

TAX COMPETITION AND HARMONISATION: THE EXAMPLE OF THE EUROPEAN UNION

Daniel Deak (daniel.deak@uni-corvinus.hu)

Professor of Law, Corvinus University of Budapest, Financial and Fiscal Law
Dept.;

Research Fellow, Taxation Law and Policy Research Institute, Monash
University, Melbourne

Paper prepared for the Australasian Tax Teachers Association conference, 22
– 24 January 2007, T.C. Beirne School of Law at the University of
Queensland, Australia

A tax policy issue that has risen to the forefront of international tax debates in the past decade is the extent to which international tax regimes can or should be harmonised and the question of whether international tax competition is a good or bad thing. In respect of the latter debate, proponents argue international tax competition forces governments to utilise resources more efficiently while opponents claim it forces foreign values on national social systems, leading to an inevitable race to the bottom.

The debate is replicated to some extent within single jurisdictions such as federal countries (Australia being a leading example) and economic unions (of which the European Union is the prime example). Within a federation or union, the case for intra-jurisdiction tax competition is usually tempered by a view that the welfare of the larger entity is enhanced if competition between the parts were based on genuine commercial factors, not state-induced tax competition. And so, in most multi-part jurisdictions there have been moves to harmonise taxes and reduce tax competition.

In Australia, this is largely been accomplished through central government usurpation of State income taxing powers and adoption of a single national consumption tax. In the European Union, by way of contrast, each part has retained its own income tax and consumption tax. Harmonisation and reduction of tax competition in the Union has been pursued through a dramatically different route – the adoption of EU rules known as directives and interpretation of national tax laws by the European Court of Justice (ECJ) in light of the directives, leading to a situation where national tax changes are to a large extent dictated by judicial rulings. Initially, the European debate on harmonisation of tax systems focused not on tax competition per se but rather on the use of tax laws to avoid competition, that is, on countries using national VAT and customs laws to limit competition from foreign goods. Early EU directives and court interpretations were aimed at eliminating these barriers to a single European market.

The issue of actual tax competition within the European Community emerged in the 1980s when it has become apparent that a few small Member States, like Ireland, are inclined to offer fiscal incentives extensively and, more importantly, they are ready to assume substantial reduction in the overall tax burden, with a view to promoting investments and attracting foreign capital. As the subject of company taxation has been put in the centrepiece of the professional interest in Europe, with

particular regard to the adoption of a European Code of Conduct,¹ this paper focuses on the competition of direct taxes. The importance of the question has been even enhanced at the time of the Eastern EU enlargement when small countries have found themselves within the single European market, still on its periphery, while arriving at European cross-roads. There have been controversies as to whether new Member States should be invited to take part in the process of creating a “level playing field” of both indirect and direct taxation, or rather they will be allowed to enjoy the competitive advantage arising from tax competition even in the long run. Clearly, like in other questions, no progress can be made without reaching political consensus, even if it does not seem to be within easy reach.²

Generally, countries refuse to give up national tax jurisdiction even when they give up everything else. However, in Europe there is a group of currently 25 countries that have come together and established an economic union and, as part of that union, have agreed that the European Union can issue rules that restrict national taxing powers. There are a few rules that do this, including

- a rule that a Member State cannot impose higher taxes on goods or services from another EU country than are imposed on competing (not necessarily the same) goods or services from its own country; and
- a rule that a national tax system must not treat foreign resident EU taxpayers less favourably than its own.

This paper first outlines EU legal and tax policy. Then it will be possible to discuss how these rules have affected tax design in Europe in the past few years.

In the first major part of the paper, the subject of tax competition will be discussed while making inquiries about the primary Community law framework for direct tax harmonisation and looking for the chances of direct tax harmonisation that would be accomplished at structural issues. This analysis will be complemented by some special questions relevant to the development of European tax competition following the Eastern enlargement. The second major part of the paper addresses EU tax harmonisation, while focusing on procedural issues. As examples for the procedure-oriented way of harmonisation, the withholding taxation of the income derived via cross-border capital market transactions and the ECJ practice on the enforcement of the rights to be protected by Community law will be highlighted.

1. EU legal and tax infrastructure

(i) EU legal order

From a sociological perspective, the European Union is a kind of integration, which means that the diverse social and economic forces of Member States are put together with a view to pursuing common objectives like the peaceful co-operation of sovereign states, the protection of human rights and democratic values and free competition within the intra-Community trade. European integration assumes the values of stability, operability and consensus, as opposed to radical changes,

¹ Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy -- Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation -- Taxation of savings; OJ C 2 (06.01.98), p. 1.

² «Turquie, France, Constitution: les critiques et le plaidoyer de M. Barroso», 22 09 04, Le Monde 2004.

dysfunctions and conflicts. From a constitutional perspective, the European Union does not pretend to form a kind of federation. Its member states have set up common institutions to which they delegate some of their sovereignty so that decisions on specific matters of joint interest can be made democratically at European level.

The Community law order is based on the sources as follows:

- international public law treaties (establishing the Communities and other treaties);
 - general principles of law, customary law ;
 - secondary legislation (regulations and directives); and
 - decisions of the representatives of the Member States meeting within the Council.
- According to Article 249 of the EC Treaty, the Council, or the Council and the European Commission, shall make regulations and issue directives, take decisions, make recommendations or deliver opinions. A regulation shall have general application. It shall be binding in its entirety and directly applicable in all Member States. A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods. A decision shall be binding in its entirety upon those to whom it is addressed. Recommendations and opinions shall have no binding force.

The European Union has been able to develop its own legal system. Importantly, those provisions of the EC Treaty that create individual rights can directly be invoked by citizens (direct effect). Furthermore, where national law is in conflict with Community law, the latter prevails over the former (supremacy of Community law). The direct effect doctrine has been introduced by ECJ in the early case of *Van Gend en Loos*.³ Not much later, in the case of *Costa versus ENEL* the supremacy principle was articulated.⁴

(ii) EU tax policy

The EC Treaty, under Article 93, specifically provides for the Council to adopt provisions for the harmonisation of Member States' rules in the area of indirect taxation (principally value added tax and excise duties) because indirect taxes may

³ Case 26/62, ECR, p. 1: "The European Economic Community constitutes a new legal order of international law for the benefit of which the states have limited their sovereign rights, albeit within limited fields, and the subjects of which comprise not only the Member States but also their nationals. Independently of the legislation of Member States, Community law not only imposes obligations on individuals but is also intended to confer upon them rights which become part of their legal heritage. These rights arise not only where they are expressly granted by the treaty but also by reason of obligations which the treaty imposes in a clearly defined way upon individuals as well as upon the Member States and upon the institutions of the Community."

⁴ Case 6/64, ECR, p. 585: "By contrast with ordinary international treaties, the EEC Treaty has created its own legal system which, on the entry into force of the treaty, became an integral part of the legal systems of the Member States and which their courts are bound to apply. By creating a community of unlimited duration, having its own institutions, its own personality, its own legal capacity and capacity of representation on the international plane and, more particularly, real powers stemming from a limitation of sovereignty or a transfer of powers from the states to the Community, the Member States have limited their sovereign rights and have thus created a body of law which binds both their nationals and themselves. The integration into the laws of each Member State of provisions which derive from the Community and more generally the terms and the spirit of the Treaty, make it impossible for the states, as a corollary, to accord precedence to a unilateral and subsequent measure over a legal system accepted by them on a basis of reciprocity. Such a measure cannot therefore be inconsistent with that legal system."

create an immediate obstacle to the free movement of goods and the free supply of services within an internal market. They may also create distortions of competition. A large number of directives and regulations (i.e., “secondary legislation”) have already been agreed in this area on the basis of that Article. The Commission’s legislative strategy, particularly in respect of VAT as well as environmental and energy taxation, has been clearly established.

Unlike indirect taxes, the EC Treaty does not specifically call for direct taxes (income and corporate taxes) to be harmonised. However, Article 94 of the EC Treaty provides for approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market. In any event, national tax rules must respect the fundamental freedoms provided for the EC Treaty. Member States have also adopted EU-wide legislation in the field of mutual assistance and co-operation in tax matters, under Articles 93, 94 or 95 of the EC Treaty.

Whether or not secondary EU legislation such as directives and regulations exists, Member States’ tax systems and tax treaties must in any event respect the fundamental Treaty principles on the free movement of workers, services and capital and the freedom of establishment (Articles 39, 43, 49 and 56 of the EC Treaty) and the principle of non-discrimination. Moreover, in more general terms, Article 18 of the Treaty provides that every citizen of the Union has the right to move and reside freely within the territory of the Member States.

The tax systems in Member States also have to be in line with Community state aid rules. According to Article 87, Paragraph 1 of the EC Treaty, any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market. State aid rules apply regardless of the form the aid takes; i.e., any kind of tax relief can constitute state aid if the other criteria are fulfilled.

In general, there is no rule on international competition even within the European Union. Therefore, countries can have any tax rates they want, including zero, provided they adhere to some other rules, namely information reporting, withholding, etc. Harmonisation has still been achieved to a certain extent, in particular in the indirect tax area. In addition, harmful tax competition may be prejudiced. The 1997 “Code of Conduct for business taxation” requires Member States to refrain from introducing any new harmful tax measures (“standstill”) and amend any laws or practices that are deemed to be harmful in respect of the principles of the Code (“rollback”). The code covers tax measures (legislative, regulatory and administrative) which have, or may have, a significant impact on the location of business in the Union. The criteria for identifying potentially harmful measures include:

- an effective level of taxation which is significantly lower than the general level of taxation in the country concerned;
- tax benefits reserved for non-residents;
- tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base;

- granting of tax advantages even in the absence of any real economic activity;
- the basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD; and
- lack of transparency.

2. Tax competition

(i) Basis of primary Community law for the approximation of national direct tax laws

In a legal perspective, the question arises whether a Member State is prevented by the EC Treaty, or by any other means of primary Community law, from freely deciding on national tax legislation. It is clear from the EC Treaty that currently there is no gateway to federation. Instead, it is the principles of “subsidiarity”, “conferral” and “proportionality” (Articles 5 and 308 of EC Treaty) that are the basics of the constitutional structure. This means that no Community body as such is authorised to act on behalf of Member States unless explicitly empowered to do so. Furthermore, the taxation landscape is shadowed by the persistent way of decision-making, based on unanimous voting, and, in general, by the fact that the provisions of the EC Treaty on internal market legislation do not cover tax matters.

A tax policy that seeks to achieve co-ordination in the structural issues of direct taxation rather than confining itself to try to eliminate non-transparent tax measures cannot be interpreted but from the constitutional perspective of a federation. After then, the political power would be shared among the various instances of nation states and, as an alternative, of the regions and the union itself. Citizenship could be thus transferred to a European level while cultural identities remain with lower-level communities. The community of citizens would be separated from national traditions, the nation state from the nation. A political community of EU citizens could be organised in terms of a republic, now being developed at a European level. National identities could then be reconsidered thanks to a vast array of discourses.⁵ As long as this political scenery will not be realised, there is no room for a coherent EU-wide tax policy that would cover the essential rather than the accessory parts of direct taxation.

The constitutional environment has not been sufficiently developed for a genuine EU-based tax policy to the extent that it cannot be completed by an EU-tailored budgetary policy, including parliamentary authorisation. Levying taxes means at least two more things: voting for an order of private property and political democracy. Due to a democratic deficit within the EU, at the moment a more ambitious tax policy could be blocked quickly.

In the common market, EU Member States are in tax matters bound to the absolute prohibition of levying customs duties and equivalent charges, and of maintaining quantitative restrictions and equivalent measures (this is absolute prohibition as regulated by Article 25, 28 and 29 of EC Treaty). By contrast, it is free for Member States to levy internal dues unless they are of discriminatory or protective nature (that can be said to be relative prohibition as covered by Article 90). In this respect, it is crucial to determine internal dues, different from customs duties. An internal duty “is part of a general system of internal dues applied systematically to

⁵ Jürgen Habermas, „Warum braucht Europa eine Verfassung?“, Die Zeit, 27/2001.

categories of products in accordance with objective criteria irrespective of the origin of the products”.⁶ Knowingly, absolute and relative prohibition, or the principles of non-restriction and non-discrimination (Articles 14 and 12 of EC Treaty), have been extended by the EC Court from case to case to the direct taxation area.

The non-restriction principle can be completed by reference to the prohibition of state aid. Direct tax incentives may well be seen as illegal state aid (Article 87 of EC Treaty). They can be considered harmful to the extent that they depart from what can be seen as “the nature or general scheme of the system”.⁷ This is a benchmark as offered by the EC Court in its reasoning of the case of subsidising the Italian textile industry.⁸

It is questionable if it is possible to distinguish between harmful and non-harmful tax competition in general terms. Although in the context of a market economy, taxation is a bias per definition, it should be still possible to move from case to case by investigating individual tax law measures. Member States are in this context expected not to depart systematically and permanently what can be seen as fiscally neutral. To the extent that selectivity qualifies for illegal state aid, tax incentives that apply to a specific circle of taxpayers can certainly be prejudiced.

The issue of direct tax relief on large investment projects is extremely sensible because this is considered as regional operating aid, which is, as a rule, prohibited.⁹ Hence, the envisaged state aid is to be notified to the European Commission and the grant of relief is subject to discretion. The corporate tax relief is eventually limited up to the effective regional ceilings (as published) and the so-called eligible expenditures. It is doubtful if the procedure of granting relief is transparent. Notably, discretion cannot be avoided in circumstances where the operating aid, inconsistent with state aid rules, cannot be granted but exceptionally.

Certain handicaps in national markets have already been noted, e.g., with Ireland. As a kind of compensation for them, the normal corporate tax rate is in Ireland as high as 12.5 percent. For the new Member States, there is obviously a way to follow the Irish example whereas the national tax systems have been streamlined (harmful tax measures have been eliminated and compliance with the EC Code of Conduct and the fiscal state aid rules has been achieved in general).

Tax policy, free of discrimination, restricting on fundamental freedoms or of distorting free competition, is a taboo as long as the appropriate political consensus of Member States will be developed on the approximation of national laws. European-wide direct tax co-ordination as a political process currently focuses on the accessory

⁶ A charge described as a consumer tax which is imposed on both imported products and domestic products but in practice applies almost exclusively to imported products because domestic production is extremely small does not constitute a charge having an effect equivalent to a customs duty on imports within the meaning of Articles 9 and 12 of the EEC treaty. *Cooperativa Co-frutta* in case 193/85; ECR (1987), p. 2085.

⁷ Commission notice on the application of the state aid rules to measures relating to direct business taxation, OJ C 384 (10.12.98).

⁸ Case 173/73, *Italian Republic v Commission of the European Communities*, ECR (1974), p. 709, Para 15.

⁹ Communication from the Commission – Multi-sectoral framework on regional aid for large investment projects (OJ C 70, 19.03.02).

parts (non-transparent tax measures) of the tax system and leave the essential parts (harmonisation of the rate and basis of taxation) of a national tax system untouched. This is because tax policy as such cannot be a legitimate subject of Community legislation unless national tax laws constitute administrative obstacles to exercising one of the fundamental freedoms or free competition is endangered in any other way by national tax law measures.

A coherent European tax policy, like a policy of another subject, is in a need of legitimisation. In a modern economy, free-rider positions are subject to various corrections, no doubt. The differentiation among market-players cannot be accepted, however, unless individual performances are commensurable and institutions are transparent. Otherwise a policy, even with the nicest ideas, will become a failure the result of which can be the development of new barriers when fundamental freedoms are to be exercised. This is also true for a tax policy targeted at creating a “level playing field”.

It is another hurdle of a more ambitious policy of harmonisation that differences in national tax systems may be maintained as stated, e.g., in the ECJ case of *Gilly* (C-336/96). Also, national public authorities may be prevented from attacking the arbitrage in jurisdictions to the extent that restrictive national law measures are not in proportion to the objective that the abuse of law should be banned.¹⁰ Even if it is within the competence of Member States to allocate their power of taxation as to between themselves or to try to attack the arbitrage in jurisdictions, Member States are bound to the Community loyalty principle as enshrined in Article 10 of the EC Treaty.

The national direct tax systems of Central Europe have been to date streamlined to the extent that fiscal incentives, although applicable to capital income, are available without regard to whether income is derived by domestic or foreign-resident (corporate or individual) taxpayers. In relying on incentive measures, the tax policy of the region favours economic stabilisation over equity considerations. Admittedly, a sort of consumption-oriented income tax policy has been necessarily introduced in order to attract foreign capital. One can still hope that the conflict between efficiency and equity will be in the long run reconciled in the light of the fiscal climate friendly to investors. It will then be possible on a higher level of welfare to revisit equity issues.

(ii) Tax competition versus the division of regulatory power

In the era of a global economy, a nation state is apparently not sovereign in exercising its taxation power. Instead, it is restricted by the jurisdiction of its counterparts, competing with it. Tax competition can take place between countries or between the federal state and local governments. It occurs when individuals can choose among jurisdictions with different levels of taxation when deciding where to work, save and invest.

Even if the term of tax competition has been a common knowledge at least since the eighties, one can conclude that this term may well be misleading. The real

¹⁰ *Centros* in C-212/97, ECR (1999), p. I-1459; *Inspire Art* in C-167/01; ECR (2003), p. I-10155.

issue under discussion is of how to divide regulatory power in particular cases. Competition can be developed in a market, suggesting economic efficiency to be achieved by parties in individual cases, providing the supply of goods or services for due compensation. Being in competition with each other, contracting parties hope to be successful where the scarcely available means are managed, based on instrumental rationality. Whereas the logic of competition and venture is extended without further considerations to an area where the subjects of competition (like national legal systems) are not fungible, the term of competition should certainly lead to confusion.

The concept of competition cannot be dissimilated from the principle of self-regulation that takes place in terms of the fluctuation of prices that are ideally balanced, at least in the long run. Where legal systems compete with each other, the mechanism of self-regulation is meaningless. Legal systems do not reach, and are not directed to arrive at, a kind of balance. Similarly, the compensation payable for the supply of the services arising from the smooth operation of a legal system cannot be interpreted. The competition of tax, or more importantly, of legal systems is hence a metaphor which seems to be appropriate, but which is in fact of limited value.

Tax harmonisation can be achieved in two different ways. By positive (explicit or deliberate) harmonisation, the harmonisation to be achieved in tax policy is aimed at approximating the substantive tax laws of Member States and addresses comprehensive statutory-law regulations. Negative (implicit or spontaneous) harmonisation occurs when tax policy merely relies on transparency and equivalency in national laws. This approach actually leads to a minimum programme of legislative harmonisation.

There may be some differences in the concepts of tax competition: In the OECD conception, it is no taxation or a very low level of tax rates (in a tax haven) that is addressed as harmful tax competition. In the EU, the lower level of taxation is to be determined in relationship to the general tax rate applicable in the affected country. The question is then about a significantly lower level of taxation than the one which generally applies in that Member State. Since there is no reference to the specific level of taxation in other Member States, the overall rate of taxation in a Member State may be very low.

The harshness of an EU-adjusted tax policy designed to achieve structural coherence can be alleviated where an ideal overall tax burden is sought on a floating basis, depending on the ever-changing average of national tax rates. Low taxation that would be vulnerable in the light of the “level playing field” could thus be determined as a bias from the average. It would then be possible to fix a maximum disparity between the lowest tax rate applied by a Member State and the average tax rate applied by other Member States. This way, the approximation of corporate tax rates could rely on a normative basis instead of an arbitrarily fixed statutory limit, requiring individual interventions, and the minimal possible tax rate would depend on the movements of the tax rates in other Member States.¹¹

¹¹ F. Vanistendael, “Memorandum on the taxing powers of the European Union”, EC Tax Review, Vol. 11, No. 3/2002, p. 124.

(iii) “Level playing field” policy in the perspective of comparative jurisprudence and constitutionalisation

In the absence of federation, it is not realistic very much to expect the expansion of EU law prevailing over national law, with an emphasis on a coherent tax policy. An ambitious EU-wide tax policy (in particular, harmonisation of the rate and basis of company taxation) can be envisaged as the product of the development of the co-ordinated Community tax law, emerging over the level of national tax legislation. The phenomenon of a coherent Community tax law might be interpreted from the perspective of the comparative law, based on the precept on historic progress and the idea of “the common law of mankind”, or a type of “world law”, which assumes that national legislation can be superseded by relying on the common European legal heritage: the Latin language, currently the English, the modern “lingua franca”, the reception of Roman law definitions, the autonomy of professional and academic institutions, etc. This evolution cannot take place unless it will be possible to get rid of the burdensome legacy of the enlightenment, that is, from the tradition that legal institutions have strictly been developed within the framework of national systems isolated from each other, and that they have been strongly established on the detailed and all-embracing prescription of statutory provisions, not leaving room for more flexible legal practices to be developed by the profession itself.¹²

The primary EU law can be seen as a constitution in formation. The European Court of Justice has elaborated the direct enforcing effect (of Community law provisions) and supremacy (of Community law over the domestic law of Member States) as key-concepts defining the hierarchy of norms between the national and Community legal order. In addition to treaty provisions, the protection of human rights may also be claimed before ECJ. This way, all the more room is available for constitutional engineering.

So far as the development of a constitutional framework for a European integration can be recognised, it is logical not simply to invoke cross-border freedoms of trade but also to claim the approximation of the laws of Member States, a means of institutional co-operation, to complete the area of free competition. Although deliberate harmonisation is inevitable in proceeding with the drafts of constitutional institutions, it is not precluded that spontaneous harmonisation, and less statutory law-based activity, can also be justified in a constitutional setting.

Preferring contractual revision over the formal mode of constitutional changes, proponents of free competition will be more sceptical about harmonisation. They may argue, the constitutional setting can be developed smoothly, yet provided that a polity, in our case the European Union, has reached a high degree of constitutional consensus and the constitutional reform does not target total revision. Where these assumptions will not be fulfilled due to competing identities, market segmentation, political conflicts as well as diversity and democratic deficit, the adequate mode of

¹² Glanz, Reichtum und Fortschritt überall hatten der Welt und damit auch der Wissenschaft eine unbeirrte Fortschrittsgläubigkeit vermittelt. ... Was sich Lambert und Saleilles nämlich vorstellten, ist die Entwicklung eines ‚droit commun de l’humanité‘, eines Weltrechts“, Konrad Zweigert, Hein Kötz, Einführung in die Rechtsvergleichung auf dem Gebiete des Privatrechts, Tübingen: J.C.B. Mohr (Paul Siebeck), 1996 (3. Aufl.), p. 2.

institution-building is the contractual one.¹³ In this context, the deliberate (explicit) harmonisation idea of Community law, including tax law, will, of course, wither.

In theory, much stress is to be laid on the harmonisation as a means of making a coherent Community law order by integration through law. The political order of EU fundamentally suffers, however, from the lack of political legitimacy. In the absence of the forms and ends of their political unit, Member States cannot see for the time being in what constitutional conditions the political power will be negotiated by them to a Community-level. Then, it is only realistic to take small steps by way of contractual revision, in the process of mutual consensus.

In a pragmatic rather than State-centred, formal way, it is also important to emphasise that in practice legal measures are to be complemented by social values. The legal body of the “*acquis communautaire*” (the set of Community law measures and practices developed so far) is to be perceived associated with social practices. This body is therefore best conceptualised as the “*embedded acquis*”. In reality, a change in the Community law as it stands includes not only the expansion of formal resources, like changes in directives or regulations adopted by the Council or the Commission. The other element relevant to the “*embedded acquis*” encompasses formalisation based on routinised practices or policy objectives, or the constitutionalisation of informal resources, like political ideas or values of shared principles. The “*embedded acquis*” is therefore a transmission belt between political processes and constitution-making.¹⁴ In this context, explicit harmonisation, even if far-reaching, cannot be hoped successful but in cases where it complies with its social and business environment.

(iv) Conclusions: abstaining from structural tax harmonisation

There is no reason to distinguish between the so-called harmful and non-harmful tax competition, once it is assumed that non-harmful tax competition is also to distort free competition. Any progress that can be made in the area of direct tax policy while moving from the transparency-oriented tax policy to a structural policy is therefore welcome.¹⁵ Hence, the idea of a coherent European tax policy is quite convincing.

The conditions for its realisation cannot be seen on the horizon, however, for the following reasons at least:

(i) The political and legal infrastructure necessary for the realisation of this policy is still missing. Once the democratic deficit could be eliminated by creating an institutional framework for the genuine European political representation, a European-wide coherent tax policy would be developed within the framework of well-established constitutional institutions.

(ii) It is not yet realistic to argue for a coherent European direct tax policy that could be interpreted in the perspective of the comparative law concept of “the common law

¹³ H. Abromeit, T. Hitzel-Cassagnes, “Constitutional change and contractual revision: Principles and procedures”, 5 *European Law Journal* 1 (March 1999), p. 41.

¹⁴ A. Wiener, “The embedded *acquis communautaire*: transmission belt and prism of new governance”, 4 *European Law Journal* 3 (September 1998), p. 303.

¹⁵ F. Vanistendael, “Janus with two faces, or the many faces of tax competition”, ERA conference paper, Trier: 2004, p. 10.

of mankind“. More success can be hoped, provided that it would be possible to get rid of nationalistic seclusion and the State-centred way of legislation.

(iii) Under the current circumstances, a more ambitious European tax policy could rely on the bureaucratic co-ordination of the big Member States only who could behave themselves like a brave prince who is to relieve its subjects from the fluctuation of market prices by fixing the allegedly just prices. That would be a kind state socialism, which is not held in good memories at least in new Member States. In the circumstances of an incomplete constitutional landscape, it is a contractarian way of institution-building that seems to be a viable means of achieving some approximation of national laws even in the field of direct taxation, full of sensitive issues.

3. Special issues related to tax competition

There are a few particular considerations of tax competition, which can be of high importance to Central European Member States. Particular consideration can be given in this respect to the relationship between the law of double tax treaties and harmonized Community law. It is important to take into consideration the interaction of the two layers of tax legislation. Therefore, one has to focus not only on certain tax treaty provisions, but also on national law. A particular reason why national law cannot be neglected is that the law of double tax treaties is far from being fully fledged. Taking into account that a number of Central European Member States have introduced low corporate tax rates, the same treaty provisions may have an impact on taxpayers in a Central European source-country context significantly different from that on taxpayers in a non-Central European source-country context. A kind of “communitisation” directive might be useful which would be addressed to two major issues:

- the national rules of a deferred company tax (if introduced in a Member State, like in Estonia or earlier in Greece) should be brought into conformity with Community law; and
- high-tax Member States (like the UK, Germany or France) need be prevented from legislating CFC rules that restrict on fundamental freedoms (as reflected in the recent ECJ case of *Cadbury Schweppes*, C-196/04).

Both the difference in taxation regimes and unilateral anti-avoidance measures can be subject to ECJ scrutiny for the purposes of applying the non-restriction principle, as discussed below. Central European Member States can be affected in the first case in terms of their levy of withholding tax to be limited by EC law, in the second case in respect of suffering from unilateral CFC sanctions coming from other Member States. As far as the first case is concerned, a deferred company tax can be interpreted as a non-restriction issue. Namely, it can be prejudiced on the grounds that those who claim distribution may suffer from arbitrary tax treatment in a host country, even if dividends received are re-invested. In the second case, in contrast to the first one, Central European countries may be protected by the Community law preventing high-tax Member States from applying CFC rules, restrictive on the right of establishment, available for cross-border investors.

(i) Deferred corporate tax versus the EC prohibition of outbound dividend taxation

It is in the centrepiece of designing a national tax policy with regard to competitiveness to maintain the corporate tax burden – a characteristic signal of the investment climate for foreign investors -- on such a low level as possible. The reduction in corporate tax can even reach a level where it is close to be zero. An example for this is the deferred corporate tax in Estonia. Tax is not payable unless distribution is made. The Estonian company tax system is simple: it lies on cash-basis accounting and does not include special rules for amortisation and depreciation. The Commercial Code provides that dividends may be paid out of net profit of a company, but only after the deduction of losses from previous years. Hence, there is no need for special tax provisions on loss carry forward.¹⁶

Consistency of a company tax policy in enforcing a kind of consumption-oriented direct tax can be limited in a particular Community law context. To the extent that the company tax to be levied on distribution can be seen as a kind of withholding tax on cross-border dividends, which is prohibited in certain conditions by the Parent and Subsidiary Directive,¹⁷ the national company tax policy can be hampered by Community law. Countries like Estonia can thus be prevented by Community law from applying a direct tax on distribution to be considered as withholding tax on outbound dividends (during the accession negotiations, Estonia has been granted derogation, namely the right to transitorily apply its company tax as it was before accession, found as not being in conformity with the Parent and Subsidiary Directive until 2009). Estonia will then need to introduce company tax in the normal sense. The country may nevertheless continue to be interested in maintaining corporate tax on as low level as possible with a view to preserving competitiveness.

Arguably, the impact of Community law on national legislation, affected by the prohibition of taxing cross-border dividends, is not the result of a deliberate Community-policy. The EC prohibition of withholding tax on cross-border dividends has been introduced in order to eliminate international double taxation in the single European market. It has been introduced in the milieu in which the tax policy was inclined to eliminate economic double taxation as well. In this respect, the tax policy is designed not to encourage the retention of profits. On the contrary, the basic idea is to stimulate distribution (e.g., by applying in Germany split-rate corporate tax until the 2002 tax reform). Although the Parent and Subsidiary Directive is not concerned about the overall reduction in the corporate tax at all, it does precisely result in preventing low-tax countries from applying a kind of deferred corporate tax.

The EC Court held in a case commonly known as *Greek Amstel* case that the tax on distribution is a kind of withholding tax, covered by the prohibition of the Directive, even if it is the corporation that is liable to pay this tax.¹⁸ That was the case until 1997 in Greece where it was required by law to divide the corporate tax base into two portions, depending on whether profits were retained or distributed. In

¹⁶ I. Vanasaun, "Taxation of transnational income: harmonisation of dividend taxation and transfer pricing regulations", Conference report, University of Bologna: 2004, p. 4.

¹⁷ Directive 90/435/EEC, OJ L 225, (20.08.90), p. 6.

¹⁸ C-294/99; European Court Reports (2001), page I-06797.

other words, a corporate taxpayer was allowed to constitute a tax-free reserve in respect of the profits retained. As a consequence, the corporate tax was to be increased by the tax base in proportion to the distributable profit upon distribution. The EC Court realised that the Greek tax on distribution was isolated from the normal corporate tax liability. For example, it was not effected by loss carry over. It was eventually taken out of consideration by the EC Court that

- it was the company itself that was obliged by law to pay the tax on distribution; and
- the company was not only to effect distribution but it was also obliged to finance the tax on it.

The EC Court focused on the facts that tax was levied upon distribution and the calculation of tax liability depended exclusively on the size of distribution. Interestingly, the Greek tax was covered by Article 10 on dividends of the Greece – Netherlands double tax convention. This is a fact that suggests that the Greek tax under discussion is not a kind of corporate tax. However, the Article in question provided for zero-rate dividend tax. This is another fact, now suggesting that the Greek tax under discussion is not a kind of withholding tax.

Interestingly, the Estonian deferred corporate tax is no isolated phenomenon. Although depreciation does not apply, losses must be deducted from previous years' profits (even if by means of the operation of not tax law, but company law or commercial accounting). The European Commission found it, however, as a kind of withholding tax to be affected by the Parent and Subsidiary Directive.

The Commission may have another reason for not accepting the concept of deferred corporate tax: a deferred company tax can also be interpreted as a non-discrimination, or rather a non-restriction issue. The institution of deferred company tax could then be prejudiced on the grounds that those who claim distribution may suffer from arbitrary tax treatment, even if the dividends received are re-invested. Discrimination cannot be legitimised where the profits distributed may well be used for financing further development, although in terms of another company, in the same way as if the subsidiary's profits had been retained.

Hungary also introduced for 1995 a composite corporate tax where the basic tax was 18 percent and the supplementary tax was levied at a 23 rate on distribution. The actual tax liability was 33 percent because the company itself incurred the financial burden of both the distribution and the tax on it.¹⁹ The Hungarian Finance Ministry argued at that time that the supplementary tax was considered as dividend withholding tax with a view to securing foreign investors the possibility to reduce the supplementary tax by way of a relevant double tax treaty. Foreign tax authorities – like Austria – were hesitant in accepting the Hungarian qualification of the corporate tax as the withholding tax payable by the foreign parent. The qualification of the Hungarian supplementary tax for treaty purposes as a withholding tax was challenged for the reason that – not to mention that it was the company that incurred the legal and financial burden of paying tax – the Hungarian national law provided for genuine withholding tax on dividends, although at a zero corporate tax-rate at that time. It was

¹⁹ $100 \times 0.18 = 18$; $(100-18) \times 100/(100+23) = 67$; $67 \times 0.23 = 15$; $18 + 15 = 33$; D. Deak, "Supplementary corporate tax in Hungary: Confusion for foreign investors", 11 Tax Notes International (December 4, 1995), 23/1995.

clearly the latter that would have been subject in fact to treaty reduction if the Hungarian tax had been more than zero.

Notably, the British pre1999 ACT or the French equalisation tax [a tax to be levied as a substitute for normal corporate tax in certain conditions, duly covered by Article 7 (1) of the Directive], cannot be considered to be withholding taxes. The ACT was taken into account while the mainstream corporate tax was calculated and the French equalisation tax is calculated under the normal corporate tax rules. They are thus not isolated from normal corporate tax calculation, unlike the Greek tax under discussion.

Similarly, the domestic tax credit to be extended to foreigners by a relevant double tax treaty is also covered by the Directive. According to Article 7 (2), they cannot be considered as withholding taxes either. In the *Océ* case, neither the British ACT, nor the British tax credit was prejudiced by the EC Court. However, the 5 percent UK withholding tax, to be levied on the dividends paid out, and grossed up by the ACT, was seen as prohibited by the Directive in respect of the withholding tax levied on dividends.²⁰

(ii) CFC legislation: a possible means of repercussion?

CFC legislation can be a reaction of high-tax Member States, adverse to the treasury interests of the low-tax Member States. This way, low-tax countries could be invited to accept moderation in their tax policies even in the absence of Community-wide measures. It is doubtful, however, whether the CFC measures of single Member States can be reconciled with the fundamental EC freedoms. CFC rules that constitute special regulations for low-taxed entities with passive income are not justifiable under Community law. Notably, a breach of a fundamental freedom can be condemned if the legal regulation is not special in nature, which is clearly not the case with a typical CFC law.²¹ The arguments for the loss of revenue, because of the overall low burden of direct taxes, those for fiscal cohesion, with regard to the domestic-resident's tax liability in the home country and the low-tax status of the subsidiary, or those for the application of restrictions on the grounds of attacking the abuse of law are not sufficient for justifying the restriction on a fundamental EC freedom (in particular, on the right of establishment or on the free movement of capital). As recently explicitly decided by ECJ, CFC legislation cannot be justified unless it is specifically addressed to artificial transactions. Reference to tax avoidance is not sufficient on the European scene longer for defending CFC legislation.²² National CFC law restrictions on fundamental freedoms could be legitimised by relying on a single Community law only that would be targeted at structural issues, which has not been the case to date.

Any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter state.²³ CFC measures or LOB (limitation on benefits) provisions of high-tax Member States should not prevent

²⁰ C-58/01; European Court Reports (2003), p. I-09809.

²¹ M. Lang, "CFC legislation and Community law", 42 European Taxation 9 (September 2002), p. 379.

²² *Cadbury Schweppes*, C-196/04, ECR (2006), not yet reported.

²³ *Eurowings* in C-294/97, ECR (1999), p. I-07447.

investors from entering a Central European Member State while exercising the right of establishment. The identification of the infringement of fundamental EC freedoms is one side of the coin. On the other side, the treaty law as such is asserted by the EC Court in the case of *Gilly*²⁴ or in the *D.* case as not affected by Community law either.²⁵

Apart from a Community-law context, the relationship between the national CFC legislation and a double tax treaty is in an individual case an open issue.²⁶ It is in this respect noteworthy that the basic function of a double tax convention is to divide taxation powers between the affected contracting states. Accordingly, in the *Schneider* decision, the French CFC rule cannot apply because both the legal and real seat of the taxpayer's subsidiary is in Switzerland and it does not have a fiscal nexus in France through a French-operating permanent establishment either. Alternatively, a double tax treaty can be interpreted as a legal instrument, one of the basic functions of which is to combat the abuse of law. Accordingly, in a Finnish decision, the Finnish CFC rule was mobilised in order to combat a Belgian co-ordination centre.²⁷ Notably, the principle of the prohibition of extraterritorial taxation applies to the source country (and not to the residence country) and to the local subsidiary (and not to the foreign parent).²⁸

4. New avenues to EU harmonisation

(i) Shifts in emphasis of harmonisation policy

The harmonisation policy of the EC, later the EU, went through several phases of development. One of major developments is the adoption of the Technical

²⁴ C-336/96, ECR (1998), p. I-02793, Para 3: "On a proper construction, Article 48 of the Treaty does not preclude the application of a tax credit mechanism such as that provided for in Article 20(2)(a)(cc) of the Convention between the French Republic and the Federal Republic of Germany for the avoidance of double taxation. ... It is not disputed that any unfavourable consequences entailed in certain cases by the tax credit mechanism set up by the bilateral convention, as implemented in the context of the tax system of the State of residence, are the result in the first place of the differences between the tax scales of the member states concerned, and, in the absence of any Community legislation in the field, the determination of those scales is a matter for the member states."

²⁵ C-376/03, ECR (2005), p. I-05821, Paras 61-63: "The fact that those reciprocal rights and obligations apply only to persons resident in one of the two Contracting member states is an inherent consequence of bilateral double taxation conventions. ... A rule such as that laid down in Article 25(3) of the Belgium-Netherlands Convention cannot be regarded as a benefit separable from the remainder of the Convention, but is an integral part thereof and contributes to its overall balance. ... Articles 56 EC and 58 EC do not preclude a rule laid down by a bilateral convention for the avoidance of double taxation such as the rule at issue in the main proceedings from not being extended, in a situation and in circumstances such as those in the main proceedings, to nationals of a member state which is not party to that convention."

²⁶ M. Lang, "CFC regulations and double taxation treaties", 57 IBFD Bulletin 2 (February 2003), pp. 57-58.

²⁷ *Société Schneider Electric*, 28 June 2002, Conseil d'Etat No. 232276, 4 Internat'l Tax Law Reports 2002, at 1077; Oyj Abp, 20 March 2002, KHO-2002-26, Supreme Administrative Court of Finland, 4 Internat'l Tax Law Reports 2002, at 1009.

²⁸ OECD Commentary on Article 10, Para 37: "It might be argued that where the taxpayer's country of residence, pursuant to its counteracting measures (such as sub-Part F legislation in the United States), seeks to tax profits which have not been distributed it is acting contrary to the provisions of paragraph 5. However, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under a counteracting legislation. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder."

Standards Directive (Dir. 83/189 EEC, as codified subsequently by Dir. 98/34 EC), breaking a path for the so-called new approach.²⁹ According to it, particular emphasis is placed on the national legislator with reference to the subsidiarity principle. Community law-making appears to be necessary, provided, however, where no equivalence can be secured longer in any other way between national laws. Following the accession in 2004 of ten new Member States and the accession negotiation with even more candidate countries, the process of the harmonisation of Community law has slowed down significantly. Arguably, the main reason for that is not the Eastern enlargement. It is the old structural problems, which have been more conspicuous in the light of the enlargement. The problems of enlargement have made it quite clear that the process of harmonizing Community law has stuck due to the significant decrease in the support of harmonisation on the side of the Member States themselves, at least in the old way.

The legal policy background for harmonisation has been remarkably changed in the recent two or three years. First, one can realise that the EC Court lays all the more stress on the application, rather than on the interpretation of Community law. A good example for this is the ECJ judgment in the *Marks & Spencer* case (C-446/03). As a matter of principle, the taxpayer's claim has been rejected that a type of group relief could be extended to the losses sustained by foreign subsidiaries in the absence of a fiscal nexus the subsidiary may have established with the (parent's) home country. However, in the instance that the losses under discussion cannot be taken into account either on the level of the domestic parent or on that of the foreign subsidiary, the parent should be allowed to get access to the relief relating to the losses sustained by the foreign subsidiary. The assumption of the particular facts constitutes a basis for the taxpayer's claim, although the taxpayer's right to foreign tax relief has not been accepted as such. The court was thus reluctant to arrive at the interpretation of the Community law that would have created for the claimant legal protection in general terms. Instead, the court, applying the Community law to specific circumstances, concluded that one must not accept a situation where the taxpayer cannot get access to loss relief in any instance, as a result of the unfortunate combination of national jurisdictions (not to mention the economic situation in which no losses can be carried forward in a certain time period for the lack of sufficient profit). The national legislations themselves have not been condemned. Objection has been raised only in connection with the impact of the interaction of national jurisdictions on the peculiar case where the taxpayer was hampered from exercising one or more of the fundamental freedoms.

Harmonisation can be seen, based on an avant-garde and a rather sceptical approach. In the first case, one can argue that

- disparities may reach a level on which they cannot be tolerated longer because they constitute serious obstacles to the smooth operation of the internal European market (see, e.g., the current Irish company tax regime); therefore, structural harmonisation would be welcome in the field of the taxation of corporations operating European-wide;

²⁹ This directive invented the method of legislation that technical standards are introduced nationally, although they are subject to a stand-still period when comments may be made by other Member States on the national standards to be introduced. Final introduction is only possible following a successful monitoring period.

- the distinction between domestic and foreign resident taxpayers or by reason of the location of investment is not necessarily of relevance in all instances (e.g., “*Avoir fiscal*” case in 270/83, *Saint-Gobain* in C-307/97); certain differences in bilateral treaties where leading to discrimination cannot be maintained (e.g., *Gottardo* in C-55/00); and
- enterprises must not be discouraged by disproportionately restrictive national tax legislation from making investment in another Member State (*AMID* in C-141/99, *Bosal* in C-168/01, *Anneliese Lenz* in C-315/02, *Manninen* in C-319/02, *De Lasteyrie du Saillant* in C-9/02, *Centros* in C-212/97, *SEVIC* in C-411/03).

On the contrary, doubts on harmonisation can be cast in the following:

- disparities cannot be identified to obstacles (e.g., *Gilly* in C-336/96, *Eurowings* in C-294/97);
- the distinction between domestic and foreign resident taxpayers, or differences in bilateral tax treaties, is certainly of relevance (e.g., *D.* case, in C-376/03); and
- restrictive national legislation cannot be identified in the absence of a fiscal nexus with the home country (e.g., *Marks & Spencer*).

Examples for the second approach have been recently ample. As a consequence, to date the judicial interpretation of Community tax law has been dubious.

The areas of the application of Community law has been increasing where the predictive character of legal norms has been blurred. An example for this is the legal treatment of state aid, which is in principle illegal. However, exceptionally, state aid can be seen as legal (compatible with the internal market) either automatically or on the basis of block exemptions. Although the European Commission has been making efforts to achieve transparency, it is hardly possible to envisage all the circumstances relevant to the decision in a particular case whether the state aid to be introduced is legal, as mentioned.

(ii) Substantive law versus the emergence of the procedural aspect of harmonisation

Following the so-called new approach to harmonisation, it has been very important for the Member States to find a balance between the different levels of regulatory powers. It is certainly not the ideal that the laws of different Member States must be the same. It is recommendable instead to find equivalence in the legal order developed in the national legislation of Member States. Even if national laws are different, they must not weaken the impact of each other’s laws and they must not endanger the smooth operation of the internal market. To date, the notion of harmonisation has been subtle in the sense that the higher-level approximation is usually confined to the design of a legal framework only, which can then be filled by implementing rules that can apply differently in different Member States. Co-operation and enforcement – as recognised in MiFID in the area of the legal regulation of capital market transactions – is a further step of doing harmonisation in a more diverse way.³⁰

The approximation of national laws in order to remove the obstacles of the exercise of fundamental freedoms can take place in different forms. MiFID is a good

³⁰ 2004/39/EC, OJ L 145 (30.04.04), p.1.

example to show that the approximation of national laws need not be uniform. The introduction by the Maastricht Treaty of the so-called two-speed Europe (as covered by Article 11 of EC Treaty) has created the possibility for the Community legislation, which does not apply necessarily uniformly to all Member States. According to Recital 64 of MiFID, new legislative techniques need be introduced, based on a four-level approach, comprising framework principles, implementing measures, co-operation and enforcement. Level 1, that is, the Directive, should confine itself to broad “framework” principles while Level 2 should contain technical implementing measures to be adopted by the Commission with the assistance of a committee. It may also be used by the Member States to introduce local regulations with a view to implementing Community law. Level 3 can address the provision of information, mutual agreements and the various forms of legal assistance and co-operation across the border. Level 4 is to provide all the facilities necessary to the easy enforcement of right and obligations.

The approximation of national substantive laws may be converted at the end of a harmonisation process into purely procedural issues. Differences in substantive laws need not necessarily be removed. What is important for the players of the internal market is to enjoy a playing field, which is not simply level, but which provides the participants with the opportunity of making agreements, using models and options, entering into qualified status, etc. The complexity of legal rules may lead to cases where law cannot provide longer parties in advance with guidance in a uniform, comprehensive and categorical way. These parties need be provided with the opportunity of starting negotiations with each other and with public authorities, trying to find solutions via bargaining. Advance rulings may be helpful with bridging over the gap experienced in stiff substantive laws.

Paradoxically, substantive law problems can be managed by way of offering procedures. It is then for the parties to start making use of an offer. This way, social players do not simply bear in mind the application of laws while respecting them. They are invited to be active in shaping the legal environment appropriate for them by way of communication. From the outset, there are disparities arising from the vital differences in substantive laws. They will not be removed once and for all. Actually they will not be removed at all. However, they will be put in the context of procedures available to parties. Then, the actual meaning, and in particular the impact, of the same laws will still be modified. For instance, a foreign resident financial intermediary may present itself as a qualified intermediary, that is, it may take steps to domesticate itself in the host country in order to benefit from the host country infrastructure as if it were domestic-resident therein. Foreign intermediaries will not be treated in the same way as normal domestic players. They can negotiate, however, a status comparable to domestic ones.

It is difficult to find equivalence and consistency in modern law. Legal notions seem to be sometimes too rigid. Then they will be replaced by a more flexible set of categories, which can provide a basis for the re-arrangements to be made if necessary, depending on the changing circumstances. An example for this is the introduction in 1996 in the American tax law of the check-the-box regulations.³¹ Based on them, certain business entities may elect to classify themselves for federal

³¹ 26 C.F.R. Sec. 301.7701 of Treasury Regulations.

income tax purposes as corporate taxpayers or flow-through entities. The regulations have brought about solution for the incomplete efforts of the legislator to deliver distinction between corporate and non-corporate taxpayers, just based on a purely conceptual framework. After then, valid law is evolving in a process of internal decisions of the affected parties.

(iii) Simplified and alternative procedures of tax withholding

To date, the national legislation of EU Member States may well constitute obstacles to the exercise of fundamental freedoms in the European securities markets, the main components of which can be enumerated in the following:

- national withholding tax rules can vary widely and, for the lack of approximation, differences in national laws may constitute obstacles to the functioning of the internal market; disparities cannot be removed but by way of harmonisation, if any; and
- national laws may be restrictive on fundamental freedoms to the extent that the procedures for claiming tax treaty relief are often not efficient (e.g., because of the establishment of a refund system) or they may be discriminatory for foreign financial intermediaries.

In considering the above difficulties, one can argue for streamlining national tax legislation. Examples for this can be mentioned in particular as follows:

- in certain jurisdictions (e.g., in Germany), there are quick refund procedures;
- various forms of simplified optional or lump-sum taxation (e.g., in France) may be in effect;
- KYC (know your customer) rules can be applied or QI (qualified intermediary) status can be held (e.g., in the USA or Ireland); and
- gross income payment is possible in a system of suspended tax liability.

Under the German “quick refund” procedure, income is initially paid net of withholding tax at the maximum rate and refunds are made by the withholding agent before the expiry of the period for transferring the withheld taxes to tax authorities. In France, domestic resident taxpayers have an option when they receive income from debt securities of European issuers between a taxation of 16% (plus 11% for social security contributions) or normal progressive income tax. When a paying agent is resident in France, this lump-sum tax is made by the paying agent in the same conditions, no matter whether applying for the income from non-French issuers. Where the paying agent is resident in Europe other than in France, the tax return and the payment are carried out by the French beneficial owner or by the foreign paying agent elected by the beneficial owner. Foreign paying agents may still sign a contract with the French tax administration to accomplish the formalities in terms of filing for tax returns and arranging for payments. In addition to the above, a further possibility is for a jurisdiction that the taxpayer is subject to a kind of advance tax, which can be final, depending on the taxpayer’s option. Also, relief can be used immediately by the financial intermediary, while remaining responsible for the correct calculation of tax withholding.

KYC rules are applied by financial intermediaries to identify their clients and ascertain relevant information pertinent to doing financial business with them. Typically, KYC rules is the product of a policy implemented to conform to a customer identification programme introduced first in the USA. KYC policies have

become increasingly important globally to prevent identity theft, fraud, money laundering, terrorist financing and fiscal evasion. A qualified intermediary is any foreign intermediary (or foreign branch of a U.S. intermediary) that has entered into a qualified intermediary withholding agreement with the Internal Revenue Service. One may treat a QI as a payee to the extent the entity assumes primary withholding responsibility or the legally required reporting and backup withholding responsibility for a payment. This entity is entitled to certain simplified withholding and reporting rules.

A U.S. Depository Trust Company (DTC) applies a simplified collective refund procedure for U.S. resident investors in respect of certain publicly traded securities of several European source countries. This refund procedure works with the help of the DTC's "Elective Dividend System". Each participant of DTC informs the DTC entity at the record date about the shares held by investors and about the applicable tax treaty rates. The DTC entity claims a collective refund at the home country's tax authority and distributes the payments received to the participants, who forward them to their customers.

Simplified optional taxation, KYC rules, QI status or similar legal standards represent alternatives for the burdensome normal procedures of tax administration. In operation, a balance of interests can be found between the tax administration (tax collection should be efficient) and the taxpayer who makes cross-border investment that must not be hampered by tax and administrative barriers. These alternative procedures do not affect the division of taxation power between the different levels of public authorities. However, they bridge over the gap arising from the lack of confidence in cross-border cases. They may bring about for investors or intermediaries extra burden initially. After then, however, a simplified tax treatment serves for the convenience of all affected parties.

Direct and indirect schemes of investment can be conceived where the liability to deduct tax rests with the paying agent acting for the issuer of securities or some times with the local custodian. In the latter case, the paying agent makes a payment in gross to the domestic custodian and it is the custodian to whom the responsibility of tax deduction is allocated. Nevertheless, such a situation cannot occur in certain countries. This is because – in the absence of recognised intermediaries -- once someone deemed to be a paying agent for tax purposes is inserted, he or she is immediately liable to deduct tax. However, the system of gross income payment alleviates the administrative burden for investors. This is a kind of suspended tax liability, which could provide a further alternative to burdensome tax formalities.

(iv) Emergence of procedural issues in the ECJ practice

Taking into account the difficulties in implementing double tax treaties, the disparities of national legislations in EU Member States, the heavy compliance burden in cross-border tax matters, the emergence of the reporting issues rather than that of distributive rules³² or the stress laid by the EC Court of Justice on the application of the EC Treaty to specific cases instead of interpreting it in abstract terms, the

³² In this respect, the Interest Savings Taxation Directive -- 03/49/EC (as amended), OJ L 157 (26.06.03), p. 49 --, and the Money Laundering Directive -- Council Directive 91/308/EEC (as amended), OJ L 166 (28.06.91), p. 1 -- can be highlighted.

procedural issues have been of growing importance. Then the second-order effects of legal regulations deserve more attention in a world where direct prescription has been blurred in many aspects. Where national legal practices may restrict on fundamental freedoms, it is all the more important to give attention to the procedural side of the taxation problems as it is clear, among other things, from the *Fokus Bank* judgment of the EFTA Court.³³

This case concerns the denial of the procedural rights of shareholders resident in a foreign country (in another contracting state). The problem has been developed as a tax avoidance issue. No one can encroach on the right of the national tax administration of one country to try to combat tax avoidance related to dividend stripping. However, in the current case, the Norwegian tax administration dealt with the domestic resident subsidiary only, depriving the non-Norwegian parent companies from their right to appeal to the decision. The national legal system may be rigid enough by not recognising the fiscal nexus of the foreign resident taxpayer with the source country which would be necessary for this taxpayer to try to enforce rights in that country. For the host country's national tax administration it seems to be sufficient to contact the local subsidiary. However, the interests of the subsidiary are not necessarily the same as those of the parent. In such a case, the parent company may remain without legal protection in the absence of a taxpayer's status to be held in the host country.

The host country's tax administration may not be willing to apply the national tax rules to non-domestic entities without a fiscal nexus therein. For instance, in the *Marks & Spencer* case,³⁴ the EC Court of Justice held that the UK is not obliged to extend its laws to an entity without a fiscal nexus with the UK. Thus, the losses of a foreign subsidiary cannot necessarily be taken into account by the UK-resident parent company, liable to tax according to the UK law on its world-wide income. Interestingly, in the *Bosal* case,³⁵ the EC Court was reluctant to accept the Dutch government's argument that the interest expenses not instrumental to the calculation of the Dutch profit cannot be taken into account with the Dutch parent company. The argument was thus not accepted by the court just from the perspective of the freedom of establishment as enshrined in the EC Treaty that the Dutch tax relief could be denied in respect of someone without a fiscal nexus with the Netherlands. Notably, the approach of ECJ to the wide applicability of national law is criticised in the profession.³⁶

The outcome of the application of the ambitious logic the EC Court assumes in these cases may be quite bizarre as a matter of any tax law or principle to the extent that the idea must be given up that national taxation power cannot be extended to a taxable event that occurs with foreign resident taxpayers in foreign territory. Just as a

³³ Case E-1/04 of 23 November 2004. The Agreement on the European Economic Area extends to individuals and enterprises of EEA States (Iceland, Liechtenstein and Norway) the principles of free movement of goods, persons, services and capital, as well as of equal conditions of competition and non-discrimination. This is why a judgment of the EFTA court may be of direct relevance to EU matters and, inversely, the EFTA court takes into consideration the developments of the ECJ practice.

³⁴ C-446/03, ECR (2005), p. I-10837.

³⁵ C-168/01, ECR (2003), p. I-09409.

³⁶ Class IV of the ACT Group Litigation (Pirelli, Essilor, Sony), AG opinion in C-374/04, 23 February 2006, Para 63.

result of the Community law's intrusion, the traditional principles of the international division of taxation powers seem thus to be suspended. This is one side of the coin, however. On the other side, it can be criticised that the national tax administration of a host country may be eager to look for a fiscal nexus as to whether national fiscal incentives can be applied, while the same tax administration can be a failure to recognise the same fiscal nexus where the question concerns the recognition of the procedural rights of non-domestic taxpayers. This is clearly untenable in the light of the fundamental freedoms to be respected in the single European market.

It is the likelihood in an EU Member State that procedural rights of foreign resident taxpayers will be recognised as long as they obtain a local tax ID number. It is a question, however, if it is consistent with Community law to require from foreign taxpayers to obtain a local – namely, a second -- tax ID number in order to exercise their rights. In particular, to the extent that services can be provided in the internal market freely across the border, this freedom does not seem to be respected in the instance that a local tax ID number may be requested. However, where it is easy to obtain a local tax ID, the procedural rights of foreigners may become live. Notably, it should not be obligatory to employ a national fiscal agent. This is why under the amended Sixth VAT Directive taxpayers resident in another Member State are not obliged to apply national fiscal agents locally. In general, the obligatory application of a local fiscal agent may seriously hinder non-domestic taxpayers from exercising their right arising from one of the fundamental freedoms.³⁷

It is a further issue whether a foreign-resident taxpayer is entitled to initiate legal disputes locally within the conditions comparable to those available for domestic taxpayers. It can be a problem even for foreigners where in a country like Hungary it is not legal to file a tax return with the reservation of the taxpayer's right to initiate a legal dispute as to the legality of the imposition of tax. More broadly, taxpayers should be provided with the possibility of opting out of the system of self-assessment. Where this option is not guaranteed, like in Hungary, this is possibly to encroach on the taxpayers' procedural rights, including foreigners.

The emergence of procedural questions and, in general, the issue of the easy enforcement of rights to be protected by Community law can be illustrated by the relevant ECJ practice. Foreigners may be prevented by national tax legislation from exercising their freedom to provide services. For example, granting financial benefits must not be subject to the domestic residence of service-providers, like in the *Svensson & Gustavsson* case,³⁸ or the introduction of discriminatory tax regimes against foreign service-providers is prohibited, like in the *Safir* case.³⁹ Where the grant of a housing benefit (in *Svensson & Gustavsson*), in particular an interest-rate subsidy, is subject to the requirement that the loans intended to finance the construction, acquisition or improvement of the housing which is to benefit from the subsidy have been obtained from a credit institution approved in that Member State, both the free movement of capital and the freedom to provide services will be infringed. In this context, one can conclude that where foreign taxpayers are prevented from claiming treaty benefits through the intervention of their domestic

³⁷ Article 21 (2)(a) in conjunction with Article 28g, as amended by Directive 2000/65/EC, OJ L 269 (21.10.00), p. 44.

³⁸ C-484/93, ECR (1995), p. I-3955.

³⁹ C-118/96, ECR (1998), p. I-01897.

service-provider, and are compelled to approach a local service-provider, the infringement of both the free movement of capital and the freedom to provide services can be identified.

As discussed in *Safir*, as regards freedom to provide services, the EC Treaty precludes the application of the legislation of a Member State, which provides for different tax regimes for capital life assurance policies, depending on whether they are taken out with companies established in that Member State or with companies established elsewhere. Similarly, the compulsory use of a domestic service-provider who is only authorised to intervene in claiming treaty benefits locally may dissuade taxpayers resident in another Member State from getting involved in securities transactions in that Member State. This is clearly to infringe the freedom to provide services principle in respect of their domestic service-provider.

In the *Futura Participations* case,⁴⁰ it turns out that a Member State is not deprived of describing for the substantive conditions for carrying forward losses even in a cross-border situation. A Member State is prevented, however, from providing for a burdensome procedure to be followed by the taxpayers seeking for tax benefits. In other words, taxpayers must be granted freedom in getting access to various avenues for the enforcement of their rights even if the substantive-law requirements are strict and comprehensive.

The EC Court held in the *Metallgesellschaft and Hoechst* case among other things that while, in the absence of Community rules, it is for the domestic legal system of the Member State concerned to lay down the detailed procedural rules governing actions for repayment of taxes levied in breach of Community law or for reparation of loss caused by breach of Community law, including ancillary questions such as the payment of interest, those rules must not render practically impossible or excessively difficult the exercise of rights conferred by Community law.⁴¹ Actions brought by individuals before the courts of a Member State for the repayment of national taxes levied in breach of Community law or for the reparation of the loss caused in breach of Community law are subject to national rules of procedure, which may, in particular, require applicants to act with reasonable diligence in order to avoid loss or damage or to limit its extent. It is, however, contrary to Community law for a national court to refuse or reduce a claim brought before it by a subsidiary resident in that Member State and its non-resident parent company for reimbursement or reparation of the financial loss which they have suffered as a consequence of the advance payment of corporation tax by the subsidiary, on the sole ground that they did not apply to the tax authorities in order to benefit from the taxation regime which would have exempted the subsidiary from making payments in advance and that they therefore did not make use of the legal remedies available to them to challenge the refusals of the tax authorities, by invoking the primacy and direct effect of the provisions of Community law, where upon any view national law denied resident subsidiaries and their non-resident parent companies the benefit of that taxation regime.⁴²

Member States need not be subject to the Community law that uniformly prescribes, which specific procedures need be followed in particular cases. It is only

⁴⁰ C-250/95, ECR (1997), p. I-02471.

⁴¹ Joined cases C-397/98, C-410/98, ECR (2001), p. I-01727, Paras 87, 96.

⁴² Paras 102, 107.

important that a Member State is required not to adopt a law which hampers taxpayers from the easy exercise of enforcing their rights. Even if tax relief is available, a taxpayer must not be enforced directly to apply for it where it is likely that this claim will be challenged by the competent tax authority. Taxpayers must not be compelled to choose certain avenues where there are avenues that seem to be more comfortable to them. In the light of the judgment in the *Metallgesellschaft* case, it is clear that it is not the vital issue what relief is available for taxpayers in a cross-border case. It is more important to focus on the procedure in which this relief can be claimed, and the relating rights can be enforced. The tax administration may be legitimate in requiring the efficient collection of taxes. However, this does not make an excuse for the national legislator to hamper taxpayers from their choice of the legal means they find appropriate to enforce their rights.

(v) Conclusions: growing need for Community legislation that facilitates taxpayers with an easy access to their rights

The approximation of national legal measures does not require the introduction of uniform and categorical rules of Community law. Harmonisation may thus tolerate the several facets of law, which does not necessarily affect in the same way those to whom the law is addressed. An example for this is MiFID legislation. The border line between binding rules and recommendations need not be very strict. Neither need it be precluded that certain persons opt out of the rules that may well be legally binding to others.

Harmonisation may generate common discussion fora in the permanently changing conditions of the real life rather than prescribe comprehensive substantive rules. Community legislation may provide citizens and enterprises with simplified application procedures. For example, it may provide for simple procedures in order to claim for double tax treaty benefits or for the various forms of lump-sum taxation. Harmonisation may suggest a framework only that will be filled, depending on the specific conditions to be developed by a Member State. The practice devolving from the line of ECJ decisions may be authoritative for national tax administrations to try to provide taxpayers with sufficient legal protection in an administrative procedure while securing for themselves the opportunity of collecting taxes efficiently.

5. Overall conclusions

Tax competition and the approximation of the national tax systems of EU Member States do not necessarily exclude each other. They can operate even simultaneously, provided that it is possible, on the one hand, to sort out the most embarrassing forms of harmful tax competition (like ring-fencing or the artificial and opaque schemes of the calculation of company tax base). On the other hand, following its direct tax harmonisation policy, the European Commission need be open enough to the fresh impetus that may come from the businesses, which seek to benefit from the single European market. A harmonisation policy need not be entangled in the heavy problems of dividing taxation powers among Member States. Instead, it should take on the forms of facilitating and multi-faceted legislation as much as possible, as well as focus on the procedural issues by providing the enterprises entering the single European market with the easy access to enforce their rights, whether contractually or before public authorities, including tax authorities.

It is not realistic very much to expect that EU harmonisation in the direct tax area could reach in the near future the structural issues of a system of company taxation like the uniform calculation of tax base or the approximation of tax rates. However, tax competition other than harmful tax competition and tax harmonisation other than state-centred, comprehensive, statutorily based harmonisation might open avenues even to the simplification of tax legislation at a multi-jurisdictional level. Moreover, the EU Member States themselves, responsible for designing their own national tax system, may also benefit from a more flexible way of harmonisation.