taxed accordingly.⁵⁹

Thus, a situation could be imagined where a UK investment fund that is structured as a limited partnership and tax transparent (acting as a pass-through entity)⁶⁰ lends money to a UK QAHC via a profit-participating loan (or convertible security) with the QAHC using these funds to make an equity investment in a European business, as illustrated in Figure 1. If the investment falls below the 25% qualifying interest threshold, no associated enterprise relationship would take effect.

Figure 1



Notes

⁵⁸ D. Imparato, *Private Equity's Byzantine Tax Stand—An Untold and New Story of Carried Interest*, 1 Brit. Tax Rev. 104–132 (2024), doi: 10.1007/978-3-030-38738-9_226-1.

⁵⁹ UK Finance Act 2022, Ch. 3, Sch. 2.

⁶⁰ D. Imparato, *The Tax Playbook of Venture Capital and Private Equity*, in *The Palgrave Encyclopedia of Private Equity* (D. Cumming & B. Hammer eds, Palgrave Macmillan, Springer Nature) 2024.

The EU venture would deduct the ACE and pay equity returns exempt from taxation at the UK QAHC level while the QAHC could still claim interest deductions against taxable income from its creditor relationships within its ring-fenced business. Also, the QAHC would apply no tax withholding on the interest due on its back-to-back shareholder debt. Last, when the UK QAHC returns profits to investors and the fund's managers through buybacks of tracker shares, these profits would be subject to capital gains tax rather than income tax (some of these investors, such as pension funds or university endowments, may even be tax exempt). The preferential capital gains tax treatment would therefore combine with the interest deduction in the United Kingdom which would be in addition to the ACE deduction in Europe.

Broadly, the analysis of all of these scenarios aims to highlight how DEBRA might potentially undermine the tax base of a third country like the United Kingdom by shifting the concentration of debt financing there which could prompt the adoption of countermeasures, including special anti-abuse regulations, and pose risks for direct investment flows towards Europe.

After all, since the *Marks & Spencer* Case (C-446/03),⁶¹ double dip structures with the potential to lead to double non-taxation or double deduction have also been deemed by the Court of Justice of the European Union (CJEU) to pose a threat to the preservation of the allocation of taxing powers between EU Member States thereby justifying restrictions on the single market's four fundamental freedoms (i.e., free movement of workers, freedom of establishment, free movement of goods, and free movement of capital and payments).⁶² However, considering that the free movement of capital under Article 63 of the Treaty on the Functioning of the European Union also applies to non-EU countries, this could lead to the paradox of third countries' (e.g., the United Kingdom) potential anti-DEBRA countermeasures de facto converging with the CJEU's anti-double-dip structure jurisprudence in their efforts to undermine Brussels' DEBRA regulations.⁶³

The potential use of double-dip structures for outsourcing debt financing (with interest deductions) because of

DEBRA could therefore have implications beyond the EU–UK investment landscape as demonstrated by the American experience. In the United States, back-to-back financing arrangements have faced legal challenges in the past, resulting in the denial of exemptions from US withholding tax on interest when back-to-back loans were routed through the Netherlands, for example.⁶⁴

This situation raises broader questions about the tax treatment of future cross-border investments between the United States and European Member States in the event of an EU-wide adoption of DEBRA, as illustrated in the following two sections.

4.2 Calling Out Tax Treaty's Implications With the United States

Concerns about outsourcing debt financing have already impacted the American regulatory system, first at the level of DTC provisions following the US Treasury Department's release of an updated version of the country's Model Income Tax Convention in February 2016 (2016 US Model).

Among other changes, Article 22 of the 2016 US Model contains a revised definition of the 'limitation on benefits' (LOB) clause. Historically, this clause has been considered as an anti-treaty shopping provision that was designed to limit tax treaty benefits to entities based in the state whose DTC with the United States is invoked. It thus prevents residents of third countries from accessing benefits under a treaty that were not intended for them.

However, under the new LOB clause of the 2016 US Model, treaty benefits (other than those for dividends) are to be denied if more than 50% of the payor's gross income is directly or indirectly passed on as deductible payments not only to residents of third countries but also to entities of the contracting resident state benefiting from a 'special tax regime' with regard to the deductible payment (excluding arm's length payments made in the ordinary course of business for services or tangible property).

While this new LOB provision only applies to transactions between 'connected persons' and not to independent

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⁶¹ *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, C-446/03, Judgment of the Court (Grand Chamber) of 13 Dec. 2005.

⁶² Y. Brauner, A. P. Dourado & E. Traversa, *Ten Years of Marks & Spencer*, 43(4) Intertax 306 (2015), doi: 10.54648/TAXI2015026.

⁶³ The CJEU jurisprudence on double dip structures has primarily focused on preventing companies from deducting losses twice across different jurisdictions within the same corporate group. See B. Da Silva, *From Marks & Spencer to X Holding: The Future of Cross-Border Group Taxation in the European Union*, 39(5) Intertax 257 (2011), doi: 10.54648/TAXI2011030.

For instance, following the *Marks & Spencer* case, the CJEU ruled in the *X BV* and *X NV* cases (*X BV and X NV v. Staatssecretaris van Financiën*, joined Cases C-398/16 and C-399/16, 22 Feb. 2008) that restrictions on the consolidation of losses from subsidiaries and foreign branches skew the playing field for investments in non-resident entities. But in the *Memira* and *Holmen* cases it was emphasized that losses incurred abroad must be 'final' to be deductible in another EU Member State (*Skatteverket v. Memira Holding AB*, C-607/17, and *Skatteverket v. Holmen AB*, C-608/17, 19 Jun. 2019). For losses to be 'final', there should be no alternative or other options to use them in the source country (e.g., selling the business before liquidation to offset losses with capital gains).

Furthermore, in the *Aures* case (*Aures Holdings a.s. v. Odvolací finanční ředitelství*, C-405/18, 27 Feb. 2020), the CJEU ruled that an EU Member State can restrict the use of losses accrued by a parent company before transferring its corporate headquarters to its territory even if the company already had a permanent establishment there. This is because those losses arose in tax periods during which the state had no tax jurisdiction over the company.

Through these rulings, the CJEU has essentially endorsed EU Member States' restrictions on using losses incurred when a company was resident elsewhere (which can be extended to prevent double deduction of interest) justified by the need to ensure a balanced allocation of taxing powers among EU Member States.

⁶⁴ P. A. Glicklich & M. J. Miller, *Appeals Court Invalidates US-Netherlands Double-Dip Financing Structure*, 49(4) Can. Tax J. 1076 (2001).

parties,⁶⁵ the statutory scope of the term ‘special tax regime’ is broad enough to cover any statute, regulation, or administrative practice offering preferential tax rates or permanent reductions in the income tax base thereby extending to notional deductions for equity.⁶⁶

In doing so, it has been noted that the 2016 US Model irreversibly shifts the original intent of the LOB clause: from an anti-treaty shopping provision aimed at ensuring a territorial nexus between the payee and the contracting resident state, to now functioning as a base erosion test to oppose related-party deductible payments in the source state when income upon receipt is subject to little or no tax.⁶⁷

Even more striking is the new Article 11 of the 2016 US Model: its paragraph 2, letter e) now denies lower treaty-based withholding tax rates on outbound interest payments to a connected person if, at any time during the taxable year in which the interest is paid, the related party lender has benefited from notional deductions treated as equity in the contracting state of residence. Stated in a different manner, Article 11 of the 2016 US Model sees the potential for foreign-parented companies to deduct an equity allowance while their US-based affiliates deduct interest payments as a means of eroding the US tax base. It responds by deeming it inappropriate for tax treaties to reduce US statutory withholding rates on deductible US source payments.

As a result, assuming an EU-wide adoption of DEBRA, if an EU company benefitted from a DEBRA ACE regardless of whether the equity injection came from an unrelated party, and then used the new equity assets to lend to a connected party established in the United States, 30% of the gross US-sourced interest payments would be subject to US withholding tax rather than the lower treaty rates of zero or 15%.

Practical consequences could be significant especially because the DEBRA ACE incentive for the EU firm would have to be weighed against the possibility of being completely offset by the high (i.e., 30%) tax withholding on interest payments from a US related party.

From a theoretical standpoint, it is true that the 2016 US Model treaty provisions would need to be incorporated into existing or new tax treaties to become legally binding. However, this process has already begun: Article 11 on interest and Article 22 on the LOB clause of the DTC signed in December 2022 between the United States and Croatia mirror the wording of the corresponding articles of the 2016 US Model.

This new treaty trend is not poised to remain confined within the EU-US relationship; it might extend beyond it. While the minimum standards in Articles 11 (Interest) and 29 (Entitlement to Benefits) of the 2017 OECD Model Tax Convention on Income and on Capital (2017 OECD Model) lack explicit restrictions on treaty benefits for notional equity deductions, the accompanying OECD commentaries open a Pandora’s box.

Notably, the commentary on Article 1 (Persons Covered) of the 2017 OECD Model enables countries to implement bilateral provisions denying treaty benefits on related-party interest payments in cases when notional equity deductions are available in one of the contracting states, echoing Article 11 of the 2016 US Model. Likewise, mirroring the 2016 US Model’s Article 22, the commentary on Article 29 of the 2017 OECD Model allows countries to regard interest paid to connected entities that benefit from domestic notional equity deductions as a ‘special tax regime’ that could facilitate base erosion through profit shifting. Such references to notional equity deductions were absent in the commentaries on the articles of the pre-2017 OECD Model dated July 2014 and preceding the 2016 US Model.

This shift could encourage other countries to follow suit. By seizing the 2017 OECD Model, they may well seek to introduce restrictions targeting notional equity deductions in future treaties with EU Member States similar to those in the 2022 US-Croatia DTC with significant ramifications for taxing cross-border financing.

Furthermore, instead of bringing the issue to the treaty level, the United States (and other countries) might still retain the option of denying interest deductibility altogether at the domestic level (that is, under domestic law) when the related income is earned by non-residents benefiting from notional equity deductions. A similar US domestic rule would indeed have an equivalent effect of an outright denial of treaty benefits on outbound interest payments but without the need for a review of the US’s DTC network.

In fact, this scenario is not unthinkable as it bears a resemblance to recent US federal regulations concerning the tax treatment of inbound dividends from overseas subsidiaries to US parent companies potentially reducing the attractiveness of foreign countries for receiving American corporate investments; this is discussed in the following section.

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⁶⁵ Under Art. 3, para. 1, letter m) of the 2016 US Model, ‘connected persons’ are those for which one holds at least 50% of the beneficial interest in the other or, in the case of a company, at least 50% of its aggregate vote and value. It also covers situations when common third-party control exists or when one entity exercises control over another based on relevant facts and circumstances.

⁶⁶ R. S. Avi-Yonah, *Full Circle? The Single Tax Principle, BEPS, and the New US Model*, 1 Global Tax’n 12 (2016), doi: 10.2139/ssrn.2673463.

⁶⁷ F. A. V. Borrego, *The Special Tax Regimes Clause in the 2016 U.S. Model Income Tax Convention*, 45(4) Intertax 296 (2017), doi: 10.54648/TAXI2017023.

4.3 From FDR to the Participation DRD, to DEBRA: What Consequences for Corporate America?

To begin, it is worth noting that, since the New Deal, the United States has had a system of intercorporate dividend taxation in which income earned at the corporate level and distributed from one US corporation to another is generally subject to double taxation. This system was introduced under the Roosevelt Administration and was part of a broader policy toolkit that included antitrust enforcement measures, enhanced investor protection, and escalating estate taxes aimed at breaking up large pyramidal groups (e.g., monopolies in the utility sector) that had threatened to take over the American economy at the beginning of the twentieth century.⁶⁸ As these began to gradually disappear from the 1940s and 1950s onwards, the US tax code (Internal Revenue Code (IRC)) has been fine-tuned over time to provide some tax relief to shelter dividends that have already been subject to US corporate tax at the level of the distributing company.

This tax relief on US-sourced dividends is governed by IRC section 243 and IRC section 245. The former covers dividends paid by domestic corporations to other domestic corporations that qualify as US-sourced dividends by definition. Aside from specific cases subject to different rules (e.g., dividends paid by mutual savings banks, cooperative banks, real estate investment trusts, or regulated investment companies), it allows for a deduction equal to either 65% or 50% of the received dividends (referred to as the dividends-received deduction (DRD)) depending on whether the corporate recipient owns at least 20% of the stock of the distributing corporation by vote and value.

A full deduction is available only on dividends received by a corporate shareholder from a subsidiary in an 'affiliated group' which is when the common parent corporation owns at least 80% of their stock (by vote and value), in which case, the recipient will benefit from a

100% DRD that reduces the tax rate on the dividend distribution to zero.

Consequently, absent an affiliated group and with a 21% corporate tax rate, if a domestic company pays out dividends to a domestic corporate shareholder, the latter is entitled to a 50% DRD resulting in an effective tax rate of 10.5% on the dividend distribution. If the corporate recipient owns at least 20% of the distributing firm, the DRD increases to 65% thereby reducing the effective tax rate on the distributed dividends to 7%.⁶⁹

IRC section 245 also covers US-sourced dividends but only when paid by foreign corporations to domestic ones in relation to income that is effectively connected to the United States by deriving from the conduct of a trade or business carried out within the United States by the distributing foreign entity.

Under IRC section 245(a)(1), the DRD on the US-sourced dividends paid by foreign corporations cannot exceed the deductions under IRC section 243 (that is, 65% or 50%) unless all of the outstanding stock of the foreign company is owned (directly or indirectly) by the domestic corporate shareholder and 100% of the foreign payor's gross income is effectively connected with the conduct of a trade or business within the United States (IRC section 245(b)).

This omits foreign-sourced dividends that are now addressed by IRC section 245A that was introduced by the Tax Cuts and Jobs Act of 2017 (Pub. L. 115–97) to adapt the shift of the US corporate tax system to a *quasi*-territorial regime. It provides for a 100% DRD on foreign-sourced dividends from foreign companies in which US corporate recipients own a 10% stake or more of the total combined voting power of all classes of their stock entitled to vote or 10% or more of the total value of shares of all of their classes of stock (Foreign Participation DRD).⁷⁰ In essence, dividends eligible for the Foreign Participation DRD are those derived from payments that are not eligible for the domestic-sourced DRD⁷¹ as the

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⁶⁸ E. Kandel, K. Kosenko, R. Morck & Y. Yafeh, *The Great Pyramids of America: A Revised History of U.S. Business Groups, Corporate Ownership, and Regulation, 1926–1950*, 40 Strategic Mgmt. J. 781 (2019), doi: 10.1002/smj.2992.

⁶⁹ It can be deduced that, compared to Europe, the United States offers less favourable tax treatment for domestic intercorporate dividends. In Europe, the 'parent-subsidiary' regime established by Directive 2011/96/EU (consolidating the earlier Directive 435/90/EEC to extend regulatory coverage to companies from countries that joined the EU after 2000, such as Bulgaria and Romania) offers significant tax advantages. Under this parent-subsidiary regime, if two conditions are met – (1) a parent company holds at least a 10% direct ownership stake in the subsidiary's capital for (2) a continuous minimum of one year – an EU Member State has two options:

(1) complete exemption on the intercorporate dividends, provided these profits are not deductible expenses for the subsidiary, or
(2) taxing them but only to the extent that the distributed profits are deductible for the subsidiary with a 5% maximum deduction (as per Art. 4 of Directive 2011/96/EU).

Thus, while US corporations can face taxes on up to 50% of their domestic dividends, European companies are only taxed on a maximum of 5% on their EU-domestic intercorporate dividends with a corresponding deduction for the subsidiary (even though corporate tax rates may differ between the parent company's EU Member State of residence and that of its subsidiary).

This disparity in tax treatment between Europe and the United States for domestic intercorporate dividends can have broader economic consequences. The prevalence of complex corporate structures with multiple subsidiaries (referred to as 'corporate pyramids') that are more common in Europe than in the United States could be partly attributed to this tax advantage. Conversely, for US companies, the higher taxation on intercorporate dividends creates a greater burden on dividend distributions throughout the corporate chain the longer that the chain becomes. For an analysis of the interaction between corporate taxes and the structure of corporate ownership, see S. A. Bank & B. R. Cheffins, *The Corporate Pyramid Fable*, 84(3) The Bus. Hist. Rev. 435 (2010), doi: 10.1017/S0007680500002191; also S. Dai & C. Helfrich, *The Structure of Corporate Ownership and Control*, Comparative Corporate Governance and Financial Regulation (Paper 9), University of Pennsylvania Law School 1–54 (2016); and, R. Morck & B. Yeung, *Dividend Taxation and Corporate Governance*, 19(3) J. Econ. Persps. 163 (2005), doi: 10.1257/089533005774357752.

⁷⁰ The 10% minimum stake is defined pursuant to IRC s. 951(b).

⁷¹ M. B. Weiss, *The Participation Dividends-Received Deduction: More Than Meets the Eye*, 16(3) J. Tax'n Fin. Prod. 65 (2019).

latter only shelters US-sourced income (whether disbursed by domestic or overseas firms) whereas the Foreign Participation DRD shelters foreign-sourced income distributed to US shareholders.

Hence, corporate America is de facto tax incentivized to make outbound direct investments abroad by either establishing subsidiaries or acquiring stakes in overseas firms considering that the minimum equity stake threshold required for fully exempt dividends is lower for the Foreign Participation DRD than for the domestic DRD: 10% versus 80%, respectively. However, this applies only as long as foreign-sourced dividends are not considered ‘hybrid dividends’ for which the distributing foreign corporation receives a deduction or other tax benefit for any income as IRC section 245A(e) strictly denies any Foreign Participation DRD in such cases.

If the scope of IRC section 245A(e) was not broader, ACE benefits under DEBRA could still be preserved and not caught in the US tax code’s net. Indeed, under DEBRA, if a European subsidiary of a US parent company received an equity injection, the European firm would deduct a notional allowance on it regardless of its decision later in the year of whether to make dividend payouts to the US parent. This is because the ACE deduction is not related to any dividend distribution *per se* and, more importantly, would be granted even if no dividends were distributed.

This also captures the OECD’s rationale for rejecting the equivalence between ACE benefits and traditional hybrid instruments on the premise that:

rules that entitle taxpayers to a unilateral tax deduction for invested equity without requiring the taxpayer to make a payment, such as regimes that grant deemed interest deductions for equity capital, are economically closer to a tax exemption or similar taxpayer specific concessions and do not produce a mismatch in tax outcomes.⁷²

Yet, Federal Regulation §1.245A(e)-1(d)(2)(i)(B) expressly extends the definition of ‘hybrid deductions’ within the context of IRC section 245A(e) to include notional interest deductions (or similar deductions) that are determined for the equity of distributing foreign companies.

As a result, upon the implementation of an EU-wide DEBRA, irrespective of its equity allowance scheme not being calculated with regard to the payment of any dividends, US corporate shareholders of EU entities that have benefited from an ACE deduction might no longer be

eligible for the Foreign Participation DRD which may potentially lead to double taxation effects.

Of course, US multinationals would be the first to suffer from any forms of double taxation on their cross-border dividend payments. However, the question remains whether this might eventually prompt corporate America to shun (when feasible) or simply reduce their corporate investment in the Old Continent in the long term – though this is a question that DEBRA does not appear to address.

5 A TAX COUNTER-DEBRA FOR THE FINANCIAL MARKETS’ GOOD

Abstracting from DEBRA’s effects on both domestic and cross-border investments in a particular market, it remains crucial to consider the rationale behind a firm’s choice of financing and the broader role of taxation. Of course, in its capacity to affect corporate decisions through multiple avenues (firstly via capital structure preferences but also through organizational form and restructurings as well as payout policy),⁷³ taxation can certainly impact firms’ debt ratios, although the magnitude of this effect may not always be significant.⁷⁴

Nonetheless, the fact that tax policy can affect debt-to-equity ratios does not generally imply that a management’s decision to borrow is inherently unsound from a business perspective nor does it suggest that such a decision would have never been made but for tax reasons. If that was the case, recurring loss-making companies with substantial tax loss carryforwards would indeed never borrow due to the tax disincentive (i.e., the unavailability of additional interest deductions). Still, this is clearly not the situation.

In that regard, taxation does not determine whether leverage is good or bad *per se*; rather, its desirability could stem from various factors that are independent of taxes. For example, issuing new stock to raise fresh equity capital might incur higher underwriting costs compared to debt financing; borrowing could also result in lower interest rates and circumvent immediate equity dilution for shareholders caused by stock sales. Hence, if debt issuance was desirable in certain circumstances, the tax benefit of interest deductions could also be considered potentially appropriate. Conversely, if debt issuance was undesirable, regulations allowing excessive headroom for interest tax deductions would likewise be unwelcome.

These considerations can be particularly significant for firms that are not solely owned by a few individuals (e.g.,

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⁷² OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report* 17–18 (Oct. 2015).

⁷³ J. R. Graham, *Taxes and Corporate Finance: A Review*, 16(4) Rev. Fin. Stud. 1075 (2003), doi: 10.1093/rfs/hhg033.

⁷⁴ Y. Cheng & C. J. Green, *Taxes and Capital Structure: A Study of European Companies*, 76 The Manchester School (Supplement), Blackwell Publishing Ltd and The University of Manchester 85–115 (2008).

sole proprietorships or limited liability companies with a few members) but rather when there is a separation between executives (including potential founders with or without majority or minority control) and external investors providing capital. Management might hesitate to issue stock if they know the firm is undervalued by the market due to their access to inside information unlike investors without control (information asymmetry), and transmitting such information could be expensive.

This prompts inquiries into the meaning of signals conveyed by business decisions including the use of debt. It has been observed that, if capital is misallocated between 'good' and 'bad' firms owing to lenders lacking sufficient information to distinguish between them and resulting in setting the identical interest rate for both – which would be too low for bad firms but too high for healthy firms thereby causing the latter to not borrow enough but the former to borrow excessively – the tax deductibility of interest would restrict benefits to the 'good' firms with taxable profits.⁷⁵ In similar circumstances, a system that offers the tax advantage of debt deductibility to subsidize borrowing by firms that perform well while denying relief for the borrowing by firms that perform poorly could be desirable for rebalancing leverage decisions between profitable and unprofitable firms. However, this holding relies on the assumption that debt issuance signals bad news to investors about a firm's health such as a firm necessitating funds to address a lack of liquidity.

Yet, the signalling effect of debt remains partially unproven empirically. Despite some financial incentive-signalling models underlining that choosing debt over equity financing reveals lower-than-expected cash flow for firms⁷⁶ and that announcements of new borrowing depress stock prices on average,⁷⁷ other studies suggest the opposite. In particular, it has also been argued that the larger the change in leverage through leverage-increasing transactions, the greater the positive price reaction driving up stock prices.⁷⁸ This aligns with the view that increasing borrowing would signal a firm's confidence in its future stream of returns (capable of meeting debt obligations) thereby enhancing the market's *perception* of the firm's value.⁷⁹

DEBRA's assessment procedure does not generally account for these non-tax considerations. The proposal is more concerned with offsetting the financial costs of the proposed allowance on equity and influencing the leveraging choices of European NFCs *quantitatively* rather than *qualitatively*. Otherwise stated, DEBRA builds on the indebtedness level of NFCs across Europe appearing excessively high and therefore having to be reduced, but it overlooks the significance of the composition of their funding sources in relation to the diversification of financing for European companies.

In effect, corporate debt levels appear elevated when measured *quantitatively* as a percentage of the EU countries' GDP as the nonfinancial corporate debt-to-GDP ratio exceeded 100% for the euro area between 2018 and 2021. However, corporate leverage levels vary significantly between industries and even more among countries. At the end of this three-year period, the non-financial corporate debt-to-GDP ratio was above 140% in Belgium, France, and the Netherlands but below 70% in Italy and 60% in Germany.⁸⁰

Additionally, a high corporate debt-to-GDP ratio does not necessarily translate into high corporate financing costs.⁸¹ For example, in 2018, Greece had a corporate debt-to-GDP ratio about half of that of France but, according to the International Monetary Fund (IMF), in 2019, a Greek firm could end up paying up to 250 (percentage) basis points more annually on debt than a comparable French firm within the same sector and of similar profitability.⁸² Given this context, the DEBRA ILR would probably not level the playing field for corporate borrowing costs across Europe; the already-discussed lack of a safe harbour or *de minimis* rule could particularly disadvantage SMEs in those Member States where financing costs are already higher than in other EU countries.

More importantly, focusing on corporate borrowing volumes as a share of the GDP can be misleading, especially when assessing debt sustainability. A more accurate indication of corporate credit risk exposure is provided by financial performance and credit quality metrics such as (1) the debt-to-surplus ratio, (2) the interest coverage ratio, and (3) the ratio of corporate debt (loans and debt securities) to total corporate assets ('gross leverage').

Notes

⁷⁵ R. H. Gordon, *Taxation and Corporate Use of Debt: Implications for Tax Policy*, 63(1) Nat'l Tax J. 151 (2010), doi: 10.17310/ntj.2010.1.06.

⁷⁶ S. C. Myers & N. S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have*, (13) J. Fin. Econ. 187 (1984), doi: 10.1016/0304-405X(84)90023-0.

⁷⁷ S. D. Howton, S. W. Howton & S. B. Perfect, *The Market Reaction to Straight Debt Issues: The Effects of Free Cash Flow*, 21(2) J. Fin. Res. 219 (1996), doi: 10.1111/j.1475-6803.1998.tb00681.x.

⁷⁸ C. W. Smith, *Investment Banking and the Capital Acquisition Process*, 15 J. Fin. Econ., North-Holland 3 (1986), doi: 10.1016/0304-405X(86)90048-6.

⁷⁹ S. A. Ross, *The Determination of Financial Structure: The Incentive-Signalling Approach*, 8(1) The Bell J. Econ. 23 (1977), doi: 10.2307/3003485.

⁸⁰ M. Truchet & E. Krief, *Optimizing the Financing of EU Enterprises: Main Issues and Challenges*, EUROFI Regulatory Update 49–55 (Sep. 2021). Also McKinsey Global Institute, *Rising Corporate Debt Peril or Promise?*, Discussion Paper (Jun. 2018), McKinsey & Company Publishing.

⁸¹ A high level of corporate indebtedness could be attributed to various factors, including a combination of them, encompassing not only high corporate tax rates (which would provide significant deduction benefits for interest payments) but also relatively high levels of investment (which could relate to research, acquiring new equipment, or renewing existing equipment) and refinancing old debt. However, borrowing could also be undertaken to fund dividends or equity withdrawal or to cover losses from operating activities. See Standards & Poor's, *What's Behind the Rise of French Corporate Debt?* (Mar. 2019).

⁸² International Monetary Fund, *A Capital Market Union for Europe*, IMF Staff Discussion Notes (2019).

The debt-to-surplus ratio measures NFCs' ability to cover repayments of all debt obligations, including principal and interest, with operational profits. It is calculated by dividing their total outstanding debt by their gross operating surplus which represents the value added generated by production activities after deducting employees' compensation.⁸³ According to the OECD, the debt outstanding relative to the annual flow of gross operating surplus was lower in 2021 for French companies than for their Japanese counterparts (a debt-to-surplus ratio of 7.0 versus 7.4, respectively). This suggests that debt might be relatively more sustainable in France than in Japan despite the former having a higher level of corporate debt to GDP than the latter (140% versus 110%, respectively). In the same year, the debt-to-surplus ratio also appeared more favourable for German, Italian, and Spanish NFCs compared to their Japanese counterparts.⁸⁴

Similar conclusions could be drawn by employing the interest coverage ratio to determine NFCs' potential inability to service their debt in the future. In detail, this metric evaluates the suitability to pay interest expenses on corporate debt (excluding the repayment of principal) and is calculated by dividing a firm's EBITDA by annual interest expenses on its debt.⁸⁵ The level of corporate default risk in Europe has remained constant over the past two decades based on OECD data with its share of companies with a low capacity to service interest payments (that is, with a low interest coverage ratio) being 22% in both 2005 and 2022. This is compared to the deterioration seen in China with an increase from 19% to 23% and in the Asia region (excluding China and Japan) from 20% to 26% while the United States experienced a slight improvement from 10% to 9%.⁸⁶

Gross leverage relates financial obligations to the assets available to satisfy them and can also differ considerably from the corporate debt-to-GDP ratio. According to a 2023 Report from the Advisory Scientific Committee of the European Systemic Risk Board (ESRB Report), corporate debt accounted for just below 35% of the total corporate assets of NFCs in France at the end of 2021,⁸⁷

notwithstanding corporate debt as a share of GDP exceeding 140% during the same period. Meanwhile, the ratio of corporate debt to total corporate assets in the European Union averaged between 30% and 35% which was well below the average gross leverage of around 70% for Australia, Canada, and Norway and even slightly below that of the United States which was between 35% and 40%.⁸⁸

Overall, these credit quality metrics reveal structural trends in the dimension of non-financial corporate leverage in Europe that do not appear significantly more severe than those in corporate America. Consequently, the urgency to complicate the European tax system by introducing a second ILR, such as the Debra ILR, in addition to the one under Article 4 of ATAD might not be as pressing as previously thought, particularly in a comparative context.

Conversely, what appears to drive Europe apart from the United States is the *qualitative* allocation of credit in terms of external financing – that is, without recourse to firms' internal retained earnings. For instance, the cost of external listed equity financing in Europe was approximately 8% between 2014 and 2021 compared to a lower range of 5–7% in the United States. This indicates that raising external equity on public markets was consistently less expensive there than in Europe.⁸⁹ In this context, introducing an EU-wide allowance on equity, such as the ACE proposed under DEBRA, might help reduce costs and level the playing field for European firms relative to their peers across the Atlantic.

Yet, the DEBRA ACE is a tax solution to a non-tax problem. The persistently high cost of listed equity funding in Europe is less about the lack of tax incentives and more about 'higher risk aversion and relatively lower expected earnings on future investments' compared to the United States.⁹⁰ More generally, in the open competition for global equity centres, the size of EU capital markets has shrunk relative to that of the United States from 2000–2023. As EU public markets have become smaller in terms of trading volume relative to market capitalization, they have also likely become less liquid.⁹¹

Notes

⁸³ Total outstanding debt is calculated as the sum the following liability categories: currency and deposits, debt securities, loans, insurance, pensions and standardized guarantee schemes, and other accounts payable.

⁸⁴ OECD Data, *Non-financial Corporations Debt to Surplus Ratio*, <https://data.oecd.org/corporate/non-financial-corporations-debt-to-surplus-ratio.htm#indicator-chart> (accessed 30 May 2024).

⁸⁵ OECD, *Global Debt Report 2024: Bond Markets in a High-Debt Environment* (OECD Publishing, Paris 2024).

⁸⁶ The higher the interest coverage ratio, the better a company can withstand financial shocks and service its debt. Companies with an interest coverage ratio below two are generally considered 'at risk' due to their low capacity to service interest payments. A ratio below one indicates that a firm's EBITDA is not sufficient to cover interest payments: if a default does not occur, it implies that the firm is either borrowing more to cover interest repayments on old debt or selling assets to repay its debt.

⁸⁷ ESRB Report, *Corporate Credit and Leverage in the EU: Recent Evolution, Main Drivers and Financial Stability Implications*, No 14 (Jun. 2023).

⁸⁸ The same 2023 ESRB Report also notes that replacing gross leverage with net leverage (by subtracting cash holdings from gross debt, assuming cash could repay debt without major disruptions to non-financial firms' operations) would show most Member States with downward trends in corporate net leverage (e.g., Austria, Germany, and the Netherlands) or mild declines within cyclical fluctuations around a stable level (e.g., France and Sweden) in the decade following the 2007–2009 financial crisis with only a few countries in Europe being prominent exceptions (e.g., Denmark, Luxembourg, and Slovakia).

⁸⁹ Truchet & Krief, *supra* n. 80, at 54.

⁹⁰ D. Kapp & K. Kristiansen, *Euro Area Equity Risk Premia And Monetary Policy: A Longer-Term Perspective*, Working Paper Series 2535, European Central Bank (Apr. 2021).

⁹¹ AFME, *Capital Markets Union, Key Performance Indicators (Sixth Edition) – European Capital Markets: Scaling Up Capital Markets 1–76* [2023].

By definition, raising risk capital funding in less liquid markets is likely to be more expensive on average than doing so in more liquid markets.

Even more significant is the limited diversification of financing sources for European firms as bank loans make up the majority of their debt liabilities whereas the US model with its mixture of banks and debt markets providing corporate funding enables American corporations to access a broader range of borrowing opportunities.

Despite the potential of corporate bond markets to diversify financial risks by providing an alternative to bank lending and the fact that the share of bond financing for euro area NFCs increased from less than 9% in 2000 to more than 12% by the end of 2019, this is still well below the 23% share in the United Kingdom and far behind the over 50% share in the United States.⁹² Such a bank-heavy reliance for corporate funding in Europe that results in a lack of diversification is even more serious when considering two factors. First, two-thirds of the already limited bond financing market for corporate Europe is dominated by financial companies compared to just 36% in the United States.⁹³ Second, bank lending to riskier and smaller firms with limited access to different sources of credit may be crowded out if banks tighten lending standards (e.g., in response to stricter regulatory requirements or financial turmoil) or when larger, better-rated firms replace bond issuance with bank loans given the limited availability of bank lending.⁹⁴

In this context, it is worth noting that Article 4 of ATAD does not distinguish between financial markets financing (e.g., bond finance) and bank lending. As an interest-to-earnings-based ('earnings-stripping') rule, the ATAD ILR does restrict tax deductibility of interest to 30% of a firm's EBITDA. However, linking tax relief for interest with EBITDA levels is likely inappropriate. This

is because the amount of paid interest derives from financial structure choices whereas a company's EBITDA is influenced by business strategy decisions and making these two parameters not highly correlated.

Thus, DEBRA's primary deficiency is in its approach: instead of focusing on improving the ATAD ILR, it aims to introduce an additional, complex interest limitation (the DEBRA ILR) on top of it. This is aside from the debate on whether thin capitalization rules should be constructed as a safe haven debt-to-equity ratio or as an earnings-stripping rule considering that a fixed debt-to-equity ratio is less sensitive to cyclical fluctuations while a fixed interest-to-earnings ratio can be more effective at counteracting intracompany interest rate manipulation.⁹⁵ Strict thin capitalization rules have also generally proved effective in reducing corporate leverage,⁹⁶ though it has been suggested that they might adversely reduce investment⁹⁷ and inadvertently reinforce tax competition,⁹⁸ for example, through a race to the bottom on statutory tax rates.⁹⁹

Conversely, DEBRA should fine-tune interest deductibility based on the type of debt and promote market sources of financing (e.g., corporate bond markets) to reduce overreliance on bank lending. This would encourage European companies to diversify their portfolio choice of borrowing sources and bring it more in accordance with the models observed in the United Kingdom and the United States.

Companies that can access public bond markets demonstrate resilience and growth potential,¹⁰⁰ and similar behaviours should not be tax penalized. DEBRA could support such firms by allowing the deduction of interest expenses on listed corporate bonds up to a certain debt-equity ratio. This approach would align tax relief for bond finance with the reality that financial distress is more

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⁹² OECD, *The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis*, Corporate Governance (2021), OECD Publishing, Paris. Overall, European firms rely much less on market sources of financing, with the IMF estimating that at the end of 2022, around 26% of their funding came from tradable equity and debt, compared to 68% for US firms; see IMF, *Background Note on CMU for Eurogroup*, Washington D.C. (15 Jun. 2023).

⁹³ OECD, *supra* n. 85, at 71.

⁹⁴ M. Giuzio & F. Lenoci, *Corporate Loans Versus Market-Based Finance: Substitutes or Complements*, in ECB *Financial Stability Review* (May 2023).

⁹⁵ International Monetary Fund, *Report on Tax Policy, Leverage and Macroeconomic Stability*, Washington D.C. (Oct. 2016).

⁹⁶ M. Overesch & G. Wamser, *Corporate Tax Planning and Thin-Capitalization Rules: Evidence from a Quasi-Experiment*, 42(5) *Applied Econ.* 563 (2010). On thin-capitalization rules limiting internal (i.e., intra-group) borrowing, see T. Buettner, M. Overesch, U. Schreiber & G. Wamser, *The Impact of Thin-Capitalization Rules on the Capital Structure of Multinational Firms*, 96 *J. Pub. Econ.* 930 (2012), doi: 10.1016/j.jpubeco.2012.06.008.

⁹⁷ T. Buettner, M. Overesch, U. Schreiber & G. Wamser, *The Impact of Thin-Capitalization Rules on Multinationals' Financing and Investment Decisions*, Discussion Paper Series 1: Economic Studies No 03/2008, Deutsche Bundesbank, Germany.

⁹⁸ M. Keen, *Preferential Regimes Can Make Tax Competition Less Harmful*, 54(4) *National Tax J.* 757 (2001), doi: 10.17310/ntj.2001.4.04.

⁹⁹ A. Haufler & M. Runkel, *Firms' Financial Choices and Thin Capitalization Rules under Corporate Tax Competition*, 56 *Eur. Econ. Rev.* 1087 (2012), doi: 10.1016/j.eurocorev.2012.03.005.

¹⁰⁰ An influential corporate finance theory on firms' choice of priority for their debt posits that new companies often begin building their reputation by incurring expensive bank-monitored debt. Once they establish a good credit record, they switch to issuing directly placed debt, such as traded bonds, to save on monitoring costs. This early bank monitoring would help to predict the future actions of corporate borrowers when they are no longer monitored. See D. W. Diamond, *Monitoring and Reputation: The Choice Between Bank Loans and Directly Placed*, 99(4) *J. Pol. Econ.* 689 (1991), doi: 10.1086/261775. Bank financing has some advantages: one among them is that bank debt is more easily renegotiable than bond payments because banks are readily accessible creditors while bondholders are often dispersed and difficult to engage in negotiations due to free-rider problems. However, bank debt also has downsides, e.g., in a short-term bank contract, a well-informed bank might demand repayment from the corporate borrower even when continuing a project would yield a positive net present value. If the bank forces the venture to share some of the project's surplus to secure continued lending, which would be possible in the absence of other borrowing sources, the borrower might not exert optimal effort thereby reducing the project's returns. See G. R. Rajan, *Insiders and Outsiders: The Choice between Informed and Arm's-Length Debt*, XLVII(4), *The J. Fin.* 1367 (1992), doi: 10.2307/2328944.

closely related to high levels of debt than to interest-to-earnings ratios. However, it would create a concurrent double-track system for which interest on bank lending would remain subject to earnings-stripping rules.

A simpler approach would be for DEBRA to set a higher maximum EBITDA threshold (e.g., 50% of a firm's EBITDA) for interest paid on listed debt securities while maintaining the standard 30% EBITDA threshold for interest from bank loan financing.

Of course, this would be a tax-counter proposal to the DEBRA ILR envisaged by the EU Commission, but it could be for the good of the European capital markets and contribute to their growth.

6 TAXATION: A STRATEGIC APPROACH BEYOND A WHAC-A-MOLE GAME

It can certainly be agreed that robust equity capitalization may enhance business competitiveness. Increased equity capital not only ensures essential liquidity for a company's immediate survival during uncertain times but can also promote the stability needed to plan for growth or potential turnarounds. Additionally, robust balance sheets enhance creditworthiness resulting in improved credit ratings that can help companies secure financing on more favourable market terms thereby ultimately reducing their cost of capital.

However, a crucial lesson learned from this article is that embracing a one-size-fits-all approach, like the one proposed under DEBRA, might not always be entirely practical or efficient. Companies vary in size, operate across diverse sectors and supply chains, and are at different stages of development (which also dictates whether they operate internationally or domestically); as a result, policies and incentives should be flexible enough to align with their specific needs.

Hence, the core issue is not simply about 'adjusting' taxation to address one bias while inadvertently creating another bias or solving one problem only to encounter another (e.g., making equity more appealing by tilting the treatment of debt). Stated differently, tax policy should not be used to plug one hole in the system (e.g., a tax loophole) only to discover that another hole has been opened akin to playing a Whac-A-Mole game. Instead, the focus should be on selectively identifying which business behaviours deserve rewards and tax incentives and which do not. If the ultimate purpose is to promote growth and strengthen businesses, corporate taxation should incentivize firms to expand and create job opportunities.

In this context, two pivotal goals of tax policy stand out. The first goal is to incentivize firms to increase equity capital to mitigate financial risks while also diversifying their funding sources to bolster economic resilience against economic downturns or cyclical fluctuations and afford opportunities for business growth. Taxation in this regard should target companies directly to support them.

DEBRA attempts to address some of these issues but does so only partially: the DEBRA ACE incentive could serve as a promising commencement. However, it remains uncertain whether its benefits could truly reach those who may need them the most such as start-ups, scale-ups, and young ventures. At the same time, the DEBRA ILR could potentially increase financing costs even for European firms with solid financial fundamentals and low debt-to-EBITDA ratios as they generally have few options other than to channel their financing needs through the banking system.

The second goal is to nurture a structural approach to attract investors by making equity capital as appealing as alternative investment avenues. However, DEBRA seems to overlook this aspect to the extent that it fails to consider that foreign investors, for example, those based in the United States, might find themselves to be tax disincentivized to make corporate investments in European firms and not vice versa.

To conclude, tax policy can be a powerful tool for incentivizing and promoting virtuous business behaviours. The absence of a coherent framework for capitalizing businesses, investing in equity, and facilitating access to capital markets represents a barrier – or, more accurately, a lack of incentive – to pursue similar virtuous paths. Taxation can therefore be a crucial factor for fostering business growth and enabling firms to access capital markets. Unfortunately, DEBRA has not yet reached this point.

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Interest Payments in Case of Amounts Levied in Breach of Union Law: An Analysis Based on Three Recent CJEU Judgments in the Field of VAT

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*The Court of Justice of the European Union (CJEU) has ruled that amounts levied in breach of Union law must be repaid, and those affected must be compensated for any losses incurred, including interest. However, it was not clear whether ‘amounts levied in breach of Union law’ only covers situations where amounts are levied due to a position taken by the tax administration that is later determined to be false, or if it also covers situations where the taxable person misinterprets the law or makes errors. Recent cases such as *Gemeente Dinkelland*, *HUMDA*, and *Schütte* have shown limitations regarding the payment of interest to taxable persons in the field of VAT. This raises questions about the extent to which a taxable person is entitled to interest payments and from which date. This article addresses these issues. This is done by discussing and analysing both the established CJEU case law dealing with amounts levied in breach of Union law and the recent CJEU case law on interest payments in the field of VAT.*

Keywords: VAT, interest, taxes levied in breach of Union law, error, unduly charged VAT, unjust enrichment, refund.

I INTRODUCTION

It is the Court of Justice of the European Union's (CJEU's) settled case law that amounts levied in breach of Union law must be reimbursed with the affected person receiving appropriate compensation for any losses incurred as a result of the undue payment including those for interest. The court ruled in the *Irimie* case¹ that a system that grants interest payments only for the day following the request for the repayment of a wrongly levied tax does not constitute an appropriate compensation for losses. This is because the loss incurred by the taxpayer occurs between the date of the undue payment of the tax and the date of the tax repayment. Interest should therefore be paid as of the day the tax was paid.² The *Irimie* case, however, does not define how ‘amounts levied in breach of Union law’ must be explained. Does this only cover situations when amounts are levied because of a position taken by the tax administration that is later determined to be false or does it also cover the situation when the taxable person has an

incorrect interpretation of the law or makes errors? In the recent *Gemeente Dinkelland* case,³ the CJEU addressed whether errors of the taxable person himself could constitute a situation for which amounts are levied in breach of Union law. Other recent VAT cases such as *HUMDA*⁴ and *Schütte*⁵ also show limitations regarding the payment of interest. These cases incite the question to what extent a taxable person in the field of VAT is entitled to interest payments and from which date he is entitled to receive those interest payments; this will be the research question addressed in this article. The procedure for interest payments under Directive 2008/9/EC⁶ will not be discussed as it contains specific provisions on the payment of interest in case of refund of foreign VAT to taxable persons not established in the EU Member State of refund, and this is a different situation. The research question also does not address the payment of interest by the taxable person to the tax administration in the event of late payments of VAT.⁷ To answer the research question, the author will first address the established CJEU case law dealing with amounts levied in

Notes

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¹ CJEU 18 Apr. 2013, C-565/11, ECLI:EU:C:2013:250.

² See also J. A. R. van Eijdsen, *De nieuwe renteregeling is in strijd met het EU-recht* (The new rules for interest payments infringes EU law), WFR 2013/302, para. 2.

³ CJEU 22 Feb. 2024, C-674/22, ECLI:EU:C:2024:147.

⁴ CJEU 13 Oct. 2022, C-397/21, ECLI:EU:C:2022:790.

⁵ CJEU 7 Sep. 2023, C-453/22, ECLI:EU:C:2023:639.

⁶ Council Directive 2008/9/EC of 12 Feb. 2008 laying down detailed rules for the refund of value added tax, provided for in Directive 2006/112/EC, to taxable persons not established in the Member State of refund but established in another Member State, OJ L 44, 20 Feb. 2008, at 23–28.

⁷ Both topics are addressed by: Ilse De Troyer, *Interest on VAT Claims*, 2 EC Tax Rev. 83–95 (2018). Stefanie Gombotz & Christina Pollak, *Is There an Obligation under EU Law to Pay Interest on VAT Credits?* 25 and 26 (International VAT Monitor Jan./Feb. 2021), address the interest payments under Directive 2008/9/EC.

breach of Union law in section 2. As a second step, the recent CJEU case law on interest payments in the field of VAT will be discussed in section 3. In this section, these cases will be critically analysed drawing on earlier case law in the field of VAT and the CJEU case law discussed in section 2. Section 4 will summarize the exceptions and limitations to interest payments for amounts levied in breach of Union law and answers this article's research question. Section 5 provides a number of final remarks.

2 ESTABLISHED CJEU CASE LAW ON AMOUNTS LEVIED IN BREACH OF EU LAW

2.1 Introduction

The entitlement to the repayment of charges levied by a Member State in breach of Union law is a consequence of and an adjunct to the rights conferred on individuals by Union provisions.⁸ The right to the recovery of sums unduly paid helps to offset the consequences of a duty's incompatibility with EU law by neutralizing the economic burden that it has unduly imposed on the operator who has actually borne it.⁹ Imposing a duty in breach of Union law hinders the internal market. It is possible that the actual imposition is not an infraction but the fact that it is levied prematurely is. When a tax is thus levied prematurely, it is a duty in breach of Union law.¹⁰ A taxpayer is therefore entitled to interest payments.¹¹ In fact, in that situation, it constitutes the 'reimbursement' of what was improperly paid in a too early stage.¹² A taxpayer is also entitled to a refund of any financial penalty imposed as a result of the breach of Union law including an interest payment.¹³

2.2 Procedural Law Up to Member States

In the absence of EU legislation, each Member State must stipulate the conditions for repayment and interest

payments of charges levied in breach of EU law, in particular the rate of the interest and the method of calculation (simple or compound interest) as well as, if applicable, exchange rates.¹⁴ The rules must comply with the principle of equivalence and effectiveness, meaning that they must not be less favourable than those applying to similar claims under national law or be arranged in such a way as to make the exercise of the rights conferred by Union law practically impossible.¹⁵

The calculation of interest cannot lead to depriving the taxpayer of an adequate indemnity for the loss because of the undue payment of the charge.¹⁶ In the joined *Sole Mizo* and *Dalmandi* case,¹⁷ the CJEU ruled that, if interest is calculated at a rate (in this case, a rate equal to the central bank's base rate) that is lower than the rate that a taxable person who is not a credit institution would have to pay to borrow a sum that is equal to the amount of the tax levied in breach of Union law, this is not in accordance with the principle of effectiveness. Likewise, the CJEU ruled in the same case that, if interest runs for a given reporting period without the application of interest to compensate the taxable person for the monetary erosion caused by the passage of time following that reporting period up until the actual payment of that interest, this could deprive the taxable person of adequate compensation and also breaches the principle of effectiveness.¹⁸ Inflation should therefore be taken into account.¹⁹ In the *Nidera* case,²⁰ the CJEU ruled that a long duration of the repayment that results in a significant amount of interest in comparison to the tax paid cannot be a reason to reduce the interest payment because this would not provide the taxable person with adequate compensation.²¹ According to the CJEU, a flat rate can be applied because this is a rule that can be easily managed and supervised. If the interest exceeds the actual losses, this is merely a result of the flat rate. In specific cases, it can be greater or less than the actual

Notes

⁸ CJEU 9 Nov. 1983, 199/82 (*San Giorgio*), ECLI:EU:C:1983:318, para. 12 and CJEU 6 Sep. 2011, C-398/09 (*Lady & Kid*), ECLI:EU:C:2011:540, para. 17. The entitlement to repayment of these amounts and the payment of interest is not derived from a specific single provision of EU law. See Stefanie Gombotz & Pollak, *supra* n. 7, at 22.

⁹ CJEU 20 Oct. 2011, C-94/10 (*Danfoss and Sauer-Danfoss*), ECLI:EU:C:2011:674, para. 23.

¹⁰ CJEU 8 Mar. 2001, C-397/98 and C-410/98 (*Metallgesellschaft and Hoechst*), ECLI:EU:C:2001:134, para. 87.

¹¹ CJEU 19 Jul. 2012, C-591/10 (*Littlewoods*), ECLI:EU:C:2012:478, para. 25.

¹² CJEU *Metallgesellschaft and Hoechst*, *supra* n. 10, para. 87.

¹³ CJEU 28 Apr. 2022, C-415/20, C-419/20 and C-427/20 (*Gräfendorfer*), ECLI:EU:C:2022:306.

¹⁴ CJEU 27 Sep. 2012, C-113/10, C-147/10 and C-234/10 (*Zuckerfabrik Jülich AG, British Sugar plc and Tereos*), ECLI:EU:C:2012:591, para. 62.

¹⁵ CJEU *Littlewoods*, *supra* n. 11, para. 27.

¹⁶ *Ibid.*, para. 29.

¹⁷ CJEU 23 Apr. 2020, C-13/18 and C-126/18, ECLI:EU:C:2020:292.

¹⁸ *Ibid.*, para. 49.

¹⁹ CFE ECJ Task Force, *Right to Be Paid Interest on Overpayment of Taxes in Breach of EU Law – Opinion Statement ECJ-TF 3/2023 on the ECJ Decision of 8 June 2023 in Case C-322/22, E. V. Dyrektor Izby Administracji Skarbowej We Wrocławiu* 10 (4 Oct. 2023).

²⁰ CJEU 28 Feb. 2018, C-387/16, ECLI:EU:C:2018:121.

²¹ *Ibid.*, paras 27–29.

loss.²² This author agrees with De Troyer that it is important to have a simple calculation of the interest rate that should only be adapted once or, at a maximum, four times a year.²³

Member States can make the interest payment conditional on the submitting of a request for it.²⁴ They cannot make repayments dependent on whether someone has brought an action for repayment before the delivery of the judgment that has made it clear that a levy is in breach of Union law. This would be contrary to the principle of effectiveness.²⁵ Likewise, it cannot be a requirement that a charge was paid under protest.²⁶ Reasonable time limits for making a claim are allowed provided those do not make claims for repayment impossible or excessively difficult.²⁷ According to the CJEU, a timeframe of thirty days counted from the moment that the CJEU decision in a case that made it clear that a levy was in breach of EU law was published in the Official Journal of the European Union infringed the principle of effectiveness. The CJEU pointed out that the finding that the tax is contrary to Union law depends on the result of verifications of the national court that may well need a period of time that extends far beyond the expiration of the thirty-days time limit.²⁸ In the same case, the CJEU ruled that excluding interest on the overpayment entirely if it is incurred after the passing of the thirty-days time limit following the publication of the CJEU's ruling is also not allowed. It is not inconceivable that a tax may continue to be levied in breach of EU law after the delivery of the CJEU's ruling and its publication in the official journal, in particular in this case when the tax is withheld by a third party.²⁹ Member States cannot adopt rules that restrict the repayments to forestall the possible effects of a CJEU judgment.³⁰ Van Nunen questions whether the fact that no information is provided about

the option to claim interest payments for a refund decision in the Netherlands and that it must be made within six weeks infringes the principle of effectiveness.³¹ This author opines that it is likely that, generally speaking, there will be no infringement of this principle considering that 'everybody is expected to know the law', the six week period provides sufficient time to become aware of the right to payment of interest under national legislation and the applicable procedure, and a taxpayer that does not show sufficient due diligence can forfeit its rights.³² This could be different in specific circumstances, however, e.g., if the law is unclear about the procedure or it is unclear whether there is indeed an infringement of EU law.

2.3 Exception: Burden of Tax Has Been Shifted

The right to reclaim taxes levied in breach of Union law does not exist if the taxpayer has fully shifted the burden of the tax to another person. Reimbursing the taxable person would result in his unjustified enrichment. The CJEU has indicated that this is the sole exception to the right to reimbursement of tax levied in breach of European Union law³³ and should be interpreted restrictively.³⁴ When the burden has only been partially passed on, the amount not passed on must be repaid. A characteristic of the VAT system is that its purpose is for the tax to be borne by the recipient, i.e., the consumer, so that the tax can achieve its objective of taxing private consumption. However, this does not intrinsically imply that the tax has been fully shifted to the recipient in each situation, thus, a case-by-case analysis is required. To establish whether there is indeed an unjust enrichment,

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²² *Ibid.*, para. 36.

²³ de Troyer, *supra* n. 7, at 95. De Troyer pleads for two times a year at a maximum. This author posits that changing the rate each quarter is acceptable considering some Member States use the calendar quarter as a tax period, and it is also the tax period used under the One-Stop-Shop, Title XII Ch. 6 s.s 2 and 3.

²⁴ CJEU Sole Mizo and Dalmandi, *supra* n. 17, para. 66.

²⁵ CJEU 2 Feb. 1988, 309/85 (Barra), ECLI:EU:C:1988:42.

²⁶ CJEU 8 Feb. 1996, C-212/94 (FMC), ECLI:EU:C:1996:40, para. 72.

²⁷ CJEU 15 Sep. 1998, C-231/96 (Edis), ECLI:EU:C:1998:401, para. 20. See also CJEU 16 Dec. 1976, 33/76 (Rewe-Zentralfinanz eG and Rewe-Zentral AG v. Landwirtschaftskammer für das Saarland), ECLI:EU:C:1976:188, para. 5 and CJEU 16 Dec. 1976, 45/76 (Comet BV v. Produktschap voor Siergewassen), ECLI:EU:C:1976:191, paras 16–18.

²⁸ CJEU 8 Jun. 2023, C-322/22 (E. Dyrektor Izby Administracji Skarbowej we Wrocławiu), ECLI:EU:C:2023:460, para. 51.

²⁹ CJEU E. Dyrektor Izby Administracji Skarbowej we Wrocławiu, *supra* n. 28, paras 52 and 53. For more about this case see CFE ECJ Task Force, *supra* n. 19 and Hannelore Niesten & Piotr Prandecki, *Insights into Compensation and the Effectiveness of Withholding Tax Refunds and Interest Payments: ECJ Decision in E. Dyrektor Izby Administracji Skarbowej we Wrocławiu (Case C-322/22)* 442–446 (European Taxation Oct. 2023).

³⁰ CJEU 2 Oct. 2003, C-147/01 (Weber's Wine World), ECLI:EU:C:2003:533, para. 92. See also the answer to the preliminary question in the *Deville* case (CJEU 29 Jun. 1988, 240/87, ECLI:EU:C:1988:349): 'A national legislature may not, subsequent to a judgment of the Court from which it follows that certain legislation is incompatible with the Treaty, adopt a procedural rule which specifically reduces the possibilities of bringing proceedings for recovery of taxes which were wrongly levied under that legislation'.

³¹ Jolanda van Nunen, *Vergoeding van 'Irmie-rente' op verzoek? (Imbursement of 'Irmie-Interest' Upon Request)*, in *Bouwen en Druwen (Building and Pushing)* 200 (Maarten Feteris a.o. ed., Deventer: Wolters Kluwer 2017).

³² See e.g., CJEU 7 Jul. 2022, C-194/21 (Staatssecretaris van Financiën (Forclusion du droit à déduction)), ECLI:EU:C:2022:535.

³³ CJEU Lady & Kid, *supra* n. 8, paras 19 and 20.

³⁴ CJEU Weber's Wine World, *supra* n. 30, para. 95.

it cannot simply be established that the tax has been passed on to the recipient of a transaction. By increasing the price of the goods, a taxable person may have suffered damages,³⁵ for example, a decrease in the volume of sales.³⁶

An economic analysis in which all of the relevant circumstances are taken into account must be made.³⁷ The burden of proof of whether the tax has been passed on lies with the tax administration. The CJEU ruled that the principle of effectiveness does not allow ‘presumptions or rules of evidence intended to place upon the taxpayer the burden of establishing that the charges unduly paid have not been passed on to other persons’.³⁸ In the *Mikhailidis* case, it ruled that it is also contrary to Union law if the person obligated to pay the charge needs to show that there has been an increase in the price of the products or a reduction in the volume of exports.³⁹ It becomes clear from the same case that, when assessing whether the amount has been passed on, both documentation provided by the competent authorities and evidence submitted by the trader concerned must be taken into account. It is for the court to subsequently evaluate that evidence.⁴⁰ The CJEU has also pointed out in the *Weber’s Wine World* case that proof does not have to be provided without the cooperation of the taxable person concerned. Member States may demand access to the supporting documents that the taxable person was required to keep under national law.⁴¹

In the *Alakor* case,⁴² the CJEU had to answer the question of whether the repayment of the tax levied in breach of Union law could be partially denied because part of the tax had been subsidized by aid granted to the taxable person and financed by the EU and by that state. The CJEU ruled that it is for the referring court to examine whether the amount of aid provided would be less had the taxable person been able to exercise its right

to deduct VAT. If that is the case, the repayment should only cover the difference between the amount of non-deductible VAT under the national legislation incompatible with Union law and the amount of the aid granted that exceeds that which would have been granted had Alakor not been prevented from exercising its right to deduct.⁴³ Whether the aid has been provided by the EU budget or by a certain Member State is of no relevance.⁴⁴ However, the CJEU ruled in the *Lady & Kid* case that a Member State may not reject an application for the reimbursement of an unlawful tax on the ground that the amount of the tax has been set off by the abolition of a lawful levy of an equivalent amount.⁴⁵

If the amount levied in breach of Union law has been passed on to the customer, he will have the right to receive a refund of the amount unjustly paid either directly from the Member State in question or from the supplier. In the latter case, the supplier must be able to request the Member State in question for compensation of the repayment it had to make.⁴⁶ Whether the customer can get a repayment from it or the supplier depends on whether reimbursement proved impossible or excessively difficult to obtain from the latter entity.⁴⁷ This could be particularly the case in the situation of the supplier’s insolvency.⁴⁸

3 RECENT VAT CJEU CASE LAW ON INTEREST PAYMENTS

3.1 Introduction

Recent CJEU case law dealing with interest payments for charges levied in breach of EU law in the area of VAT deals with two topics that will be addressed separately below: unduly charged VAT and interest payments in the event of errors.

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³⁵ CJEU 14 Jan. 1997, Joined Cases C-192/95 to C-218/95 (*Comateb* e.a.), ECLI:EU:C:1997:12.

³⁶ CJEU *Weber’s Wine World*, *supra* n. 30, para. 99.

³⁷ *Ibid.*, para. 100.

³⁸ CJEU 9 Nov. 1983, 199/81 (*San Giorgio*), ECLI:EU:C:1983:318, para. 14. See also CJEU 21 Sep. 2000, C-441/98 and C-442/98 (*Kapniki Mikhailidis AE and Idrima Kinonikon Asphaliseen*), ECLI:EU:C:2000:479, para. 37 and CJEU 25 Feb. 1988, 31/85, 376/85 en 378/85 (*Bianco and Girard*), ECLI:EU:C:1988:97, paras 18–21.

³⁹ CJEU *Kapniki Mikhailidis*, *supra* n. 38, para. 38.

⁴⁰ *Ibid.*, paras 40 and 41.

⁴¹ CJEU *Weber’s Wine World*, *supra* n. 30, para. 115.i.

⁴² CJEU 16 May 2013, C-191/12, ECLI:EU:C:2013:315.

⁴³ CJEU 16 May 2013, C-191/12 (*Alakor*), ECLI:EU:C:2013:315, paras 32 and 33.

⁴⁴ *Ibid.*, para. 34.

⁴⁵ CJEU *Lady & Kid*, *supra* n. 8.

⁴⁶ CJEU *Danfoss and Sauer-Danfoss*, *supra* n. 9, para. 28.

⁴⁷ CJEU 11 Apr. 2024, C-316/22 (*Gabel Industria Tessile SpA and Canves SpA v. A2A Energia SpA, Engerit SpA and Agenzia delle Dogane e dei Monopoli*), ECLI:EU:C:2024:301.

⁴⁸ CJEU *Danfoss and Sauer-Danfoss*, *supra* n. 9, para. 38.

3.2 Unduly Charged VAT

3.2.1 No Tax Levied in Breach of EU Law for Unduly Charged VAT: The HUMDA Case

In the *HUMDA* case,⁴⁹ the CJEU had to answer preliminary questions in a situation in which services were provided to a Hungarian company related to a building project in Milan for the world exhibition. Hungarian VAT was charged, but this was incorrect because the services were subject to VAT in Italy under the place of supply rule for services related to immovable property. HUMDA, as the recipient of the services, filed a refund request with the Hungarian tax administration in which it requested a refund of the Hungarian VAT unduly charged and a payment of interest. The service provider BHA was in liquidation, and the liquidator declared that it was impossible to amend the invoice already drawn up by BHA. The VAT was paid to the treasury by BHA which had not requested a refund of the VAT improperly paid. There was no fraud involved.

Referring to earlier case law,⁵⁰ the CJEU makes it clear that, if the refund of VAT becomes impossible or excessively difficult, the principles of neutrality and effectiveness require the Member State in question to provide the recipient with instruments to recover the VAT that has been unduly invoiced, in particular a direct reimbursement from the tax authorities. The supplier's insolvency is mentioned as a situation for which it was impossible or excessively difficult to obtain a refund from the supplier.⁵¹ Regarding the payment of interest, the CJEU states that this case does not deal with a refund of VAT paid in breach of EU law but with VAT that is due pursuant to Article 203 VAT Directive.⁵² Based on this provision, VAT is payable by any person who enters it on an invoice. Member States are under an obligation to provide an adjustment or refund of VAT invoiced and paid in error. Such a refund claim can be compared to an excess of VAT as referred to in Article 183 VAT Directive.⁵³ The principle of neutrality requires that a financial loss incurred due to a refund of excess VAT that is not made within a reasonable period of time is compensated through the payment of default interest. Likewise, the CJEU concluded in the present case that interest must be paid in the situation when a request that is made for a refund of unduly paid

VAT by the recipient is not granted within a reasonable period of time. The rules for applying interest on the amount are within the procedural autonomy of the Member States. These rules should be in accordance with the principles of equivalence and effectiveness. They cannot result in the taxable person being deprived of adequate compensation for the loss caused by the late refund of that amount.⁵⁴

3.2.2 Refund of Unduly Charged VAT for Recipient of Goods With Interest Payment: The Schütte Case

The *Schütte* case⁵⁵ deals with a German entrepreneur purchasing wood and selling it as firewood. Its suppliers charge VAT against the general VAT rate of 19% whereas Schütte himself applies the reduced VAT rate of 7%. The suppliers have paid the VAT to the tax administration. Schütte has deducted the VAT on the invoices in full and has paid 7% VAT on its supplies. The German tax administration took the position that Schütte's supplies are subject to the general VAT rate. In legal proceedings it became clear that the reduced VAT rate indeed applies (judgment of 2 July 2019). However, the court also ruled that the supplies that Schütte received are subject to the reduced rate, and the VAT deduction should be adjusted accordingly. Following the judgment, the German tax administration issued VAT assessments for the VAT unrightfully deducted including interest. Schütte made a request to his suppliers to obtain a repayment of the VAT unduly charged, however, they referred to the statute of limitation. Schütte subsequently requested the German tax administration to annul the VAT assessment and interest. This was denied because, according to the German tax administration, the situation was caused by Schütte himself. It should be noted that there was no fraud involved nor was there a situation of the supplier's (upcoming) insolvency.

Like in the *HUMDA* case, the CJEU ruled that, under the circumstances, a supplier can obtain a refund of VAT unduly paid directly from the tax administration.⁵⁶ This is also possible in a situation like the one of Schütte in which the suppliers refer to a statute of limitation while not being insolvent.⁵⁷ This even applies if there is a risk of

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⁴⁹ CJEU 13 Oct. 2022, C-397/21, ECLI:EU:C:2022:790.

⁵⁰ In particular CJEU 5 Mar. 2007, C-35/05 (Reemtsma Cigarettenfabriken), ECLI:EU:C:2007:167 and CJEU 11 Apr. 2019, C-691/17 (PORR Építési Kft.), EU:C:2019:327.

⁵¹ CJEU 13 Oct. 2022, C-397/21 (HUMDA), ECLI:EU:C:2022:790, paras 22 and 23.

⁵² *Ibid.*, paras 34 and 35.

⁵³ *Ibid.*, para. 36.

⁵⁴ *Ibid.*, para. 40.

⁵⁵ CJEU 7 Sep. 2023, C-453/22, ECLI:EU:C:2023:639.

⁵⁶ *Ibid.*, para. 23.

⁵⁷ *Ibid.*, paras 27 and 29.

a double refund. If the suppliers were to ask for a refund of the VAT unduly charged in this situation, this would amount to an abusive practice. Concerning the payment of interest, the CJEU points out that the implementation of the judgment of the referring court of 2 July 2019 that reduced the input tax from 19% to 7% would be capable of resulting in an economic burden for Schütte.⁵⁸ If he already paid the tax authorities the amount corresponding to the reduction of the initial deduction, he would suffer financial damage because that amount is not available to him. In that situation when the improperly collected VAT is not reimbursed within a reasonable time, that financial damage must be compensated by the payment of default interest.⁵⁹

3.2.3 Analysis of the HUMDA and Schütte Cases

With its judgment in the HUMDA case, the CJEU builds on its earlier case law dealing with VAT refund claims under Article 183 VAT Directive (the refund of excess VAT)⁶⁰ and Article 90 (1) VAT Directive (reduction of taxable amount in case of (partial) non-payment).⁶¹ It becomes clear from earlier cases that default interest does not need to be paid for the period prior to the submission of the request.⁶² A national practice pursuant to which the payment of interest of a claim made in a request from the taxable person with effect from the end of a time limit of thirty or forty-five days imposed on the tax authority for dealing with a request is not contrary to the principle of effectiveness.⁶³

It makes sense that, for VAT that is payable under Article 203 VAT Directive, interest payments must be made only if the VAT is not refunded upon request within a reasonable period of time. As becomes clear from the *Schmeink* and *Strobel* cases, VAT that is due under Article 203 VAT Directive needs to be adjusted before it can be refunded to the taxpayer, and the Member States are required to stipulate the conditions in which improperly invoiced VAT may be adjusted.⁶⁴ It also seems reasonable that EU Member States have some time to process the request since they will need to establish, e.g., whether the issuer of the invoice was in good

faith or, if that is not the case, whether the risk of any loss in tax revenues has been sufficiently eliminated.⁶⁵

Both the *HUMDA* and *Schütte* cases deal with a situation in which it is not the supplier adjusting the unduly charged VAT but the recipient of the supply reclaiming that VAT. Under the CJEU's case law, the recipient will first have to request the supplier for a refund of the VAT. Only in the situation when that would turn out to be impossible or excessively difficult can he turn to the tax authorities to obtain a refund. It should be noted, however, that the recent *H GmbH* case⁶⁶ shows that, when VAT has been reimbursed to the supplier, the recipient should request a refund from him even if he is insolvent and it is thus excessively difficult or even impossible to obtain that amount. Allowing the recipient to make a direct request to the tax administration would mean that the tax administration would need to refund the VAT twice.⁶⁷ The CJEU case law does not question the order of priority of creditors in the context of liquidation proceedings.⁶⁸ Following the CJEU's case law, this author opines that this means that, for the recipient, his request to the tax administration is decisive for determining the moment at which a right to default interest exists (i.e., after a reasonable period after the moment the request was made has lapsed). The CJEU's reasoning in the *Schütte* case, however, may suggest that an earlier moment needs to be taken into account. The court refers to the fact that the judgment of 2 July 2019 resulted in an economic burden for Schütte and that he has suffered financial damage *once he paid the amount corresponding to the reduction of input tax deduction to the tax administration*. However, later in that judgment, the CJEU states that, when the improperly collected VAT is not reimbursed within a reasonable time, the financial damage must be compensated with the payment of default interest. As the *Schütte* case does not deal with the question at which moment a right to payment of default interest arises, the author posits that it cannot be derived from this case that the moment at which the taxable person is bearing the financial burden of improperly charged VAT is decisive for determining during which period the taxable person is entitled to the payment of default interest. How the

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⁵⁸ *Ibid.*, para. 35.

⁵⁹ *Ibid.*, para. 36.

⁶⁰ See also Tamás Fehér case law note CJEU 13 Oct. 2022, C-397/21 (HUMDA), Highlights & Insights 2023/16 and Pieter Tielemans & Patrick Vettenburg, *Hongarije moet onverschuldigd betaalde btw terugbetalen bij insolvable ondernemer* (Hungary must refund unduly paid VAT in case of insolvent entrepreneur) BrwBrief 2023/5.

⁶¹ CJEU 12 May 2021, C-844/19 (Technorent), ECLI:EU:C:2021:378, para. 41.

⁶² CJEU Sole Mizo and Dalmandi, *supra* n. 17, para. 73.

⁶³ *Ibid.*, para. 68.

⁶⁴ CJEU 19 Sep. 2000, C-454/98, ECLI:EU:C:2000:469, paras 48, 49 and 65.

⁶⁵ *Ibid.*, paras 56 and 58.

⁶⁶ CJEU 5 Sep. 2024, C-83/23, ECLI:EU:C:2024:699.

⁶⁷ *Ibid.*, para. 40.

⁶⁸ *Ibid.*, para. 40.

situation should be dealt with when the supplier has improperly charged the VAT due to a position taken by the tax administration is discussed in section 3.3.2 after examining the *Gemeente Dinkelland* case.

In earlier CJEU case law, the CJEU has also made it clear that the reason why the refund of excess VAT is delayed is, in principle, irrelevant. Whether the claim has simply been dealt with beyond the time limits that apply or the excess VAT has been set off against tax assessments that later turned out to be unlawful is not relevant.⁶⁹ The CJEU has ruled that the period within which a refund of excess VAT under Article 183 VAT Directive must take place can be extended to carry out a tax investigation if the extension does not exceed what is necessary for successfully completing the investigation.⁷⁰ The extension of the refund, however, cannot have the effect that interest is payable only from the date on which the investigation is completed.⁷¹ The situation is different if the delay in completing the investigation has been caused by the taxpayer himself. The CJEU indicates that it cannot be accepted that a taxable person that refuses to cooperate with tax authorities – and thus impeding the investigation procedure – may claim default interest for the delay caused by him.⁷² Now that the CJEU regards a VAT refund request within the meaning of Article 203 VAT Directive equivalent to a refund of excess VAT within the meaning of Article 183 VAT Directive regarding interest payments, this must also apply in the same way to the former.

3.3 Interest Payments in Case of Mistakes

3.3.1 No Interest Payments in Case of Mistakes and Calculation of Allocation Key under Own Responsibility: The *Gemeente Dinkelland* Case

The *Gemeente Dinkelland* case⁷³ addresses the situation in which a taxpayer has made corrections regarding deductible input VAT. As a municipality, *Gemeente Dinkelland* has economic and non-economic activities with the latter being either exempted or subject to

VAT. Adhering to amendments to the national legislation on municipal accounting and amendments of the classification of some of its activities, *Gemeente Dinkelland* had calculated a new percentage of deductible VAT that resulted in an increase of it. It also had its accounts examined which revealed some errors in the classification of certain services provided by it and in the entry of certain debit or credit line items. These errors also resulted in an additional deduction of VAT. In this situation, the question has been raised whether the Dutch tax administration is required to pay interest and, if so, as of which date.

Referring to its earlier case law on interest payments for taxes levied in breach of EU law (*see* section 2), the CJEU makes it clear that, when a tax levied in breach of EU law is repaid, this should include interest payments.⁷⁴ In this respect, the taxpayer's loss depends on the duration of the unavailability of the sum levied in breach of EU law and occurs, in principle, in the period between the date of the undue payment of the tax and the date of repayment.⁷⁵

The question that should be answered in the present case, however, is whether the situation can be qualified as a tax levied in breach of EU law.⁷⁶ In this respect, the CJEU first makes it clear that an amount of VAT levied because a person has not exercised his right to deduct constitutes an amount levied or collected.⁷⁷ Second, the CJEU refers to the *HUMDA* case to clarify that VAT levied pursuant to Article 203 VAT Directive is not levied in breach of EU law (*see* section 3.2.1).⁷⁸ The CJEU subsequently refers to Article 250 (1) VAT Directive. Under this provision, every taxable person must submit a VAT return setting out all of the information needed to calculate the tax that has become chargeable and the deductions to be made. The tax authority does not act in breach of EU law when it levies an amount of VAT due on the basis of that return even if the taxable person has not provided the information necessary to establish the extent of its right to deduct VAT (and has thus not exercised that right).⁷⁹ Regarding the recalculation of the deductible proportion for VAT on general costs, the CJEU points out that VAT can only be levied in breach of EU law if the initial rules for the calculation

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⁶⁹ CJEU 24 Oct. 2013, C-431/12 (*Rafinăria Steaua Română*), ECLI:EU:C:2013:686, para. 25.

⁷⁰ CJEU 12 May 2011, C-107/10 (*Enel Maritsa Iztok 3 AD*), ECLI:EU:C:2011:298, para. 53.

⁷¹ *Ibid.*, para. 61.

⁷² CJEU 6 Jul. 2017, C-254/16 (*Glencore Agriculture Hungary*), ECLI:EU:C:2017:522, para. 26.

⁷³ CJEU 22 Feb. 2024, C-674/22, ECLI:EU:C:2024:147.

⁷⁴ *Ibid.*, para. 31.

⁷⁵ *Ibid.*, para. 33.

⁷⁶ *Ibid.*, para. 34.

⁷⁷ *Ibid.*, para. 35.

⁷⁸ *Ibid.*, para. 36.

⁷⁹ *Ibid.*, para. 37.

are incompatible with EU law due to the applicable national legislation or a tax authority's requirement.⁸⁰ The court subsequently refers to the Dutch rules for calculating the deductible amount in the case of economic and non-economic activities that meet the required conditions.⁸¹ Although consultations took place between Gemeente Dinkelland and the tax authority in the interest of legal certainty, no agreement had been concluded between them. The tax authority merely accepted the methodology consisting of determining the actual use of the goods and services on the basis of that municipality's accounts. This methodology used reflects the actual use of the goods and services.⁸² The CJEU therefore concludes that the allocation key was calculated under the sole responsibility of that municipality.⁸³ Therefore, the recalculated amount of deductible VAT does not constitute an amount levied in breach of EU law.⁸⁴

However, even though the amount is not levied in breach of EU law, the VAT amount should be refunded within a reasonable period. The CJEU in this respect again refers to Article 183 VAT Directive.⁸⁵ The period of eight weeks after which an interest payment is required in the Netherlands is according to the CJEU to be regarded as a reasonable period for the tax authority to deal with an application for a VAT refund, including the actual refund transaction.⁸⁶

3.3.2 Analysis of the Gemeente Dinkelland Case

With its judgment in the *Gemeente Dinkelland* case, the CJEU makes it clear that, when the amount of VAT that needs to be paid is calculated under the sole responsibility of the taxable person, the right to default interest payment exists only when a request for a VAT refund has not been addressed within a reasonable period. This situation has not yet been considered in the CJEU case law as most

of it deals with situations when national legislation is in breach of a treaty,⁸⁷ a directive, or regulation⁸⁸ or because a regulation of the Commission was declared invalid.⁸⁹ Earlier case law, however, shows that default interest payments must also be made in certain circumstances if the national legislation is not in breach of EU legislation but instead there is an incorrect application or interpretation of the national legislation (and consequently the EU legislation) by the tax administration. The *Marks & Spencer* case⁹⁰ shows that, in the event of an erroneous qualification of a product under the general instead of zero rate by the tax administration, VAT has been levied in breach of EU law, and the taxable person is entitled to interest payments. Likewise, the *Gräfendorfer* case⁹¹ makes it clear that the right to a repayment of the tax and the payment of default interest does not only apply if an EU act proves to be unlawful. Taxes are also levied in breach of EU law if the national authority has misapplied (in light of EU law) an EU act or national legislation implementing or transposing such an act when it imposes a tax on a person,⁹² e.g., an incorrect application of EU law based on misinterpretation, an error of law, or an incorrect assessment of the facts.⁹³

It can be concluded based on the analysis that, in a situation when the tax is self-assessed, the national legislation does not show any incorrect implementation of the VAT Directive and there has been no requirement from the tax authorities to pay a certain amount of tax, the tax is not levied in breach of EU law.⁹⁴ Instead, it is levied because the taxpayer failed to apply the tax in a correct manner. This is in accordance with earlier case law, in particular, that dealing with the statute of limitations where it is also clarified that a taxpayer that has not been sufficiently diligent in exercising his right can forfeit his right to deduct VAT.⁹⁵ If all of the situations for which the taxable person has failed to exercise a right to

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⁸⁰ *Ibid.*, para. 39.

⁸¹ *Ibid.*, para. 52.

⁸² *Ibid.*, para. 54.

⁸³ *Ibid.*, para. 56.

⁸⁴ *Ibid.*, para. 57.

⁸⁵ *Ibid.*, paras 58 and 59.

⁸⁶ *Ibid.*, para. 60.

⁸⁷ See e.g., CJEU 27 Mar. 1980, 61/79 (*Denkavit Italiana*), ECLI:EU:C:1980:100, CJEU 9 Feb. 1999, C-343/96 (*Dilexport*), ECLI:EU:C:1999:59 and CJEU 12 Dec. 2006, C-446/04 (*Test Claimants*), ECLI:EU:C:2006:774.

⁸⁸ See e.g., CJEU 15 Sep. 1998, C-260/96 (*Spac*), ECLI:EU:C:1998:402 and CJEU *Edis*, *supra* n. 27.

⁸⁹ See e.g., CJEU *FMC*, *supra* n. 26, CJEU *Zuckerfabrik Jülich AG, British Sugar plc and Tereos*, *supra* n. 14 and CJEU 18 Jan. 2017, C-365/15 (*Wortmann*), ECLI:EU:C:2017:19.

⁹⁰ CJEU 10 Apr. 2008, C-309/06, ECLI:EU:C:2008:211.

⁹¹ CJEU *Gräfendorfer*, *supra* n. 13.

⁹² *Ibid.*, paras 63 and 64.

⁹³ *Ibid.*, para. 65.

⁹⁴ See also Marie Lamensch, case law note on CJEU 22 februari 2024, C-674/22 (*gemeente Dinkelland*), *Highlights & Insights* 2024/87.

⁹⁵ CJEU 12 Apr. 2018, C-8/17 (*Biosafe*), ECLI:EU:C:2018:249, para. 37.

deduct VAT or has failed to apply the correct tax rules (e.g., not applying a reduced rate or exemption) are to be regarded as a situation where VAT has been levied in breach of EU law, that would mean that there would be a right to a refund and interest payments regarding each amount of tax not due.

Pursuant to the judgment in the *Gemeente Dinkelland* case, there is no right to interest payments in the situation when the allocation key that was calculated was under ‘the sole responsibility of that municipality’. This wording seems to suggest that, if the tax administration has been involved in calculating the allocation key (that later turned out to be incorrect), there would be a situation in which VAT is levied in breach of EU law. For *Gemeente Dinkelland*, the involvement of the tax administration is limited to it reviewing the methodology of the calculation. In the author’s view, what is relevant in this context is that, concerning the calculation of the deductible proportion based on actual use and, in particular the allocation key for economic and non-economic activities, it is not a simple question of whether a certain calculation methodology is right or wrong. Multiple calculation methods could be providing the desired result for which one may be more precise than the other. The CJEU has also pointed out in the *Wolfgang und Wilfried Rey* case that it is not required that the most precise method of calculation is chosen.⁹⁶ In other situations when the taxable person consults the tax administration questioning whether its application of the national VAT legislation is correct, this may be different. An example is a situation when a taxable person is of the opinion that its services are subject to VAT and not exempted and informs the tax administration that it takes this position. If the tax administration agrees with his position by confirming it, e.g., in a ruling or letter, that later turns out to be incorrect, this author posits that VAT has been levied in breach of EU law even though the taxable person himself made the initial incorrect qualification.

This author opines that the nature of the incorrect application or interpretation by the tax administration is irrelevant. This interpretation can be derived from a tax assessment, a ruling from the tax authorities, an audit in which the tax authorities have indicated that a certain VAT treatment should be applied or from the information provided by the tax authorities to the public (e.g., via decrees or information on a website).⁹⁷ All of these can be

regarded as situations when tax was levied due to an incorrect application or interpretation by the tax administration. Account should be taken, in this author’s view, of how the taxable person could reasonably have understood a position taken by the tax administration. This author posits that, in the event of obvious mistakes that cannot reasonably be interpreted as being correct, a taxable person would not be entitled to interest payments if he has acted based on the clearly incorrect position.⁹⁸ It is important to note, however, that it also becomes clear from the *Gräfendorfer* case that Member States may refuse to pay interest if legal proceedings have not been initiated (but instead an administrative appeal or complaint) provided that the exercise of Union rights is not excessively difficult.⁹⁹ Taxable persons that do not address the incorrect application or interpretation by the tax administration at court will therefore, in principle, not be entitled to default interest. This is also in accordance with the CJEU’s reasoning in the *Kühne & Heitz* case¹⁰⁰ for which it has ruled that an administrative body is required to review a final administrative decision to take account of the interpretation given in the meantime by the CJEU only if the administrative decision has become final as a result of a national court ruling at a final instance. The person concerned must also complain to the administrative body immediately after becoming aware of the CJEU’s decision.

When a taxpayer has failed to exercise its right to deduct VAT by not claiming the correct amount via its VAT return and the tax administration is aware of this, e.g., because they have asked the taxpayer to substantiate its claim with invoices received, the author postulates that the situation is different than in the *Gemeente Dinkelland* case. In the *CHEP equipment pooling* case, the CJEU made it clear that, in such a situation (in that case, a refund request under Directive 2008/9/EC), the principle of good administration would require the tax administration to allow the taxable person to amend his request. This applies to errors that are easily recognizable.¹⁰¹ If the tax administration would simply process the VAT return as it is filed, it would infringe this EU principle of good tax administration. As becomes clear from the *Hauptzollamt B* case, a breach resulting from a failure to observe the general principles of EU law also results in an obligation to pay interest.¹⁰²

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⁹⁶ CJEU 9 Jun. 2016, C-332/14, ECLI:EU:C:2016:417, para. 33. Even though this case deals with the deductible proportion calculated for exempt and taxable supplies, the *Securita* case (CJEU 13 Mar. 2008, C-437/06, ECLI:EU:C:2008:166) makes it clear in para. 34 that the Member States are to establish methods and criteria appropriate for establishing to what extent costs are attributable to economic activities. Those methods should be consistent with the principles underlying the common system of VAT (para. 34). Therefore, this ruling from the *Wolfgang und Wilfried Rey* case is relevant as well when calculating the allocation key for economic and non-economic activities.

⁹⁷ Compare: Joost Vetter, case law note CJEU 22 Feb. 2024, C-674/22 (*Gemeente Dinkelland*), NLFiscaal 2024/0556.

⁹⁸ Compare the CJEU’s ruling in the *Elmeke* case where it is made clear that the principle of legitimate expectations applies when the conduct of the tax administration has resulted in a reasonable expectation in the mind of a reasonably prudent economic agent; CJEU 14 Sep. 2006, C-181/04 to C-183/04, ECLI:EU:C:2006:563, para. 32.

⁹⁹ CJEU *Gräfendorfer*, *supra* n. 13, para. 84.

¹⁰⁰ CJEU 13 Jan. 2004, C-453/00, ECLI:EU:C:2004:17.

¹⁰¹ CJEU 21 Oct. 2021, C-396/20, ECLI:EU:C:2021:867.

¹⁰² CJEU 9 Sep. 2021, C-100/20, ECLI:EU:C:2021:716, para. 28.

Last but not least, it is interesting to address the interaction between the *HUMDA* and *Schütte* case discussed in section 3.2 and the case law discussed in this section. An example is a company that is of the opinion that a reduced VAT rate applies to its products while the tax administration takes the position that the general VAT rate applies. The company can charge the general VAT rate and collect this VAT from its customer while appealing this application of VAT. The second option is to charge the reduced VAT rate while awaiting a tax assessment that is subsequently appealed. In the first situation, the CJEU's case law seems to suggest that there will be no right to payment of default interest because, even if the court rules in favour of the taxable person, this VAT will be due under Article 203 VAT Directive. Default interest only applies if the refund request has not been processed within a reasonable period. If the taxable person opts to use the second solution, he may need to prefinance the difference between the general and reduced VAT rate unless a deferral of payment is granted. In the latter case, the taxable person may be required to pay interest when he is found to be incorrect. The taxable person might also not be able to charge his customer for the additional VAT afterwards in the second option. On the other hand, if the court rules in favour of the taxable person, he will be granted default interest. If he chooses the first option, he can be confronted with financial damages if the tax later turns out to be levied in breach of EU law at the outset. Charging the general VAT rate might, for example, lead to a reduction in sales or decreased profit. As this is caused by the tax administration's position, the author's view is that default interest should be paid as of the moment the tax is paid but only to the extent that the taxable person has not been able to pass on the burden of the tax to another person (*see* section 2.3).

4 SITUATIONS IN WHICH THERE IS AN ENTITLEMENT TO INTEREST PAYMENTS

The central research question in this article is to what extent a taxable person in the field of VAT is entitled to interest payments and from which date he is entitled to receive those interest payments.

The recent CJEU cases are additional examples of taxes being levied in breach of EU law that results in both the obligation of repayment of the tax and the payment of interest as of the moment the tax was paid. Situations in which taxes are levied in breach of EU law include:

- situations when national law is in breach of a treaty, directive, or regulation;
- situations when EU law is declared invalid;
- incorrect interpretation or application of national law that is, in itself, not in breach of EU law; and

- error of the assessment of the facts while the national law is not in breach of EU law.

The author posits that the nature of the incorrect application or interpretation is irrelevant and covers a tax assessment, a ruling from the tax authorities, an audit in which the tax authorities have indicated that a certain VAT treatment should be applied, or a provision of information by the tax authorities to the public (e.g., via decrees or information on a website) on the basis of which the taxpayer has acted. Equivalent to the principle of legitimate expectations and, particularly in the latter situation, how the taxable person could have reasonably interpreted the tax administration's position is relevant in the author's view.

Taxes are not levied in breach of EU law if the taxpayer is required to self-assess the tax and commits errors while doing so. An exception, according to this author, applies when the mistake is easily recognizable for the tax administration. The principle of good tax administration in that situation requires the tax authority to make the taxable person aware of his mistake and allow him to correct it. If this does not occur, the tax administration acts in breach of an EU principle which is also to be regarded as a situation when a tax is levied in breach of EU law. Taxes are also not levied in breach of EU law when it concerns the refund of excess VAT under Article 183 VAT Directive, a refund of VAT because of, e.g., a price reduction or non-payment under Article 90 VAT Directive, and a refund of VAT that was unduly charged. However, when that VAT has not been refunded to the taxable person within a reasonable period of time, it has a right to a payment of interest. A period of up to eight weeks is considered reasonable by the CJEU, but perhaps a longer period would also be acceptable. A tax administration's long delay cannot be a cause of a reduction in the default interest to be paid with the only exception being a delay caused by the unwillingness of the taxable person to cooperate in, e.g., an audit that takes place to assess his right to a refund. Last but not least, in the author's view, when Article 203 VAT Directive applies because the taxable person invoices in accordance with the position of the tax administration that he later challenges, the tax should be regarded as a tax levied in breach of EU law if the tax administration's position turns out to be incorrect. In this situation, the taxable person may already have suffered financial damages caused by the tax administration's position.

As a general exception, a tax levied in breach of EU law cannot be refunded, and no interest payment takes place if and insofar as the taxable person has been able to pass on the tax to another person. The burden of proof lies with the tax administration, but the taxable person is required to provide the relevant documentation if so requested. To establish whether the refund of the tax would result in an unjust enrichment, account should also be given to the fact that levying the tax can cause financial damages

because of, e.g., a reduction in sales or profit because of an increased price.

5 FINAL REMARKS

While there is already a substantial body of case law dealing with the payment of default interest for taxes levied in breach of EU law, it is likely that some more will come. Not all questions have yet been answered such as which situations should be regarded as a tax administration's incorrect interpretation or application of the law and how to deal with the situation when the taxable person is confronted with the application of Article 203 VAT Directive because of the tax administration's position. The right to the repayment of taxes levied in breach of EU law and the payment of interest are fundamental to the internal market and should therefore, in the author's view, not be interpreted restrictively.

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POLICY NOTE

An Asian Perspective on Pillar One Amount A and Digital Service Taxes

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The standard narrative in Pillar One of the G20-OECD BEPS 2.0 is that digital service taxes (DSTs) and similar unilateral measures will proliferate if the Amount A Multilateral Convention (MLC) does not succeed. The only real deterrent in that scenario is the threat of US retaliation using section 301 trade tariffs. This article presents a more nuanced view. A key insight is that, although European jurisdictions use DSTs to tax offshore digital services that lack a physical nexus to impose regular income tax, very few Asian jurisdictions use European-styled DSTs to tax offshore digital services. They extend pre-existing value added tax (VAT) instead that is not subject to the US section 301 retaliation partly due to the non-discriminatory nature. For the foreseeable future, it is unlikely that Asia will follow the European or African approach as advocated by the African Tax Administration Forum (ATAF) of adopting European DSTs. This is partially because Asia, in contrast to Africa, lacks a regional organization such as the EU or ATAF advocating DSTs as the alternative to the OECD endorsed Amount A. Further, Asia also does much more trade with the United States than Africa does, giving Asian jurisdictions more pause before risking US retaliation.

Keywords: Base erosion and profit shifting, BEPS, digital service tax, pillar one, amount A, Asia, digital tax, G20, OECD.

I INTRODUCTION

Pillar One of the G20-OECD's two-pillar solution to the tax challenges of the digitalization of the economy (commonly termed as the Base Erosion and Profit Shifting 2.0 Project or BEPS 2.0) seeks to ensure that profits of large multinational enterprises (MNEs) are taxed where the products or services are consumed or services are consumed. Pillar One is premised upon reallocating taxing rights to market countries where the customers or consumers are to address the problem of how to correctly capture value and tax businesses characterized by a reliance on intangible assets, no or an insignificant physical presence in the tax jurisdictions where commercial activities are carried out ('scale without mass'), and a considerable user role in value creation.¹ The consensus to adopt Pillar One by 130 members² of the BEPS Inclusive Framework was formalized on 8 October 2021 and was accompanied by a detailed implementation plan.³

Pillar One comprises Amount A and Amount B.

Amount A is to be implemented via a multilateral convention (MLC) by coordinating a reallocation of taxing rights (Amount A) to market jurisdictions of a portion of profits in excess of 10% of revenue for MNEs with global revenue greater than EUR twenty billion and a pre-tax profit margin greater than 10% of total revenue with a corresponding obligation to relieve double taxation. The MLC is to provide tax certainty to all MNEs (including those not in scope) by inter alia preventing the imposition of digital services taxes (DSTs) and other similar unilateral measures.

Amount B attempts to simplify the approach to applying the arm's length principle to certain baseline marketing and distribution activities, particularly for low-capacity countries.

As of the time of writing this article, Amount B is making good progress with the final report published on 19 February

Notes

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¹ European Parliament Briefing, *Digital Taxation State of Play and Way Forward*, [https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/649340/EPRS_BRI\(2020\)649340_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2020/649340/EPRS_BRI(2020)649340_EN.pdf) (accessed 30 Sep. 2024).

² At the time of writing this article, the Inclusive Framework has increased to 147 members.

³ OECD (2021), Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy, <https://www.oecd.org/en/about/news/announcements/2021/10/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.html> (8 Oct. 2021) (accessed 30 Sep. 2024).

2024,⁴ and it has been incorporated into the OECD Transfer Pricing Guidelines for adoption by countries.⁵ However, a framework remains outstanding to be developed, aiming for gathering information on the practical application of the Amount B approach once it has been in operation for a period of time, and there is an ongoing push by the United States to make Amount B mandatory and to link it to Amount A (*see* discussion below). A draft of the Amount A MLC was published in October 2023.⁶ However, the deadline of 30 June 2024 for a final agreement on it has passed. Nevertheless, the director of the OECD Centre for Tax Policy and Administration was reported as saying: ‘Countries are still at the table, precisely because we are making progress ... As each of these milestones arrives, whether we successfully conclude by a given date or not, we get closer to the finish line’.⁷

The 30 June timing was for a final version of the MLC to be released for signature by Inclusive Framework members. A key challenge is that, for the MLC to enter into force per the October 2023 draft, it needs to be ratified by at least thirty jurisdictions including the headquarters jurisdictions of at least 60% of MNEs currently expected to be within Amount A’s scope. This means the United States, with the largest number of in-scope MNEs, must ratify the MLC for the Amount A rules to take effect.⁸ However, tax treaty ratification requires sixty-seven votes in the US Senate, making the adoption of Pillar One, Amount A challenging without broad bipartisan support in the United States.⁹ More recently, an Indian Ministry of Finance official stated that India will not sign Pillar One unless it addresses dispute resolution and treatment of withholding tax.¹⁰

A more immediate issue is that the 30 June deadline marked the end date of the truce of the unilateral measures compromise between Austria, France, India, Italy, Spain, the United Kingdom,¹¹ and the United States.¹²

The United States had initiated section 301 investigations into the DSTs of these countries and those of Brazil, the Czech Republic, the EU, and Indonesia¹³ focused on whether these taxes discriminate against US MNEs (e.g., 75% of the French DST on advertising would be paid by two US firms, Alphabet and Meta, and 90% of the GST in the United Kingdom was paid by five firms who are likely largely or completely US firms¹⁴) and concerns about ‘retroactivity and possibly unreasonable tax policy’. If such DSTs were found to be discriminatory, the United States would threaten retaliation with trade tariffs. For example, the 301 investigations on the French DST instigated the United States to threaten to impose a 25% tariff on USD 1.3 billion on French cosmetics, handbags, and other products in retaliation for France’s 3% DST covering USD fifteen billion in revenues of US companies. It would have collected USD 450 million in taxes from the companies in scope of the French DST during 2020 and USD 500 million during 2021.¹⁵

Under the truce, Austria, France, India, Italy, Spain, and the United Kingdom all enacted DSTs before 8 October 2021 and are not required to withdraw them until Pillar One takes effect. However, to the extent that taxes that accrue to these countries due to existing DSTs during a defined period and before Pillar One takes effect exceed an amount equivalent to the tax due under Pillar One in the first full year of its implementation, such excess will be creditable against the portion of the corporate income tax liability associated with Amount A in these countries. In return, the United States agreed to end the 301 investigations and potential trade retaliation until the end of 30 June 2024. The deadline was preceded by Canada’s DST going into effect on 28 June 2024 that resulted in the media speculating whether it would instigate section 301 retaliation by the United

Notes

⁴ Organization for Economic Co-operation and Development (2024), Pillar One - Amount B, https://www.oecd.org/en/publications/pillar-one-amount-b_21ea168b-en.html (accessed 30 Sep. 2024).

⁵ OECD Secretary-General’s Tax Report to G20 Finance Ministers and Central Bank Governors (G20 Brazil Jul. 2024), https://www.oecd.org/en/publications/oecd-secretary-general-tax-report-to-g20-finance-ministers-and-central-bank-governors-g20-brazil-july-2024_3bacc6e8-en.html (accessed 30 Sep. 2024).

⁶ OECD website on Pillar One, <https://www.oecd.org/en/topics/sub-issues/reallocation-of-taxing-rights-to-market-jurisdictions/multilateral-convention-to-implement-amount-a-of-pillar-one.html> (accessed 30 Sep. 2024).

⁷ *OECD Reports Progress, But No Deal Yet on Global Tax Treaty*, <https://news.bloombergtax.com/daily-tax-report-international/oecd-reports-progress-but-no-deal-yet-on-global-tax-treaty-1> (accessed 30 Sep. 2024).

⁸ Deloitte *OECD Pillar One – Amount A Multilateral Convention* (Oct. 2023), <https://taxsape.deloitte.com/article/oecd-pillar-one—amount-a-multilateral-convention.aspx> (accessed 30 Sep. 2024).

⁹ Tax Foundation, *The Latest on the Global Tax Agreement* (11 Jul. 2024), <https://taxfoundation.org/blog/global-tax-agreement> (accessed 30 Sep. 2024).

¹⁰ Reuters, *India Will Not Sign Global Tax Deal Until Its Concerns are Addressed, Official Says* (25 Jul. 2024), <https://sg.finance.yahoo.com/news/india-not-sign-global-tax-134912668.html> (accessed 30 Sep. 2024).

¹¹ US Treasury Press Release (15 Feb. 2024), <https://home.treasury.gov/news/press-releases/jy2098> (accessed 30 Sep. 2024).

¹² Business Standard, *India, US Extend 2% Digital Tax on E-commerce Supplies Till June 30: FinMin* (28 Jun. 2024), https://www.business-standard.com/industry/news/india-us-extend-2-digital-tax-on-e-commerce-supplies-till-june-30-finmin-124062800962_1.html; Reuters, *US, India Extend Digital Tax Truce to Sunday as Deadline Approaches* (29 Jun. 2024), [https://www.reuters.com/world/india/us-india-extend-digital-tax-truce-sunday-deadline-approaches-2024-06-28/#:~:text=June%2028%20\(Reuters\)%20%2D%20The,companies%2C%20the%20US%20Treasury%20said](https://www.reuters.com/world/india/us-india-extend-digital-tax-truce-sunday-deadline-approaches-2024-06-28/#:~:text=June%2028%20(Reuters)%20%2D%20The,companies%2C%20the%20US%20Treasury%20said) (accessed 30 Sep. 2024).

¹³ US Trade Representative website, *Section 301 – Digital Services Taxes*, <https://ustr.gov/issue-areas/enforcement/section-301-investigations/section-301-digital-services-taxes> (accessed 30 Sep. 2024).

¹⁴ Congressional Research Service, *The OECD/G20 Pillar 1 and Digital Services Taxes: A Comparison*, <https://crsreports.congress.gov/product/pdf/R/R47988> (accessed 30 Sep. 2024).

¹⁵ US Trade Representative, Docket No. USTR–2019–0009, https://ustr.gov/sites/default/files/enforcement/301Investigations/France_Digital_Services_Tax_Notice_July_2020.pdf.

States.¹⁶ Such a possibility was heightened when the House of Representative Ways and Means Committee Chairman, Jason Smith, and Trade Subcommittee Chairman, Adrian Smith, in a letter signed by every Republican on the Committee, urged US Trade Representative (USTR), Ambassador Katherine Tai, to retaliate with section 301 sanctions against the Canadian DST.¹⁷ At the time of this writing, there has not been an official reaction from the Biden Administration. Nevertheless, there is a warning of the threat of a broader trade war not just against Canada but against the other countries implementing what the United States would consider discriminatory DSTs.¹⁸ 'The threat of a new tax and trade war with Europe is very real, with economic damages on both sides of the Atlantic' (Testimony of Tax Foundation at House Ways and Means).¹⁹ This prompted the communique of the G20 Finance Ministers and Central Bank Governors Meeting on 25 and 26 July 2024 to 'encourage Inclusive Framework members to expeditiously complete the negotiations on a final package on Pillar One through resolving the remaining issues on a framework for Amount B'²⁰ allowing the [MLC] to be finalized and opened for signing as soon as possible'.²¹

2 DIGITAL SERVICES TAX

DSTs differ from conventional corporate income taxes in that they are levied on gross turnover or revenue derived from a variety of digital services. Unlike value added tax (VAT), there is no input credit for tax on gross sales to refund the same tax on input goods and services that go toward producing the digital services.

DSTs cover a broad range of digital services including advertising services of search engines and social-media platforms, digital intermediation services facilitating

the exchange of supplies of goods or services, streaming services, and even sale of user data. The tax rate ranges from 1–8% of gross turnover.²² Three variations of DSTs can be broadly identified as exemplified by the following:

- (1) Conventional European styled DSTs: An example is the French 3% DST that applies to revenue from digital services supplied in France by digital platforms and online advertisements supplied to advertisers.²³ It is noteworthy that European styled DSTs tend to be viewed as alleviating the inability of conventional income tax that fails to tax the off-shore supply of digital services into Europe due to the lack of a physical nexus. Another feature of European DSTs is the high revenue thresholds limiting the impact to large MNE groups that are disproportionately American resulting in the US allegation of discrimination for justifying section 301 retaliation.
- (2) DSTs on streaming services: An example is the Canadian tax on streaming services that imposes a 5% tax on Canadian revenue to be earmarked for the Canadian broadcasting system that began on 1 September 2024.
- (3) The India styled equalization levy with a low threshold that does not apply to MNEs with a permanent establishment: India imposes an equalization levy of 2% on amounts received/receivable by a nonresident e-commerce operator from e-commerce supplies or services and 6% for online advertisements. It does not apply if the foreign provider has a taxable presence in India.²⁴ In this sense, the Indian equalization may be thought of as *sui generis* combining a gross based levy, a low revenue threshold unlike the high thresholds of European styled DSTs, and the income tax concept of a permanent establishment. The recent Indian budget has announced the repeal

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¹⁶ The Globe and Mail, *Business Brief: Canada's Digital Taxes Set Stage for Trade War* (8 Jul. 2024), <https://www.theglobeandmail.com/business/article-business-brief-canadas-digital-taxes-set-stage-for-trade-war/> (accessed 30 Sep. 2024)

¹⁷ 'As you know, Section 301 gives USTR ample authority to take action against unreasonable or discriminatory acts that burden or restrict US commerce. In fact, thanks to aggressive action by the prior administration, between 2019 and 2021, USTR investigated the harmful DSTs implemented by other countries, creating a path for USTR to respond quickly in this instance. Without swift action, the United States will not be ready to immediately retaliate when Canada's discriminatory DST is applied. This is especially concerning because of the potential retroactive application of the DST'. <https://waysandmeans.house.gov/2024/07/11/ways-means-republicans-demand-biden-administration-take-decisive-action-to-combat-canadas-digital-services-tax/#:~:text=WASHINGTON%2C%20D.C.%20%E2%80%93%20Canada's%20decision%20to,a%20letter%2C%20signed%20by%20every> (accessed 30 Sep. 2024)

¹⁸ Bloomberg Tax, *Canada's Digital Services Tax Sets the Stage for a US Trade War* (11 Oct. 2023), <https://news.bloombergtax.com/tax-insights-and-commentary/canadas-digital-services-tax-sets-the-stage-for-a-us-trade-war>; Wall Street Journal *Canada Enacts Digital-Services Tax Amid Risks of U.S. Trade Retaliation* (4 Jul. 2024), <https://www.wsj.com/world/americas/canada-enacts-digital-services-tax-amid-risks-of-u-s-trade-retaliation-f4993cf5#:~:text=In%20its%202024%20budget%20plan,billion%20over%20a%20half%20decade> (accessed 30 Sep. 2024)

¹⁹ Testimony of Daniel Bunn, President & CEO of Tax Foundation, before the US House Ways & Means Subcommittee on Tax hearing on (7 Mar. 2024) titled, *OECD Pillar 1: Ensuring the Biden Administration Puts Americans First*, https://taxfoundation.org/research/all/federal/pillar-one-digital-services-taxes/#_ftn6 (accessed 30 Sep. 2024)

²⁰ A framework to gather information on the practical application of the Amount B approach once it has been in operation for a period of time is to be developed by the Inclusive Framework.

²¹ *The Rio de Janeiro G20 Ministerial Declaration on International Tax Cooperation*, <https://www.g20.org/en/documents/documents-resulting-from-the-3rd-g20-finance-ministers-and-central-bank-governors-meeting-rio-de-janeiro-25th-and-26th-of-jul.-2024> (accessed 30 Sep. 2024)

²² Tax Foundation, *Digital Taxation*, <https://taxfoundation.org/tags/digital-taxation> (accessed 30 Sep. 2024)

²³ Bird & Bird, *Digital Services Tax in France* (18 Oct. 2021), <https://www.twobirds.com/en/insights/2019/global/digital-services-tax-in-france> (accessed 30 Sep. 2024)

²⁴ RSM, *India Has Significantly Expanded Its Equalization Levy* (23 Jan. 2023), <https://rsmus.com/insights/services/business-tax/india-has-significantly-expanded-its-equalization-levy.html>; Dezan Shira & Associates, *Equalization Levy Compliance Framework for Non-resident E-Commerce Operators in India* (10 Aug. 2023), <https://www.india-briefing.com/news/equalization-levy-compliance-framework-for-non-resident-e-commerce-operators-in-india-29238.html> (accessed 30 Sep. 2024)

of the 2% levy on e-commerce supplies or services with effect from 1 August 2024 in the interest of moving towards Pillars One and Two.²⁵

As of June 2023, there were twelve countries with an active DST and nineteen other countries that either have paused their DST or are discussing introducing one.²⁶

DSTs are expected to yield significant revenues. In its 2024 budget plan, Canada indicated that its DST would generate revenue for the current fiscal year ending 31 March 2025 of approximately CAD 2.3 billion and nearly CAD six billion over a half decade.²⁷ For the twelve countries with implemented DSTs, revenues ranged between EUR 166 million and EUR 474 million each. Perhaps it is even more significant that the amount of revenues collected have considerably increased by 134% for Turkey, 100% for India, 71% for France, 67% for Spain, and 24% for Italy compared to the first year of implementation in these countries.²⁸ With growth factors such as increasing 5G bandwidth and widespread artificial intelligence adoption, the upward trajectory of DST collection is clear.

In comparison, the OECD estimates that 'Amount A increases net global [Corporate Income Tax] CIT revenues in Inclusive Framework jurisdictions by an average of USD 9.8–22.6 billion over the years 2017–2021 and USD 17.4–31.7 billion in 2021 due to the reallocation of taxing rights on average from lower tax jurisdictions to higher tax jurisdictions'.²⁹ The calculus for individual countries would depend on whether they would collect more from DSTs or from Amount A. The Joint Committee on Taxation in the US Congress³⁰ estimated that the United States would likely lose some tax revenue due to Amount A. Their preferred single year estimate is USD 1.4 billion. They also estimated that approximately 70% of the potential profits to be reallocated under Amount A would be generated by US domestic MNEs.

The impact of DSTs on individual businesses depends on several factors:

- (1) Market power: Dominant players have the advantage as they can pass on the burden from the DST to customers but those that are inferior cannot. For example, Amazon passed on the full UK DST to sellers, however, E-bay did not.³¹
- (2) Scale advantage: Here, it is worth drawing from the practical experience of the US sales tax³² for which large players with more resources and better systems have the advantage over smaller companies in navigating and helping users of their platform comply with state level sales tax collection across the fifty states of the United States. Large players would likely have a similar advantage over smaller MNEs and start-ups in being able to handle the complexities and helping users to comply with DSTs across different jurisdictions around the world.
- (3) Threat to low profit business models and start-ups: Gross revenue-based DSTs imposed regardless of profitability pose particular risks to unprofitable or thin-margin business models (e.g., ride-hailing, e-commerce) and start-ups compared to business models with relatively high margins (e.g., online streaming) unless the costs can be passed on to customers/consumers.

Regardless, as DSTs are unilateral measures that are not coordinated like Amount A, a proliferation of DSTs will mean businesses face:

1. increased complexity and compliance costs, as well as more tax disputes;
2. increased double taxation due to an overlap with other taxes and the fact that DSTs are generally not eligible for tax treaty or income tax credit relief as they are not income taxes;
3. increased tax across a company's value chain as gross revenue-based DSTs impact them at multiple points³³ without the opportunity for recouping or

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²⁵ Livemint, *India Drops E-commerce Levy That Irked the US* (23 Jul. 2024), <https://www.livemint.com/budget/e-commerce-union-budget-2024-tax-nirmala-sitharaman-financial-services-equalization-levy-tax-law-cloud-services-11721736776585.html>.

²⁶ Kane Borders, Sofia Balladares, Mona Barake, Enea Baselgia, *Digital Service Taxes*, EU Tax Observatory https://www.taxobservatory.eu/www-site/uploads/2023/06/EUTO_Digital-Service-Taxes_June2023.pdf. The countries that have an active and implemented DST are Austria, France, India, Italy, Kenya, Kyrgyzstan, Nepal, Portugal, Spain, Tanzania, Turkey, and the United Kingdom. The countries that have paused DSTs are Belgium, Brazil, Canada, Colombia, Czechia, Hungary, Poland, Sierra Leone, Tunisia, Uganda, and Zimbabwe. Countries that have discussed a DST are Australia, Cyprus, Israel, Latvia, New Zealand, Norway, Slovakia, and Slovenia.

²⁷ Wall Street Journal, *Canada Enacts Digital-Services Tax Amid Risks of U.S. Trade Retaliation* (4 Jul. 2024), <https://www.wsj.com/world/americas/canada-enacts-digital-services-tax-amid-risks-of-u-s-trade-retaliation-f4993cf5#:~:text=In%20its%202024%20budget%20plan,billion%20over%20a%20half%20decade> (accessed 30 Sep. 2024)

²⁸ https://www.taxobservatory.eu/www-site/uploads/2023/06/EUTO_Digital-Service-Taxes_June2023.pdf.

²⁹ P. O'Reilly et al., *Update to the Economic Impact Assessment of Pillar one: OECD/G20 Base Erosion and Profit Shifting Project*, OECD Taxation Working Papers, No. 66, OECD Publishing, Paris (2023), <https://doi.org/10.1787/7c35a55c-en> (accessed 30 Sep. 2024)

³⁰ Joint Committee on Taxation report on Amount A under Pillar One of BEPS 2.0, ahead of Ways and Means hearing, <https://www.jct.gov/publications/2024/jcx-7-24/> (accessed 30 Sep. 2024)

³¹ Bytes, *Unlike Amazon, eBay Won't Pass Along UK Tax to Sellers* (11 Aug. 2020), <https://www.ecommercebytes.com/2020/08/11/unlike-amazon-ebay-wont-pass-along-uk-tax-to-sellers> (accessed 30 Sep. 2024)

³² Account Talent, *Why Amazon.com Supports the Online Sales Tax*, <https://accountalent.com/why-amazon-com-supports-the-online-sales-tax>.

³³ Information Technology and Information Foundation, *Digital Services Taxes: A Bad Idea Whose Time Should Never Come* (13 May 2019), <https://itif.org/publications/2019/05/13/digital-services-taxes-bad-idea-whose-time-should-never-come>; also Tax Foundation, *Testimony: The OECD's Pillar One Project and the Future of Digital Services Taxes* (7 Mar. 2024), https://taxfoundation.org/research/all/federal/pillar-one-digital-services-taxes/#_ftn6.

refunding these taxes like the aforesaid VAT which offers input credits and theoretically only taxes the incremental value added at each stage of the supply chain rather than the entire gross output or sales at each stage.

For the economy, DSTs will likely be inflationary if the costs of the impacted digital services sector are passed onto customers or absorbed by businesses and when taking into account the increased costs of administering and complying with the tax.

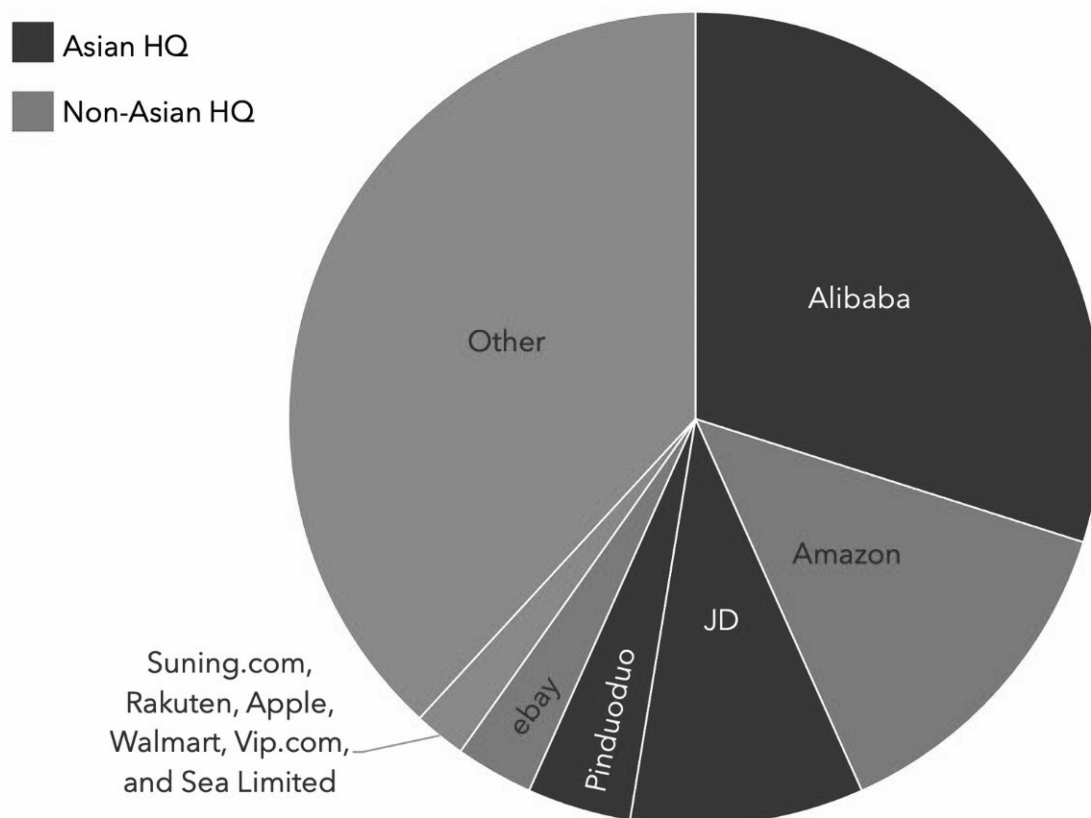
3 ASIA PERSPECTIVE

Of the top twenty digital companies in the world ranked by market capitalization as of July 2024,³⁴ the United States dominates with only five headquartered in other tax jurisdictions (two European, one Chinese, one Taiwanese, and one South Korean). Any DST imposed in Asia, like those in Europe, would likely significantly impact US MNEs. However, an International Monetary Fund (IMF) study pointed out that, in certain areas such as e-commerce, developing tech giants in Asia make up a significant portion of the global market³⁵ (see diagram below).

The global market share of e-commerce firms

Tech giants in Asia make up a large portion of the global market share.

(percent of total, by gross merchandise volume, 2019)



Sources: Statista and Activate.

IMF

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³⁴ Largest tech companies by market cap (21 Jul. 2024) <https://companiesmarketcap.com/tech/largest-tech-companies-by-market-cap> (accessed 30 Sep. 2024)

³⁵ Era Dabla-Norris, Andrew Hodge, Dinar Prihardini, *How to Tax in Asia's Digital Age* (14 Sep. 2021), <https://imf.org/en/Blogs/Articles/2021/09/14/blog-how-to-tax-in-asias-digital-age#:~:text=Some%20Asian%20countries%20have%20started,for%20profit%20taxation%20is%20adopted.>

Notwithstanding the rise of e-commerce in Asia, the same IMF study somewhat finds that DSTs surprisingly do not raise much revenue there and have other drawbacks even though they are easy to implement. This is contrary to the aforementioned significant revenue collection by European countries' DSTs. The study states:

A digital services tax similar to India's Equalization Levy would have yielded only 0.02 percent of GDP in 2019 for Bangladesh, Indonesia, Philippines, and Vietnam. Digital services taxes can also distort business decisions and still be vulnerable to tax avoidance. Moreover, they can complicate trade relations, because they are usually applied only to large firms headquartered abroad.

Perhaps it is not surprising then, in the context of potential US retaliation, that only three Asian countries have enacted DSTs (India, Kyrgyzstan, and Nepal³⁶). Significantly, none of the Asian OECD countries (Australia, Japan, New Zealand, and South Korea), the developing G20 countries (China, Indonesia, except for India), the ASEAN countries (Brunei, Burma, Cambodia, Darussalam, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand, and Vietnam) or the regional hubs of Hong Kong and Singapore have adopted DSTs. On 2 June 2020, the USTR commenced a section 301 investigation into Indonesia's proposed DST equivalent,³⁷ but it was discontinued as Indonesia did not proceed to implement the DST.³⁸

Instead, the vast majority of Asian countries merely extended their VAT systems to tax digital services. Japan was an early mover when it imposed its consumption tax on digital or electronic services in October 2015 which covered non-resident providers.³⁹ This was followed by other Asian countries – see Table 1.⁴⁰

The USTR has not investigated these VATs on digital services. They are extensions of their countries' respective pre-existing VAT regimes and not a

separately introduced one like the European style DST. Such extensions may involve making non-resident suppliers of digital services or e-commerce goods register for VAT or introduce a reverse charge mechanism.⁴¹ Another reason may be that the design of these VATs tends to have low thresholds when compared with European DSTs (see Table 2), thus, US Tech MNEs are not singled out. At this juncture, it is of value to observe that the European countries and the OECD via the OECD International VAT/GST Guidelines established the standard on VAT and certainly have the same VAT tools to tax digital services. A review of the Asian VAT rates suggests that they are, on average, lower than the EU's average standard VAT rate of 21.6%.⁴² The same VAT extensions to tax digital services in European should arguably yield more revenues than the comparable extension in Asia. Therefore, the more targeted European styled DSTs over and above the use of VAT suggests that the US' concerns of discrimination may not be unfounded.

China has constraints on the inbound supply of digital services by overseas companies not only from a regulatory perspective but also due to the language barrier and, most importantly, the highly competitive nature of online local digital services champions, resulting in little penetration by offshore providers. Therefore, there is no urgent need to levy a DST on top of VAT for non-resident suppliers of digital services.

4 GOING FORWARD

Now that India has announced the repeal of its 2% equalization levy, DSTs, or, more specifically, European styled DSTs, the section 301 US retaliation seems to primarily be a European and trans-Atlantic phenomenon if Pillar One does not proceed. Whether it will remain so depends on a few factors.

Notes

³⁶ Both Nepal and Kyrgyzstan levy a 2% DST. <https://globaltaxnews.ey.com/news/2023-1454-nepal-inland-revenue-department-amends-vat-and-dst-procedures-relating-to-digital-service> and <https://www.vatcalc.com/kyrgyz-republic/kyrgyz-republic-2-digital-services-tax> (accessed 30 Sep. 2024)

³⁷ Perppu No. 1 of 2020 had proposed a deemed digital PE concept and electronic transactions tax. Apr. 2020, <https://indonesien.ahk.de/en/infocenter/news/news-details/tax-regulation-changes-in-perppu-1-2020-is-aimed-at-mitigating-the-impact-of-the-covid-19-pandemic> (accessed 30 Sep. 2024)

³⁸ US Trade Representative, Notice of Termination of s. 301 Digital Services Tax Investigations of Brazil, the Czech Republic, the European Union, and Indonesia, https://ustr.gov/sites/default/files/enforcement/301Investigations/DST_Termination_FRN_March.pdf.

³⁹ Asquith, Richard, 'Finance Ministry to extend VAT collections to app stores 1 April 2025', VATCalc (12 Aug. 2024), <https://www.vatcalc.com/japan/japan-consumption-tax-on-digital-services-update>.

⁴⁰ Adapted from table in *supra*, <https://www.vatcalc.com/japan/japan-consumption-tax-on-digital-services-update>.

⁴¹ See e.g., Indonesia (<https://www.roedl.com/insights/vat-guidelines/indonesia-rate-registration-declaration-requirements>) and Singapore New GST Regimes – Overseas Vendor Registration and Reverse Charge (Apr. 2020), https://www.luther-lawfirm.com/fileadmin/user_upload/NF_GST_Singapore_v2.pdf.

⁴² Tax Foundation, *VAT Rates in Europe*, <https://taxfoundation.org/data/all/eu/value-added-tax-2024-vat-rates-europe/#:~:text=The%20EU's%20average%20standard%20VAT,rate%20required%20by%20EU%20regulation.>

Table 1 Asia-Pacific VAT on Digital Services (12 August 2024 by VATCalc)

<i>Country</i>	<i>Rate</i>	<i>Date</i>	<i>Threshold</i>	<i>Comments</i>
<u>Australia</u>	10%	17 July	AUD USD 75,000	
<u>Azerbaijan</u>	12%	17 January	–	
<u>Armenia</u>	20%	22 January	AMD 115 million	
<u>Bangladesh</u>	5–15%	19 July	–	B2B and B2C
<u>Bhutan</u>	7%	21 July	Nu five million	
<u>Cambodia</u>	10%	22 March	KHR 250 m	
<u>China</u>	6–13%	16 May	Nil	Withholding VAT; B2B and B2C
<u>Fiji</u>	9%	To be confirmed	FJD 300,000	
<u>India</u>	18%	17 July	-	
<u>Indonesia</u>	11%	20 August	IDR 600m or 12k customers	
<u>Japan</u>	10%	15 October	JPY ten million	
<u>Kazakhstan</u>	12%	22 January	Nil	
<u>Kyrgyzstan</u>	12%	22 January	Nil	
<u>Laos</u>	10%	22 February	LAK 400 m	
<u>Malaysia</u>	8%	20 January	RM 500,000	
<u>Nepal</u>	13%	22 July	Rupees two m	Also 2% DST
<u>New Zealand</u>	15%	16 October	NZD 60,000	
<u>Pakistan</u>	2%	21 September	Nil	Marketplace Withholding VAT
<u>Palau</u>	10%	23 January	USD 300,000	
<u>Philippines</u>	12%	2024 ?	P three million	
<u>Singapore</u>	9%	2 January	SUSD 100,000	
<u>South Korea</u>	10%	15 July	Nil	
<u>Sri Lanka</u>	18%	2025?	LKR sixty m	Proposals only
<u>Taiwan</u>	5%	17 May	NTD 480,000	
<u>Tajikistan</u>	14%	21 January		
<u>Thailand</u>	7%	21 September	1.8 m Baht	
<u>Uzbekistan</u>	12%	20 January	Nil	
<u>Vietnam</u>	10%	20 December	Nil	

Table 2 European DSTs Tend to Have High Thresholds

Country	Rate	Threshold	
		Global Revenue	Domestic Revenue
Austria	5%	EUR 750 million	EUR twenty-five million
Belgium	3%	EUR 750 million	EUR three million
Czech	5%	EUR 750 million	CZK100 million
France	3%	EUR 750 million	EUR twenty-five million
Italy	3%	EUR 750 million	EUR 5.5 million
Spain	3%	EUR 750 million	EUR three million
Turkey	7.5%	EUR 750 million	TRY twenty million
UK	2.0%	GBP 500 million	GBP twenty-five million

source: <https://taxfoundation.org/data/all/eu/digital-tax-europe-2020/>.

- (1) Whether Amount A MLC will come to fruition and how wide the prohibition is of unilateral measures:

(a) Despite reports of the impending failure of Pillar One,⁴³ at least considering the unlikelihood that the US Senate will ratify an Amount A MLC, the G20 and G7⁴⁴ continue to support the OECD's push to complete BEPS 2.0. One possible compromise may be the approach of the BEPS 1.0 Multilateral Instrument (MLI) for which willing participants can join first before the others do so later. The MLI entered into force on 1 July 2018 after five jurisdictions ratified it.⁴⁵ Since then, the number of signatories has increased and exceeds 100, covering approximately 1900 bilateral treaties.⁴⁶ A hurdle as mentioned above would be the self-declared threshold of at least thirty jurisdictions including the headquarters jurisdictions of at least 60% of

in-scope MNEs in the draft MLC that made US participation essential. This precondition will have to be renegotiated and be made less stringent in the final version.

- (b) A further complication is whether there should be a connection between Amount A and Amount B. At the time of this writing, Amount B has already moved ahead on the basis of voluntary adoption by countries. However, the US position is that Amount B must be mandatory.⁴⁷ This is resisted by other Inclusive Framework members such as India that has significant objections to the current Amount B.⁴⁸
- (c) If the MLC comes into force, the final language in Article 39 to preclude 'digital services tax or relevant similar measure' will be key. Article 39 (2) in the draft MLC⁴⁹ states:

- (2) For purposes of this article, the term 'digital services tax or relevant similar measure' means any tax

Notes

⁴³ Reuters, *Yellen says India and China binding 'Pillar 1' tax deal* (25 May 2024), <https://www.reuters.com/business/finance/yellen-says-india-china-binding-pillar-1-tax-deal-2024-05-24/>; Adam N. Michel, *The OECD's Pillar One Global Tax Cannot Be Salvaged* (14 Mar. 2024), <https://www.cato.org/blog/oecd-pillar-one-global-tax-cannot-be-salvaged>.

⁴⁴ G20 Finance Ministers and Central Bank Governors reiterated the focus on finalizing BEPS 2.0, <https://globaltaxnews.ey.com/news/2024-0536-g20-finance-ministers-continue-focus-on-finalizing-the-beps-20-project>. See also the statement of G7 Finance Ministers and Central Bank Governors' Statement (Washington, DC 17 Apr. 2024) https://www.mof.go.jp/english/policy/international_policy/convention/g7/20240417.pdf.

⁴⁵ <https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-multilateral-instrument-coming-into-force-changes-treaties.pdf>.

⁴⁶ See OECD website on BEPS Multilateral Instrument, <https://www.oecd.org/en/topics/sub-issues/beps-multilateral-instrument.html>.

⁴⁷ Tax Notes, *An Update On Pillar 1 Amount B*, <https://www.forbes.com/sites/taxnotes/2024/03/19/an-update-on-pillar-1-amount-b>.

⁴⁸ 'India wishes to record its reservation on the incomplete nature of the report owing to the non-inclusion of the definitions of "low-capacity jurisdictions (LCJs)" and "qualifying jurisdictions"; and an appropriately designed optional qualitative scoping criterion. Further, India also wishes to record its reservation on various aspects of the Amount B design, including but not limited to the operating expense cross-check mechanism and the overall design of the pricing methodology'. As reported by D. P. Sengupta, *Amount B of Pillar 1 – OECD Fails to Simplify & Streamline!* (30 Apr. 2024), <https://taxindiainternational.com/columnDesc.php?quer43fcxzt=NDQy>.

⁴⁹ OECD *The Multilateral Convention to Implement Amount A of Pillar One*, www.oecd.org/tax/beps/multilateral-convention-to-implement-amount-a-of-pillar-one.pdf.

imposed by a Party, however described, if it meets all of the following criteria and is not described in paragraph 3:

- (a) the application of such tax, or the amount of tax imposed, is determined primarily by reference to the location of customers or users, or other similar market-based criteria;
- (b) such tax either:
 - (i) is applicable by its terms solely to businesses carried out by persons that:
 - (A) are not residents of that Party ('non-residents'); or (B) are primarily owned, directly or indirectly, by non-residents of that Party ('foreign-owned businesses'); or
 - (ii) applies revenue thresholds, exemptions for taxpayers subject to domestic corporate income tax in that Party, or other scope restrictions that:
 - (A) cause the measure to apply in practice exclusively or almost exclusively to non-resident or foreign-owned businesses; and
 - (B) have the effect of insulating domestic businesses from the application of the tax.

Determining whether the condition of clause (B) is met shall take into account all relevant facts and circumstances, including the policy objectives of the tax and the overall distribution of domestic and foreign businesses in that Party. The mere fact that there are few or no domestic enterprises in the relevant market is not dispositive; and

- (c) such tax is treated by that Party as outside the scope of any agreements (other than this Convention) in force between that Party and one or more other jurisdictions for the avoidance of double taxation with respect to taxes on income.

Apart from leaving out withholding taxes which means that measures such as Article 12B of the UN Model Tax Convention (*see below*) are allowed under the MLC, Article 39(3) in the MLC further leaves out 'enhanced permanent establishment' concepts such as virtual permanent establishment and significant economic presence,⁵⁰ VAT and

anti-avoidance unilateral measures targeting permanent establishments such as the UK's Diverted Profits Tax, Australia's Multinational Anti-Avoidance Tax.

- (d) African Tax Administration Forum (ATAF) in its policy brief 'Taxing Digital Firms in Africa', published in January 2024⁵¹ offers Member States options other than waiting for the MLC to come into force. These include:
 - (ii) Option 2 – Enact DST legislation that is not an income tax based on the ATAF suggested approach to drafting DST legislation;
 - (iii) Option 3 – Enact DST legislation that is an income tax;
 - (iv) Option 4 – Adopt alternative nexus rules;
 - (v) Option 5 – Adopt Article 12B of the UN Model Tax Convention (*see below*)

The ATAF advocates that Member States consider these measures *in addition to* the MLC on the basis that its high EUR twenty billion threshold is only applied to 100 MNEs whereas the other measures can be more broadly based given the proper thresholds.

It will be interesting to see if the final MLC language will be expanded to preclude some of the above measures or whether it will allow jurisdictions to have their 'Amount A' cake and still take other measures to tax digital services.

- (2) Whether DSTs will proliferate widely beyond Europe:
 - (a) Some commentators have urged developing countries to leave Pillar One behind and move on with DSTs, VATs, or other less complex ways to raise revenue from digital services.⁵² This line of argumentation is supported in Africa by the ATAF that has generated policy briefs on DSTs⁵³ and even suggested approaches to drafting DST legislation.⁵⁴ The ATAF's counterpart in Latin America, the Inter-American Centre for Tax Administration, however, appears more keen on VAT rather than promoting DSTs among its members.⁵⁵

Notes

⁵⁰ Allison Christians & Kimia Towfigh, *Significant Economic Presence (SEP): Threshold to Taxing Digital Profits*, https://www.ctf.ca/EN/EN/Newsletters/Blogs_and_Reports/Digital_Services_Updates/Entries/Entry04.aspx (accessed 30 Sep. 2024).

⁵¹ ATAF Policy Brief, *Taxing Digital Firms in Africa* (Jan. 2024), https://events.ataftax.org/media/documents/232/documents/ATAF_Policy_Brief_TAXING_DIGITAL_FIRMS_IN_AFRICA_ENG_DIGITAL.pdf.

⁵² See Leopoldo Parada *Moving On: The Case for Developing Nations to Leave the OECD Pillar One Behind*, <https://kluwertaxblog.com/2024/07/10/moving-on-the-case-for-developing-nations-to-leave-the-oecd-pillar-one-behind> (accessed 30 Sep. 2024).

⁵³ ATAF, *Domestic Resource Mobilization (Digital Services Taxation in Africa)*, https://events.ataftax.org/index.php?page=documents&func=view&document_id=61.

⁵⁴ ATAF *Suggested Approach to Drafting Digital Services Tax Legislation*, https://events.ataftax.org/index.php?page=documents&func=view&document_id=79.

⁵⁵ See e.g., CIAT, *Leveling the Playing Field in Times of Crisis: Indirect Taxation on the Digital Economy in Latin America and its Potential Revenue* <https://www.ciat.org/leveling-the-playing-field-in-times-of-crisis-indirect-taxation-on-the-digital-economy-in-latin-america-and-its-potential-revenue/?lang=en#:~:text=Given%20this%20scenario%2C%20some%20Latin,registration%20of%20the%20provider%20and>.

- (b) It is interesting to contrast the EU's push for a new digital levy on top of their existing VAT regimes that subsequently evolved into individual EU members' introducing new DSTs,⁵⁶ with the OECD. The latter whilst advocating the rollback of DSTs in the Amount A MLC, is, at the same time, encouraging the use of VAT to tax the digital economy. On 23 June 2021, the OECD published a VAT digital toolkit for Latin America and the Caribbean. It provides detailed guidance to tax authorities in Latin America and the Caribbean on implementation strategies, policies, best practices, and pieces of legislation to secure VAT revenue in the event of e-commerce.⁵⁷ On 10 March 2022, the OECD published a similar VAT digital toolkit for the Asia-Pacific region⁵⁸ and one for Africa on 15 February 2023.⁵⁹
- (c) Asia's equivalent of the ATAF is the Study Group on Asia-Pacific Tax Administration and Research (SGATAR). The meetings are confined to government-to-government and, although there appears to be sharing on digital taxation at the SGATAR meetings (e.g., Korea shared on its ongoing endeavours to establish a solid foundation for the new digital tax regime⁶⁰) but, to date, the SGATAR has not published policy recommendations or digital tax toolkits for its members.
- (d) Apart from DST and VAT, the United Nations has offered the alternative under a new Article 12B on Income from Automated Digital Services in the United Nations Model Tax Convention suggesting that countries may wish to impose a 3–4% withholding tax on gross digital revenue or 30% tax on net digital income.⁶¹ This proposal is being studied with interest in Africa⁶² and Latin America.⁶³ Some have suggested that African

countries will readily adopt this UN alternative into their bilateral tax treaties over Pillar One.⁶⁴ There is no public indication that Asian governments are enthusiastic about it, however. Nevertheless, its simplicity and likelihood that it will not face US section 301 retaliation makes it a potentially attractive proposition for Asia if VAT does not prove to be adequate.

- (3) Outcome of the November 2024 US Presidential elections:
- (a) The section 301 investigations were initiated by the USTR under the prior Trump Administration. Thereafter, this issue did not come to the fore beyond the aforesaid truce being extended under the Biden Administration. This is in accordance with its more multilateral approach in international affairs and Secretary Yellen's general support for completing the twin pillars. Despite the passing of the 30 June deadline and requests by US tax writing leaders for the section 301 retaliation against Canada's DST,⁶⁵ the USTR has continued the Biden Administration's restrained approach and requested dispute settlement consultations with Canada under the United States-Mexico-Canada Agreement (USMCA) instead of resorting immediately to section 301.⁶⁶
- (b) At the time of this writing, President Biden has announced his withdrawal as a candidate for November. It appears as though the aspiring Harris Administration would likely continue his policy approach, however, if there is a second Trump Administration, his pronouncements on widespread tariffs⁶⁷ increases the chance that section 301 will once again be used as leverage to dissuade others from implementing DSTs.

Notes

- ⁵⁶ Juan Manuel Vázquez, *Digital Services Taxes in the European Union: What Can We Expect?* (14 Feb. 2023), <https://kluwertaxblog.com/2023/02/14/digital-services-taxes-in-the-european-union-what-can-we-expect> (accessed 30 Sep. 2024).
- ⁵⁷ *VAT Digital Toolkit for Latin America and the Caribbean*, <https://web.archive.oecd.org/temp/2023-02-06/592324-vat-digital-toolkit-for-latin-america-and-the-caribbean.htm>.
- ⁵⁸ *VAT Digital Toolkit for Asia-Pacific*, <https://web.archive.oecd.org/temp/2023-02-06/625553-vat-digital-toolkit-for-asia-pacific.htm> (accessed 30 Sep. 2024).
- ⁵⁹ *VAT Digital Toolkit for Africa*, <https://web.archive.oecd.org/temp/2024-03-12/650926-vat-digital-toolkit-for-africa.htm> (accessed 30 Sep. 2024).
- ⁶⁰ Press release, *National Tax Service Attends the 52nd SGATAR Annual Meeting*, <https://www.nts.go.kr/comm/nttFileDownload.do?fileKey=1cafbc3ad3d628e1229cfd0723c304b> (accessed 30 Sep. 2024).
- ⁶¹ PWC, *UN Tax Committee Adopts Article 12B for Model Treaty Rules on Digital Services*, Tax Policy Alert, <https://www.pwc.com/gx/en/tax/newsletters/tax-policy-bulletin/assets/pwc-un-tax-committee-adopts-article-12b.pdf> (accessed 30 Sep. 2024).
- ⁶² See ATAF Technical Review of the Draft Article 12B United Nations Model Tax Convention, https://events.ataftax.org/includes/preview.php?file_id=81&language=en_US (accessed 30 Sep. 2024).
- ⁶³ Pablo Porporatto, *New UN Proposal for the Taxation of Automated Digital Service*, CIAT <https://www.ciat.org/new-un-proposal-for-the-taxation-of-automated-digital-services/?lang=en> (accessed 30 Sep. 2024).
- ⁶⁴ Anjana Haines, *This Week in Tax: Article 12B is Ready for Use in Tax Treaties*, International Tax Review (29 Apr. 2022), <https://www.internationaltaxreview.com/article/2a6abcbtm7tszx6vhf7cw/this-week-in-tax-article-12b-is-ready-for-use-in-tax-treaties> (accessed 30 Sep. 2024).
- ⁶⁵ Deloitte, *US Tax Writing Leaders Renew Call for Retaliatory Trade Response to Canadian DST*, <https://www.taxathand.com/article/34585/United-States/2024/US-taxwriting-leaders-renew-call-for-retaliatory-trade-response-to-canadian-dst> (accessed 30 Sep. 2024).
- ⁶⁶ See US Trade Representative Office Press Release (30 Aug. 2024), <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2024/Aug./united-states-requests-usmca-dispute-settlement-consultations-canadas-digital-services-tax> (accessed 30 Sep. 2024).
- ⁶⁷ Bloomberg, *Trump on Taxes, Tariffs, Jerome Powell and More* (16 Jul. 2024) <https://www.bloomberg.com/features/2024-trump-interview> (accessed 30 Sep. 2024).

To conclude, the situation at the time of this writing appears to be that DSTs (at least European style ones) and the attendant threat of section 301 tariff retaliation by the United States remains largely a trans-Atlantic phenomenon. Asian jurisdictions appear to mostly avoid such a European styled DST design and rely on extending VAT instead. For the foreseeable future, it would likely remain that way. Asia, in contrast to Africa, lacks a regional institution such as the ATAF advocating for alternatives to the OECD endorsed approaches. Asia also does much more trade with the United States than Africa does (2024 US trade in goods with Africa was USD twenty-eight billion⁶⁸ v. USD 774 billion⁶⁹ in Asia). Therefore, Asian jurisdictions hesitate to implement DSTs due to risking US retaliation.

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⁶⁸ United States Census Bureau, *Trade in Goods With Africa*, <https://www.census.gov/foreign-trade/balance/c0013.html> (accessed 30 Sep. 2024).

⁶⁹ United States Census Bureau, *Trade in Goods with Asia* <https://www.census.gov/foreign-trade/balance/c0016.html> (accessed 30 Sep. 2024).

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