Introduction

Chapter 1 focuses on the historical background to EU corporate tax law. Prior to this analysis, there is a brief discussion of the legislative bases used for *de minimis* harmonisation and the limitations of this legal framework. This chapter considers some of the tax obstacles to the cross-border movement of companies and investment in such companies, for which international tax law and the OECD Model provide limited or no solutions. This sets the context in which the discussion in the following chapters takes place.

The next two chapters consider in greater detail the actual sources of EU corporate tax law. Chapter 2 delves into the EU legislative instruments on direct tax law – that is positive integration. There is an analysis of the EU direct tax Directives in force, the Arbitration Convention and some soft law instruments. The draft proposal for a Common Consolidated Corporate Tax Base is reviewed in Chapter 3.

Chapter 4 deals with negative integration and the effects of tax litigation in the development of EU corporate tax law. The jurisprudence of the Court of Justice is considered from a broad perspective and its methodology considered. The concept of reverse subsidiarity is also discussed in this context. The remaining chapters examine specific topics.

Chapter 5 focuses on the taxation of companies and parent–subsidiary relationships. Some of the tax obstacles arising in the cross-border movement of companies are examined, the emphasis being on direct investment. This chapter also considers the taxation of permanent establishments. The concept of corporate residence and its importance as a connecting factor for tax purposes is also discussed in the beginning of this chapter.

Chapter 6 examines the taxation of passive income such as dividends, interest and royalties. Economic and juridical double taxation are considered. It is explained that although the international tax community through the OECD Model has sought to tackle juridical double taxation but not economic double taxation, the jurisprudence of the Court of

Justice seems to be going the opposite way. Juridical double taxation is considered to be the result of the parallel exercise of taxing powers by Member States and, as such, is outside the ambit of EU law, whereas economic double taxation is heavily targeted. These trends are detected and critically assessed. This chapter examines the taxation of non-portfolio investment and portfolio investment in the EU.

Chapter 7 concentrates on the tax treatment of some types of reorganisations. The emphasis is on mergers, divisions, transfers of assets and corporate migration. The case law of the Court of Justice as well as the provisions of the Merger Directive are considered. This chapter also considers whether the use of EU corporate vehicles such as the Societas Europaea facilitate corporate reorganisations from a tax perspective.

Chapter 8 deals with tax avoidance in the EU. It examines the response of the Court of Justice to specific practices such as controlled foreign companies, thin capitalisation and transfer pricing. There is also a discussion on whether a uniform principle has developed in the area of direct tax law.

The book concludes with a general discussion on the current state of EU corporate tax law and its future perspectives.

It should be noted that throughout the book, the term 'host State' refers to the source State and the term 'home State' refers to the State of residence. In addition, the terms 'branch' and 'permanent establishment' are used interchangeably. This is because while the OECD Model and the EU direct tax Directives use the term 'permanent establishment', in case law references are more often made to a 'branch'. Finally, unless stated otherwise, the case references relate to the judgments of the Court of Justice.

The contents of this book are based on materials available up to 6 September 2012.

1

The historical background to EU corporate tax law

1.1 Introduction

Member State corporate tax regimes are heavily influenced by European Union law. What is notable, however, is the absence of EU harmonising legislation (i.e. hard law). This is attributed to a number of factors.

First of all, the lack of Union competence in direct tax matters. Under the principle of attribution of powers,[1] a cornerstone of the European legal structure, the Union[2] and its institutions only enjoy competence in the areas of law assigned or conferred to them under the Treaties. This principle of attribution of powers must be respected both internally and in the Union's external sphere of affairs. Therefore, every act must be based on a general or specific Treaty provision (the legal basis) empowering the Union, expressly or impliedly, to act.

It is widely acknowledged that Member States have retained competence in direct tax matters. Successive European Treaties have been silent on direct tax and more generally on EU taxes.[3] While the Treaties dealt with indirect taxes to some extent,[4] there were never any references to direct taxes. As a corollary, there has never been an explicit legislative base

[1] Art. 5 Treaty on European Union (TEU). This is also called the principle of conferred powers.

[2] Following the Lisbon Treaty, the TEU is amended and the Treaty establishing the European Community (EC Treaty) is amended and renamed as the Treaty on the Functioning of the European Union (TFEU). Thereafter, the name 'European Union' replaces and succeeds the 'European Community'.

[3] As Malherbe et al. point out, there are no EU taxes other than perhaps taxes levied on salaries and pensions of EU officials (Reg 260/68). See Jacques Malherbe et al., *The Impact of the Rulings of the European Court of Justice in the Area of Direct Taxation* (Policy Department Economic and Scientific Policy, European Parliament, 2008), p. 5.

[4] See Art. 28 TFEU (ex Art. 23 EC), which provides for a Union based upon a customs union. See Arts. 30 and 110 TFEU (ex Arts. 25 and 90 EC), which led to the harmonisation of excise duties. See Chapter 5 of Ben J. M. Terra and Peter J. Wattel, *European Tax Law*, 6th edn (Alphen aan den Rijn: Kluwer Law International, 2012).

for the harmonisation of direct taxes.[5] General legislative bases under Articles 115 and 352 of the Treaty on the Functioning of the European Union (TFEU) (ex Articles 94 and 308 EC Treaty (EC)) have been used for direct tax legislation. These legislative bases focus on the attainment of the Internal Market[6] and their use is strictly policed by the Court of Justice.[7]

Article 115 TFEU authorises the Council to issue directives for the approximation of laws, regulations or administrative provisions of Member States directly affecting the establishment and functioning of the Internal Market. Directives can only be adopted under Article 115 on the basis of unanimity. In addition, Article 352 TFEU authorises the Council, on a proposal from the Commission and after obtaining the consent of the European Parliament,[8] to adopt appropriate measures when Union action is necessary to attain one of the objectives of the Treaties. Again, the Council (i.e. all Member States in Council) has to act unanimously. There is another general legal basis for harmonisation under Article 116 TFEU, which could be used for legislative action when differences in Member State laws are distorting the conditions of competition in the Internal Market. Although this legislative base does not require unanimity and does not exclude direct tax measures,[9] it has never been used for tax harmonisation purposes.

Overall, the fiscal veto, that is the power of even one Member State to object to a harmonising measure in direct tax law, is a fiercely guarded prerogative that has survived numerous successive Treaty amendments and attempts to move to qualified majority voting.[10] In addition, the

[5] By contrast, there is an explicit tax base for harmonisation of indirect taxes under Art. 113 TFEU (ex Art. 93 EC).

[6] See Claudio M. Radaelli, 'Governance areas in EU direct tax policy' (2008) 46(2) *Journal of Common Market Studies*, 315–36, 316.

[7] There have been a number of cases where the EU legislation was challenged on the basis of misuse of one of these general Treaty bases. See Annette Schrauwen, 'Sources of EU Law for Integration in Taxation', Chapter 1 in Dennis Weber (ed.), *Traditional and Alternative Routes to European Tax Integration* (Amsterdam: IBFD, 2010).

[8] Under ex Art. 308 EC there was only a duty to consult the European Parliament.

[9] Contrast with Art. 114 TFEU (ex Art. 95 EC), in the wording of which it is expressly stated that it cannot be used for direct taxes.

[10] See, for example, the draft Treaty establishing a Constitution for Europe (Constitutional Treaty), which provided for qualified majority voting for measures on company taxation when the Council unanimously found that these measures related to administrative cooperation or combated tax fraud and tax evasion. See Art. III-63, which reads as follows: 'Where the Council of Ministers, acting unanimously on a proposal from the Commission, finds that measures on company taxation relate to administrative cooperation or combating tax fraud and tax evasion, it shall adopt, by a qualified majority, a European law

Commission has always tried to base its proposals on the basis of one of the general legislative provisions that require unanimity – Articles 115 or 352 TFEU.[11] Therefore, lack of explicit competence combined with the fiscal veto under 'proxy' bases meant that the regulation of direct taxes was left within the competence of the Member States. This is reiterated with the ratification of the Treaty of Lisbon.

In addition, international (direct) taxation in general is not as regulated as other areas such as trade or investment. In principle, every country has jurisdiction to tax however it pleases. Whilst there are regularly updated model tax treaties, such as the OECD Model Tax Convention (OECD Model)[12] or the UN Model Tax Convention (UN Model)[13] that recommend ways of allocating tax jurisdiction between the country of source and the country of residence, these models are not binding on countries[14] and are regularly updated. It is, therefore, quite understandable why, when the EEC was created in the mid-1950s, the regulation of direct taxes was not seen as a priority; nor as an option for that matter. The main priority was the removal of the distortions caused by trade barriers – hence the concentration on the harmonisation of indirect taxes.

However, there are tax obstacles that create serious impediments to the integration of the market – tax obstacles for which the international tax community and the OECD Model do not offer solutions, or not very good ones, or for which the solutions are conflicting. As far as corporate taxes are concerned, many of the problems arise from the interaction of different systems of taxation of Member States, who have different approaches

or framework law laying down these measures, provided that they are necessary for the functioning of the Internal Market and to avoid distortion of competition.

That law or framework law shall be adopted after consultation of the European Parliament and the Economic and Social Committee.'

The Constitutional Treaty was never ratified by all Member States and the Treaty of Lisbon was drafted to replace it.

[11] The same approach was followed with ex Art. 293 EC, which provided that Member States must as far as possible enter into negotiations to secure, inter alia, the abolition of double taxation. This provision has been interpreted as not having direct effect. See Case C-336/96 *Gilly* [1998] ECR I-2793, para. 16. Therefore, ex Art. 293 EC could not be used as a legal basis for direct tax legislation. In any case, this provision has now been abolished from the TFEU. See analysis in 4.3.3.

[12] OECD Model Tax Convention on Income and on Capital, last updated 2010.

[13] United Nations Model Double Taxation Convention between Developed and Developing Countries (2011).

[14] Some countries, such as the USA, have their own models. The US Model was last updated in 2006.

to the integration of shareholder and corporate taxes. For example, under the classical system profits are taxed independently in the hands of the company and its shareholders. This leads to the phenomenon of economic double taxation – that is where there is more than one tax imposed in respect of the *same income*, even if the taxes are paid by different persons, and which affects domestic and foreign shareholders the same way. By contrast, under an imputation (or tax credit) system, part of the corporation tax on distributed profits is credited against income tax, so relief to mitigate economic double taxation on dividends is given at shareholder level. Under a split-rate system, relief for economic double taxation on dividends is given at company level, as a lower rate of corporation tax applies for distributed than for retained profits. To the extent that the tax credit or the lower tax rate for distributed dividends is reserved for resident shareholders, then non-resident shareholders would incur economic double taxation. As shown in this book, the OECD Model does not offer any solutions on economic double taxation, deferring to the States' discretion in dealing with it.

Cross-border investments lead to further problems. The same person may be taxed twice by two different States over the same income. This is juridical double taxation. In the Introduction to the OECD Model this is defined 'as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods'.[15] For example, if a company is taxed on a worldwide basis, then foreign profits may be taxed in the State where they accrue (source State or, in this book, host State). The same profits may also be taxed in the State of residence of the company (residence State or, in this book, home State) leading to juridical double taxation. Similarly, cross-border passive investment income such as dividends may be taxed both in the State of the distributing company (the host State) and the State of residence of the shareholder (the home State). As will be shown in later chapters of this book, usually in such situations either the host State does not tax or does not fully tax the income, or the home State *exempts* foreign profits or gives a *credit* for the foreign (withholding) tax paid. The exemption method and the credit method are important double taxation relief mechanisms.[16] The reliefs can be provided either on a unilateral basis or a bilateral basis (through tax treaties) or on a multilateral basis (through multilateral tax agreements). Some of these reliefs are contained in the OECD Model,

[15] Introduction to the OECD Model, para. 1.
[16] See also analysis in 6.1.

whose avowed purpose is to eliminate or mitigate juridical double taxation but not economic double taxation.

From an EU perspective, whilst both phenomena themselves are problematic as the increased tax burden creates economic distortions and inefficiencies,[17] in the absence of EU legislation to remove the distortions, action cannot be taken unless the general Treaty provisions are breached. Here, as shown in later chapters, the major point of conflict that has empowered the Union (indirectly) to act is derived from a different stance on non-discrimination and the comparability of residents and non-residents. Under established international tax law and the OECD Model, residents and non-residents are not in a comparable situation. Under EU law, this cannot be assumed and has to be proved in each case.

As shown throughout this book, this deceptively simple issue of the (non–)comparability of residents and non-residents has had a huge impact on how juridical double taxation and economic double taxation are dealt with in the European Union and the ability of Member States to choose between classical systems and imputation systems of taxation. The non-discrimination principle, on its own and through the medium of specific fundamental freedoms, as interpreted by the Court of Justice, has also led to further developments, circumscribing Member States' overall powers to structure their corporate tax systems. For example, a host State may not be able to tax branches of foreign companies more heavily than resident companies. In addition, a home State may not be able to limit the availability of loss relief to resident group companies or domestic branches only – it may have to extend it to non-resident companies or branches. Similar restrictions may arise in the taxation of inbound and outbound passive investment income. A host State may no longer be able to impose withholding taxes on outbound dividends when domestic dividends are exempt. Or a home State may have to extend the imputation credit to shareholders receiving foreign dividends as well. Furthermore,

[17] See, for example, the OECD Commentary on juridical double taxation that '[i]ts harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries'. Introduction to the OECD Model, para. 1. See also American Law Institute, *Integration of the Individual and Corporate Income Taxes* (Philadelphia: Federal Income Tax Project, 1993); Treasury Department, *Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Washington Government Printing Office, 1992); Christiana HJI Panayi, *Double Taxation, Tax Treaties, Treaty Shopping and the European Community*, EUCOTAX Series (Alphen aan den Rijn: Kluwer Law International, 2007), Chapter 1.

reliefs and deferrals granted for domestic reorganisations may have to be extended to cross-border ones. Finally, Member State tax avoidance regimes now have to be drafted in a specific way so as to be proportional – broad and vague rules may no longer be accepted. All these issues are examined in Chapters 4 to 8.

This book strives to show how European Union law has become of prime importance as far as the cross-border movement of companies and the cross-border investment in such companies is concerned. Topics such as the harmonisation of the corporate tax base, the taxation of subsidiaries and branches, the taxation of passive investment income, economic and juridical double taxation, corporate reorganisations and anti-abuse rules are considered in detail. What becomes evident is that, notwithstanding the lack of competence in direct tax matters, this has become an area densely regulated as a result of both positive and negative integration. It is shown in Chapter 2 that the Union has legislated in a number of areas, including corporate tax law, where it was deemed expedient for the proper functioning of the Internal Market. Therefore, integration through proper legislative routes, that is positive integration, *does* exist, but it is scarce compared to the growing volume of case law. Topics discussed in this book illustrate how the legislative vacuum was addressed by the Court of Justice by interpreting and applying several general provisions of successive EU Treaties in the direct tax context. This is also called negative integration. In the analysis, the pivotal role of the Commission in some of the legislative and judicial developments also becomes obvious. This European institution has long been vocal on the detrimental effect of tax obstacles to the completion of the Single Market and later on the Internal Market.[18]

Notwithstanding these developments, it will be shown that the limitations of international tax law in these areas have not been eliminated under EU law. This is understandable given that the main generator of developments – the Court of Justice – can only respond to specific questions asked in litigated cases. It cannot act as a substitute legislator and construct a concrete tax system, free of the inadequacies of the current systems. As a result, there are still many tax obstacles that impede the completion of the Internal Market. This book considers some of these obstacles from a corporate angle.

[18] Although technically the two terms (as well as 'common market') are not synonymous, they tend to be used interchangeably. Broadly, these terms reflect steps towards the EU's economic integration, the common market being first, leading to the Single Market, which ultimately led to the Internal Market.

In order to understand the current situation, an overview of the historical background to some of the legislative proposals is apt. It is shown that efforts to put in place a comprehensive system for corporate taxation have long been debated, though so far none have reached fruition, with one last hope – the Common Consolidated Corporate Tax Base, which is examined in Chapter 3. By contrast, piecemeal legislative solutions (e.g. directives, conventions etc.) and soft law have always been more appealing.[19]

1.2 The historical background

The main concern of the Community, now to be called the Union, as far as corporate tax law was concerned, has always been the degree of harmonisation needed. Proposals for the harmonisation of corporate taxes have a long history. Whilst initial proposals recommended the unification of Member States' corporate tax systems with a single tax rate and a uniform tax on distributed profits, subsequent proposals moved away from harmonisation to coordination and ad hoc legislative solutions. What is evident early on is that the Community oscillated between the classical system and the imputation system, with its main focus being harmonisation rather than coordination. This is reflected in the recommendations of the various reports produced in the last fifty years.

1.2.1 The Neumark Report

In 1960 the Commission set up a committee of taxation and financial experts, under the chairmanship of Professor Fritz Neumark, to investigate all aspects of taxation in relation to the common market. The Neumark Report,[20] published in 1962, broadly recommended harmonisation of income tax, capital gains tax, corporation tax and indirect taxes, though the committee insisted that the aim was not uniformity.[21]

[19] See Franco Roccatagliata, 'The European Commission's Soft-Law Approach and its Possible Impact on EC Tax Law Interpretation', in Pasquale Pistone (ed.), *Legal Remedies in European Tax Law* (Amsterdam: IBFD, 2009). See also Chapter 2 of this book.

[20] 'Report of the Fiscal and Financial Committee' in *The EEC Reports on Tax Harmonisation* (Amsterdam: IBFD, 1963) (*Neumark Report*). For general commentary see Alex Easson, 'Harmonisation of direct taxation in the European Community: from Neumark to Ruding' (1992) 40 *Canadian Tax Journal*, 600–38, 604; Simon James and Lynne Oats, 'Tax harmonisation and the case of corporate taxation' (1998) 8(1) *Revenue Law Journal* (epublication), 50; and Sandra Eden, 'Corporate tax harmonisation in the European Community' [2000] 6 *British Tax Review*, 624–52, 627.

[21] *Neumark Report*, p. 102.

Harmonisation was not a synonym for unification to the committee.[22] The former should have been the guiding principle of the Commission's policy in tax matters. The latter should have been avoided. Complete unification of the tax systems of the Member States was not considered to be 'as necessary from the aspect of integration policy, since experience proves that on many grounds moderate differences limited to the nature (structure) and to the rate of taxes do not hinder the free play of competition'.[23]

Adopting a clearly centralist approach, the Neumark committee considered it desirable to levy the same type of single tax on income in all Member States, with the same structure of scales, even if the rates were different.[24] As far as company taxation was concerned, the committee recommended a special tax on companies. Under this proposal, retained profits would be taxed at 50 per cent,[25] whereas distributed profits would be taxed, in the form of withholding tax at source, at a recommended rate of 25 per cent and not less than 15 per cent.[26]

For distributed profits, a relatively low rate of 10–20 per cent was to be applied to EEC-resident recipient persons, who owned either registered or bearer shares. A higher rate of at least 25 per cent would apply to all other persons.[27] The Neumark committee further suggested that, if dividend recipients provided information of their identity, then the withholding tax should be reimbursed to the State in which the shareholders were domiciled.[28] It would seem that incentives for information exchange were suggested very early on.

Dividends distributed from subsidiaries to parent companies would be exempt from withholding tax, unless the parent company was established outside of the EC, or there was uncertainty whether the beneficiary of the dividends was a company or an individual. Under certain circumstances[29] dividends received by parent companies from their subsidiaries

[22] See also analysis in Adolfo Martín Jiménez, *Towards Corporate Tax Harmonization in the European Community: An Institutional and Procedural Analysis*, Series on International Taxation (London: Kluwer Law International, 1999), p. 108.

[23] *Neumark Report*, p. 102.

[24] Ibid., p. 119.

[25] That would have been a split-rate system as existing at the time in Germany. See *Neumark Report*, pp. 122–3, 139. See also Appendix F: Harmonization of the Taxes on Companies and on Dividends, written by Prof. Bernard Schendstok, who discusses in greater detail how specific elements of the proposed system can be applied.

[26] *Neumark Report*, p. 139.

[27] Ibid., pp. 139–40.

[28] Ibid.

[29] There had to be a participation of at least 15–20 per cent of the capital of the distributing company, held at least one or two years before distribution of the dividend. See generally ibid., pp. 140–1.