EC LAW AND DIRECT TAXATION: TOWARDS A COHERENT SYSTEM OF TAXATION?

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Helsinki 2007. EATLP Meeting.

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1. Introduction.

In 2007, very few scholars doubt about the relevance and incidence of EC Law on the development of direct tax rules and systems in EU member States. Despite the fact that Member States *still* retain exclusive competence on direct tax matters, it is obvious that an important number of amendments and reforms in direct tax matters in the last few years have been directly required by the need to encompass the exercise of such an exclusive competence on income taxes with EC law requirements, or at least have been *inspired* by, or concerned about the direct and indirect constraints coming from the ECJ case law on direct tax matters. The European Court of Justice has become, either voluntary or involuntarily, one of the actors of the determination of the present and future patterns of direct taxes across Europe.

Meanwhile, the ECJ case law on direct tax matters is broadening drop by drop, and the relationship with the fundamental freedoms requirements is getting *more precisely* defined. There is, however, some more pending and new issues to be considered by the ECJ and, at the same time, a certain impression that the ECJ is re-considering certain aspects of the extent of the fundamental freedoms and the possible justification of certain restrictions derived from the exercise of the tax power on direct tax matters, plus renewed calls for a *new* equilibrium between tax sovereignty and the exercise of the free movements protected within the EU.

On occasion of the EATLP Meeting in Helsinki, I have been asked to prepare a list of certain issues to be considered as regards the development of the ECJ case law on direct tax matters. Due to the specific conditions in which the debate is going to be conducted, and the limited space to consider the different matters, I will present the report through brief inputs to be developed during and after the conference. What I would like to discuss here is whether it would be possible or not to *create a set of coherent rules, principles and criteria* which determine the compatible relationship between EC Law requirements and the scope and effects of income tax systems.

Taking into account the brief statements that should be derived from my paper and my short posterior intervention during the Congress, I will simply try to fix and comment certain critical particular aspects of conflict between EC Law and income taxes according to the criteria set out –until now- by the ECJ. I will briefly refer to them, pointing out some problems derived from the ECJ construction, its understanding and the possible reaction of Member States in order to accommodate to EC Law requirements on direct taxation *as interpreted by the ECJ.*

In order to discuss about such a coherent set of rules, principles and criteria, I will structure the presentation in a brief introduction of the origins of the ECJ case law on direct taxation, a description of the situation of the case law on direct tax matters, and a brief reference of the possible evolution of the jurisprudence according to the standards set out so far. I tend to examine in the present paper where we do come from, where we do stay and where we can go with the relationship between EC Law and direct taxation in Europe. The subjects chosen for my consideration relate to the presence of certain tax principles assumed by the ECJ as principles of EC Law, such as the inter-nations tax equity, or the inter-taxpayers equity, and their consequences on certain aspects of the tax systems, such as the correlation between income and expenses for tax purposes or the application of exit taxes. I will present other aspects, such as the need to revise the effects of the ECJ cases on the income tax area, the scope of measures to combat tax avoidance and tax abuse, the taxation of trans-national dividends, the place and effects of Double Tax Treaties, and the correlation between the application of measures to enhance the single market and the exercise of fundamental freedoms and the reaction against state aid measures.

2. Where we stay and where we come from.

2.1. Where we stay.

The interpretation of the non-discrimination principle in the light of the exercise of the fundamental freedoms has led to an analysis of the potential incompatibilities of income tax rules with EC Law requirements. In a progressive and expanding case law, the ECJ has tackled to a polyhedric approach which has allowed it to ascertain such compatibility. Starting from a classical and direct comparability analysis of the treatment of foreigners as compared to nationals, and based on a material and substantial approach, the ECJ has expanded from a direct to an indirect discrimination, from a direct from *à rebours* discrimination, from the prevention of discriminatory treatment to the prohibition of unjustified restrictions to any of the different fundamental freedoms, from inbound to outbound restrictions, from restrictions from the provider's perspective, to restrictions to the recipient's perspective, from an EU-based protection to an EEA-based declaration of effects.

This approach has been complemented by the application of a *rule of reason* as in the Cassis de Dijon case, but with a very strict acceptance of justification parameters and under a restrictive rule of acceptance, giving and utmost preference to the content of the fundamental freedoms. In that sense, *simple* economic considerations –as the lack of resources derived from tax evasion- have not been accepted, and those few considered admissible –tax coherence, fiscal control and supervision, territoriality,…-have done so under a restricted analysis for admission –valid public goal, proportionality and necessity principles, and relation between means and goals-.

Facing this approach, Member States are put in a difficult situation: no matter what they do, they end up discriminating. Many writings have appeared in the last few years in that respect, pointing out the many areas of failure of the obligations derived from the respect to the exercise of fundamental freedoms in the income tax legislation of different Member States. But the real question remains as to whether this is a correct approach to be taken for the future: can this continuous and expanding determination of the contravention of EC Law by many and different domestic and international tax rules constitute a *valid and acceptable* mechanism for the development of income taxation in Europe? Amending the tax systems in order to *prevent* or *react* against the ECJ case law on direct taxation is a recommendable direction to be taken as the predominant way of evolution of income tax systems? Should the ECJ leave some room for certain fiscal policy considerations to manoeuvre? Does the ECJ know where it wants to go, or what goals to reach as regards the formulation of a compatible approach between income taxes and EC Law? Is that peculiar 'give and take' system, ECJ action and MS reaction, a proper way of getting such goals? What can be said at that point is that, no matter what is the outcome of the next decision in tax matters, it is very difficult to ascertain or to systematize the orientations of the ECJ case law in a set of certain rules and criteria, or make a simple list of considerations as regards their implications and the fulfilment of their obligations.

2.2. Point of departure: Where we came from.

The point of departure and evolution of the interrelation between direct taxes and EC Law is dominated by the following settings.

As a starting principle, Member States retain exclusive competence on direct taxation matters, both on the definition of the domestic rules and the determination of the criteria distributing the taxing powers on income and wealth in order to eliminate (international) double taxation. These two statements are true as far as there are no unifying or harmonising measures adopted by the Community.

The unanimity requirement to adopt harmonization measures in the field of taxation has prevented –and will make almost impossible in the near future- to adopt far-reaching measures of coordination among different tax systems, despite the need to adapt them to the functioning and requirements of the single market. In absence of such unanimity, the ECJ has taken an active role in *eliminating* direct tax obstacles to the pursuit of the single market requirements, and the respect of the exercise of the fundamental freedoms, followed and complemented by the task taken by the European Commission. It should be borne in mind that the ECJ is simply taking the role –despite an active one- given by the EC Treaty: to settle the basic structure of the single market eliminating the different obstacles –even tax ones- that are faced through the cases presented before the ECJ

Nevertheless, the ECJ does not seem very convinced about the specific limitations and scope of the territorial exercise of the tax power and tax systems, and also of the tax systems and the inter-dependence between tax rules of different countries and their effects. Despite the *limited territorial effects* of tax rules, they can have consequences on other Member States' tax legislation when they apply to income with some trans-national elements. However, just in few cases, the ECJ is decided to consider the effects of the parallel exercise of the tax power by different EU Member States. In most of the cases, the ECJ keeps a one-single-state approach.

Territoriality determines that tax sovereignty can *only* be exercised in the confines of the territory of the Member State, despite the fact that tax rules may affect situations, acts, activities and taxpayers located abroad. Territoriality also determine, although not necessarily, the territorial scope the income subject to tax, the deductible expenses, or the scope of fiscal policies oriented to improve economic and social conditions of the country.

Based on that, tax systems of Member States cannot be said to be independent of each other. The scope of tax systems, taxing both foreign income and foreign taxpayers makes them to interrelate, especially as regards the determination of tax consequences applied to trans-national income. The *interaction* between tax systems, though, depends on many different factors, rules and circumstances, and it is impossible to precisely define the consequences of such interactions. First, it depends on the scope of the domestic tax system, whether it applies a territorial approach or taxes income on a worldwide basis. It also depends on the application of the specific *form of taxation* and also of certain fiscal benefits and whether they affect or not foreign income, situations or taxpayers. Finally it depends on the concrete method applied to alleviate international double taxation in their different forms. Second, it depends on the existence, application and interpretation of double tax treaties and their effects as a consequence of their interaction with domestic tax rules of *both* Contracting States. Territoriality, at the end, is concreted in a different way and form in any and every particular case depending on the different types of tax rules covering that case.

Not understanding properly such complex mechanisms may derive in an incorrect determination of the proper *solutions of accommodation of income tax systems to the single market*, if not of the proper determination of the EC Law consequences, or the concretion of which State –and rule- is contravening EC Law.

The ECJ has first oriented the compatibility analysis on a separate *per country* approach, without taking into account the results, the effects or the situation in the other country. Nevertheless, in some recent cases, especially after *Manninen*, the ECJ opts for an analysis of the global (European) effects of the taxpayer situation in order to concrete the non-fulfilment of the EC law obligations, or properly speaking, to *justify or unjustify* certain rules and mechanisms. The pan-European approach to the compatibility analysis may lead and oblige to a different treatment and different consequences in some cases already solved. Additionally, it will imply new focus of interest for determination of the possible compatibility/incompatibility.

3. Inter-nations tax equity, inter-taxpayers equity and EC Law.

That is so because EC Law is not *initially* oriented to focus or to solve issues of fairness or equal distribution of tax powers among States, or tax burdens between taxpayers. In principle, no *inter-nations* tax equity informs EC Law and it is therefore for the Member States to determine the fair tax allocation rights among themselves.

Nevertheless, there has been an intense debate in the tax literature about whether the EC Law respected one of the two main formulations of the economic side of such a formulation, the tax neutrality; or, properly speaking, which formulation of the tax neutrality –either capital import neutrality, CIN, or capital export neutrality, CEN- would be (more) compatible with EC law requirements. The debate looks to us certainly of theoretical importance, but difficult to follow the consequences in practice as there is no perfect and pure translation of those theoretical constructions in any tax system. Most of them respect a certain hybrid formulation, and do not follow a pure representation of such principles. Therefore, regardless of the conclusions reached in the theoretical debate, it is possible to consider that:

- In some occasions, the breach of EC Law is the result of the incoherences derived from maintaining CEN on a domestic basis and CIN as a principle governing the allocation and the methods for eliminating international double taxation. This was the outcome in the *Schumacker* case. Had the residence State maintained the taxation of the income obtained in the source State, Schumacker would had been entitled to the application of the *personal and familiar allowances* in the residence State and, thus, no claim in that sense would had been made or accepted in the source State.

- Therefore, it must be seen, *on a case by case basis* whether CEN or CIN parameters conform with or break the EC Treaty requirements on fundamental freedoms. Because of such a *case by case* approach it is then difficult to establish a general rule that adapts the tax system to EC Law requirements, maintaining at the same time a certain level of domestic coherence.

In fact both primary and secondary EC law *recognize* or at least maintain or offer the (rather theoretical) possibility to Member States to apply measures which represent the development of such theoretical formulations. The EC Treaty recognizes the aprioristic validity of tax systems based on capital import neutrality and capital export neutrality, as far as free movement of capitals is concerned.

Article 58 of the EC Treaty prescribes that

“1.The provisions of Article 56 shall be without prejudice to the right of Member States:

(a) to apply the relevant provisions of their tax law which distinguish between *taxpayers who are not in the same situation* with regard to their place of residence or with regard to the place where their capital is invested”

Therefore, a literal interpretation of article 58 considers not being comparable the tax treatment of taxpayers when a distinction is made on the place of residence (treatment of resident and non-resident taxpayers), and not being comparable the tax treatment given to the [income derived] from capital invested domestically or abroad (the regulation of this statement as a general principle can be seen in *UFA* and *Schumacker* cases). The fact that this article has been reduced to a minimum significance and content as a result of the interpretation of article 58.3 by the ECJ should be a point of discussion.

Also, article 4.1 of the Directive 90/435/EC allows Member States to apply either an exemption or an imputation credit in order to alleviate international -economic and juridical- double taxation.

Neither *inter-taxpayer tax equity* informs or is present in principle in the formulation of the principles that should govern the running of the single market. It is for the Member States, in the exercise of their exclusive competence in direct tax matters, to precise the criteria for distributing the public burdens among different taxpayers and also to categorize and classify them according to the standards they see fit.

However, the fact that the EC Treaty does not expressly recognize the existence of sound principles of direct and international taxation does not imply that the ECJ will not take them into account when considering the reasoning behind the case or supporting the outcome.

This is my understanding of certain ECJ *key* decisions in direct taxation. Only if we consider that here is a need to reach certain level of tax fairness for the taxpayer according to his specific situation can these cases be properly understood.

That is what happens as regards the reasoning behind the *Schumacker type* case law (*Schumacker, Gschwind, de Groot, Wallentin, Meindl*). The ECJ develops in that series of case law the right to move for economic reasons into the right to get *at least once, or* just once (Gschwind) personal and familiar allowances in the income tax, whether in the residence State (in general terms) or in the source State (when certain undetermined conditions are met). Moreover, States cannot unilaterally split those allowances unless there is a certain common agreement among the States (*de Groot*). What is the basis of such EC *right*, -the definition of a personal and *familiar* tax allowance-, remains however to be clarified in order to distinguish the application of this and other ECJ doctrines on personal income tax benefits extension (the *Asscher* case could be considered a good example of the confusion). To consider that this statement can be object of an *EU autonomous and uniform interpretation* is even more a simple desire that a technical and workable solution (the same will happen as regards the determination and computation of *foreign losses* in the *Marks & Spencer* case). Misunderstandings, misinterpretations and wrong assumptions on the tax law applicable to the cases have *helped* to develop such doctrine.

The ECJ has further developed this doctrine thus enhancing the benefits from it not only to persons exercising an economic freedom but to all European citizens, on the basis of the general principles of non-discrimination based on nationality grounds and of free movement of persons stated in the ECT (Article 12 EC and Article 18(1)) (*Turpeinen*). Nevertheless, some cases show that the extension of the economic rights to citizens do not apply in cases where the result is consequence of a disparity between different tax systems and not the direct result of a discriminatory treatment (*Schempp*).

The facts of that case (also the facts of the *Werner* case) show the vulnerability of tax systems to EC Law *as applied according to the circumstances of the case brought to the ECJ*. Despite of the general character of tax rules, they may –or may not- be *declared* incompatible to EC Law depending on whether the particular claiming the protection of EC Law *exercises or not* a fundamental freedom of a right conferred by EC law. Simply considering a different factual situation in the *Schempp* case, if it were Mr Schempp moving from Austria to Germany for employment after divorce and not his divorced spouse from Germany to Austria, the denial of the right to deduct his maintenance to his divorced spouse should possibly have led to a restrictive tax treatment prohibited under EC Law.

This situation can hardly lead to a systematization of a certain standard criteria and parameters of compatibility between personal income taxes –especially as regards the personal and familiar allowances- and EC Law. It is difficult not only to describe such general parameters from the perspective of the free configuration of the income tax systems by Member States. But it is even more difficult to simply try to *accommodate* income taxes based on different parameters to the ECJ requirements on the basis of the outcome and consequences derived from a *specific interpretation of EC law based on the factual circumstances of the case brought to the ECJ*.

4. Effects of income tax cases and amendment of tax laws.

The development of income taxes in Europe should not be dependent on the interpretation of certain cases whose decision is based on the *particular circumstances of the case*. Income taxes cannot evolve based on such peculiarities, giving the supreme authority for the determination of the main lines of the evolution to the supreme judicial body. The attribution of *juridical effects* to the ECJ declarations (not just to its *stare* *decisis*) on the interpretation and scope of EC Law forces Member States to be aware of the evolution of the ECJ doctrine on direct case law. The consolidation of such *effects* in the ECJ case law is broad and flows along the lines, but a certain modulation should be considered by the ECJ.

- Accommodation of certain tax rules needs most of cases the active role of domestic legislator, taking into account the requirements of the legality principle in tax matters. It is not simply a question of time, but also of discussion and debate of the tax decisions in the Parliament as a necessary legitimate answer to the accommodation needed to EC Law.

- The attribution of retroactive effects to *interpretative decisions* (in the area of preliminary rulings, as well as in the area of infringement procedures) should be reconsidered.

This is not the proper place to discuss the scope of the *declarative interpretative decisions of the ECJ*. What it is clear, however, is that the supreme interpretation of EC Law –primary and secondary- represents in *certain cases* the origin of *new* rights that derive from the interpretation given to prior existing EC Law and rights attributed by it–either, primary, secondary or jurisprudential-. If that is the case (the discussion about what is a *new right* is not developed in the present paper), the ECJ should be concerned about the temporal criteria of application and claims of *such a right* under the existing supervened *incompatible tax laws*.

The evolution of EC Law under the ECJ case law parameters overrides the traditional distinction between creation and interpretation of law, thus invalidating, to a certain extent, the attribution *ex officio* of retroactive effects to the *interpretative decisions*, taking into account the material effects linked to these decisions. It seems to me difficult to understand why in such a case the *constitutional guarantees* linked to the exercise of tax power should not be respected nor taken into account *simply because it derives from a declaration based on the primacy of EC law*. In order for a tax law being attributed retroactive effects either it should respect the principle of legal certainty or not being contrary to other constitutional principles (ability to pay,…). On the contrary, ECJ decisions on tax matters have *as a general rule* retroactive effects, despite of being based on a *creative interpretation* of pre-existing EC Law and being derived on a construction and statement of the rights conferred by EC Law which was not considered previously, nor it was reasonable that such a construction could be derived or assumed by the ECJ.

To apply the retroactivity as a general rule in direct tax matters, when applying general principles such as those established in the non-discrimination principle or in the content of the fundamental freedoms is not consistent, either, with the doctrine of prospectivity used by other Supreme Courts (such as the US Supreme Court) when modulating, changing or establishing a *new doctrine* from that consolidated previously. In those cases, prospective overrulings determine the limitation of the effects to the future.

The arguments considered by the Advocate General Stix-Hackl in its opinion delivered on the *Meilicke* case (and also in the *Banca di Cremona* case, despite the fact of not dealing directly with income taxes) seems, thus, to me, a good line of rethinking the effects of case law on direct tax matters. Otherwise, tax legislations in Member States are at hands of particulars and national judges desiring to combat sound and established principles which form the basis of the actual infrastructure of income tax systems in Europe.

To develop tax systems in Europe in such a way, even if protected by the political willingness of the EC Commission, represents to me a significant institutional deficiency in the building of Europe that should be seriously reconsidered by the actors of such construction. At least, it should be made clear, when defining the compatibility limits between EC law and income tax systems where do we want to go, or what is the goal to be pursued by tax systems and the functions attributed to each of the different actors –EC Institutions, and Member States-. The evolution of income taxes on tow of ECJ case law, or even the anticipation to them to avoid potential negative consequences does not seem a sound tax policy to be followed by the EU Member States.

5. Coherent approach to tax treatment of income and expenses.

Traditionally, source-based taxation is levied on a gross basis. It is not income but gross receipts what normally counts for the determination of the taxable base to which a withholding tax is applied. There is, thus. a different approach of Member (and non-Member) States when taxing income as *resident States* (net income, or profit/loss) and as a *source States* (gross income). In the majority of cases the different tax treatment is neutralized by tax treaties with a certain threshold (183-days-rule, fixed base, permanent establishment), or modulated by domestic law allowing the deduction of certain expenses.

Nevertheless, in the case of artists and sportpersons DTC allow taxing them according to what is determined in domestic law with no treaty threshold being applicable.

This state of art has allowed the ECJ to establish a consolidated doctrine forcing to reconsider the basis for taxation, or the concept of income to be used when taxing non-residents income. After the *Gerritse* and *Scorpio* cases it becomes clear that the basis for determination of the taxable income cannot be distinguished and differently applied to resident and non-resident taxpayers (rendering –dependent or independent- services, or being established in the territory), which forces the States to reconfigure the basis for the application of the non-residents (net) income tax.

We want to consider that this approach represents an evolution to the existing international tax rules of distribution of tax powers. Traditionally, distributing rules have focused on the allocation of taxing rights on income or profits, but have left the room for a proper allocation of expenses, costs and losses to the unilateral consideration of (contracting) States, thus leading to situations of excess taxation of the net total income, or to taxation of net income to effective rates superior to the nominal ones. In fact, part of the work actually done by some international organizations on international taxation reflect the need to take into account not only the income obtained but also the generating costs and establish certain basic criteria and distributing rules for allocating costs (i.e. development of article 7.3 MC, cost-sharing agreements under article 9 MC, contribution to pension schemes,…). In that sense, the ECJ case law on equal treatment of tax expenses *in the source State* should be considered as a development in a *similar* direction to that pursued by those other international organisations.

One could also consider that this approach is not coherently maintained by the ECJ in all cases where this correlation is being presented. In that sense, for example, one should consider the outcome of the *Bosal* and *Keller* cases, or even the decision arisen in *Marks & Spencer*. In my view, however, the perspective is different and therefore, the conclusion taken by the ECJ can also be justified.

First we have to consider that *Gerritse* and *Scorpio* are, so to say, *source State based cases*, where *Bosal*, *Keller* and *Marks & Spencer* are resident State based cases.

Second, the claim to set up a coherent and rational allocation of expenses from the residence State, when applying a territorial scope of taxation, presupposes (wrongly and unilaterally, as in *de Groot*), that other states are taking the *same and similar approach*, which may be wrong and, consequently, may lead to taxation of certain income without costs being taken into account in any State. Therefore, for a state –residence State- to claim the right not to take into account certain expenses it must verify whether those expenses are somewhere taken into account for income taxation purposes. If that is not the case, and expenses are normally included on the basis for taxation of resident taxpayers or domestic income comparables, the fundamentals of the single market are broken and not fulfilled.

Last but not least, in all cases, more than setting clear allocation criteria for expenses and losses, the ECJ is claiming the need to take into account them for tax purposes *at least once*. In fact, in our opinion, that is the reason behind the decision made by the ECJ in *Marks & Spencer*. Even if there are valid reasons of public interest that could justify not having taken into account losses incurred by foreign subsidiaries, the Court uses the interpretation of the *principle of necessity* to conclude –in justice- that not allowing deduction of foreign subsidiary's losses not being deducted *anywhere* by the resident State 'goes beyond what is necessary to attain the essential part of the objectives pursued here'. The right of *secondary establishment* is thus *transformed* into a right to take into account at least once the potential losses derived from such a secondary establishment for tax purposes in some tax jurisdiction.

Nevertheless, this *EC right* conferred to EU companies is not absolute. Either if it is derived from the non-discrimination principle or from the exercise of fundamental freedoms, both are maintained and developed as a consequence of the *equal treatment*, based on a comparison with the national or the domestic, internal treatment. Therefore, it cannot be said that ECJ case law attributes rights taxpayers as regards their activities of a trans-national character. At the end, the concretion of such rights depends on the specific articulation of the tax system by every Member State. In other words, foreigners or *trans-national situations* have the right to enjoy similar tax benefits to those enjoyed by nationals or domestic situations, but it is for every Member State to concrete the content of such tax benefits, and whether or not to implement it.

If the ECJ wants to consolidate those *taxing rights* associated to the exercise of the fundamental freedom it should take a step forward linking them to a material principle of taxation arising from the exercise of fundamental freedoms. If not, being based on a pure basis of *equal treatment*, it is for the Member States to decide the *proper reaction* to the EC Law requirement. In that case there is a risk that the evolution of income taxes in Europe will be based on the action-reaction policy, Member States reacting against the ECJ *liberalizing decisions* on tax matters like a boomerang, not only not expanding *tax incentives and benefits*, but eliminating them for the *comparable equal situation*, which at the end, would not consolidate the potential advantages of a single unitary market, but would transport us into a system of more closed rigid tax systems.

6. Inter-nations tax equity and exit taxes.

Marks & Spencer is also a relevant case because it recognizes the need to preserve the balanced allocation of the power to impose taxes between Member States as a reason of public interest that, if other conditions are met, serve to justify the maintenance of restrictive tax measures under EC Law requirements. Therefore, the establishment of the inter-nations tax equity has been considered as a valid reason of public interest to be considered under EC Law. What meaning to be attributed to the balanced allocation of the power to impose taxes between Member States is a question to be decided on a cases by case basis, but, again, in *Marks & Spencer* is referred to the correlation between the taxation of profits and losses of a certain company under the residence criteria (in tax matters profits and losses are two sides of the same coin and *must be treated symmetrically* in the same tax system).

It is interesting to point out the recognition of the proper allocation of taxation rights between Member States as a valid criterion of public interest, as it would serve to solve the risks and uncertainties derived from the outcome given to the cases on exit taxes, such as *Lasteyrie du Saillant*, and *N.* It is surprising to see no mention to such a valid reason to justify restrictions in the case, despite the fact that the application of proportionality principle would possibly have lead to the same result. Again a certainly strict application of the proportionality principle led to a rigid and invariable solution that will demand a greater amount of cooperation among tax administrations of Member States. Probably this situation may be due to the lack of general recognition of such an allocation right to (partially) tax capital gains arisen on assets transferred from one jurisdiction to another or from (movable) capital gains obtained by a transferred person on previous assets. The claim of many Member States is not reflected in the distributive rules of the Double Tax Treaties, which led to the taxation *prior* to the transfer or the loss of the residence condition.

Whatever the solution proposed for the amendment of the outdated rules contained in Double Tax Treaties, what seems clear is that the application of the exit tax at the moment of the *transfer* is not a coherent mechanism, despite of responding to a *legitimate right to tax*. The *momentum* of taxation needs to be re-elaborated and a greater administrative cooperation and integration between tax rules and valuations of different Member States is needed. For that reason, it is also doubtful that the simple set of *coordinating measures* recently proposed by the Commission may solve the issue. Multiplying the domestic situations in which a simple *transfer* would lead to the transfer of capital gains would not only constitute a response contrary to the enhancement of the competitiveness goals established in Lisbon, but would also signify a real thread to the requirements of the ability to pay principle.

7. Tax avoidance, tax abuse and EC Law.

The consideration of exit taxes as unjustified fiscal barriers, being contrary to the requirements of the fundamental freedoms has extended the worrying of Member States about the development taken by the ECJ case law. Member States have failed to use before the EC Law the traditional measures to *protect their* tax base, not being able to use traditional anti-avoidance or anti-delocalization measures. Furthermore, the lack of resources as a result of tax avoidance has not been accepted as a valid justification criterion to maintain restrictive tax measures. In front of that situation, Member States have to face tax competition among them, and also (indirectly) with third States, with a different approach than a classical one consisting on the application of a vast number of *unilateral* measures, even with precedence over Double Taxation Conventions.

The ECJ case law has considerably helped to reach that situation. Despite some recent minor rethinking of the matter, the application of anti-avoidance or anti-delocalization tax measures had been invariably seen as discriminatory or unjustified measures, contrary to the exercise of fundamental freedoms with very minor exceptions (*Daily Mail*). To summarize the process, the acceptance of anti-abuse tax measures was limited to the abuse of the exercise of the rights derived from the fundamental freedoms, some of them turned to the minimum after the *Centros* decision.

Apart from this, the acceptance of anti-abuse tax rules was limited to those rules 'having the specific purpose of precluding from a tax benefit *wholly artificial arrangements* whose purpose is to circumvent or escape national tax law (*ICI*, *De Lasteyrie du Saillant*, *Marks & Spencer*). The literal formulation of such a doctrine certainly restricted the acceptance of application of such measures to arrangements *wholly* artificial. Partly artificial arrangements could even benefit from the protection of EC Law in front of tax law.

Cadbury Schweppes represents, in our opinion, and important development of the doctrine of the admissibility of anti-avoidance mechanisms under EC Law, and it is expected that the *Thin Cap Litigation Group* may consolidate such a doctrine. The case mentioned the need to take into account the *content* of the exercise of the freedom: the actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there. The ECJ dismisses the application of the CFC legislation to situations where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives that CFC is *actually established* in the host Member State and *carries on genuine economic activities* there.

The ECJ thus forces to intensify the analysis of compatibility of anti-abuse or anti-evasion tax rules with EC Law. Simple *tax driven planning* may not in itself be considered abusive and deserve EC Law protection if they respect an actual establishment and involves the carrying on genuine economic activities there. General and automatic anti-avoidance mechanisms cannot, thus, overcome the primacy of EC Law. To that extent, many anti-avoidance schemes, even contained in Double Tax Treaties should be reconsidered in the light of the strict parameters of acceptance formulated by the ECJ. Whether these schemes are workable in practice to effectively prevent tax avoidance it is a question to be seen.

8. Taxation of transnational dividends.

The tax treatment of EU trans-national dividends has been object of a special consideration by the ECJ –and also by the EEA Court- in the last few years. To assure a *neutral* treatment of payments of dividends between companies, entities and/or individuals resident in different Member States constitutes a core element in the realization of a single capital's market. European institutions were certainly aware of such importance, reflected in the approval of one of the first Directives on direct taxation, Directive 90/435/EC. This matter needed to be considered at a European level, taking into account the lack of (total) solution given to the problem of interaction between taxes paid on the same income by different taxpayers (international economic double taxation) in existing Double Tax Treaties and the need to observe a coordinated harmonized approach.

Nevertheless, the ECJ case law on trans-national dividends shows that the impact of taxes on such movements was of greater relevance for the construction of the single market and the exercise of the freedoms of establishment and movements of capital. The *Verkooijen* case allowed considering in more detail the tax treatment of trans-national dividends, thanks to a strict consideration of the territoriality principle and a conception of the *tax coherence* overcome in subsequent cases.

The taxation of trans-national dividends can (and have to) be seen from at least a bilateral perspective: from the point of view of the State of the company distributing the dividends, and from the point of view of the State of the company, person or entity receiving the dividend.

From the point of view of the State of the company distributing the dividends, the analysis is based on a comparison between dividends paid to a non-resident shareholder (outbound dividends) and dividends paid to a resident shareholder. In that respect, both the ECJ (*Denkavit*) and the EEA Court (*Focus Bank*), opt for a single State analysis, in favour of the extension to outbound dividends of the *national comparable system* applicable to dividends paid to resident shareholders. These statements, together with the actions of infringement initiated by the Commission would force Member States to change either the treatment of payments of domestic dividends or change the withholding tax rules on non-resident shareholders. It is to be noted the consequences of that approach. The *extension of the national treatment* to dividend payments to non-resident shareholders would require re-thinking the model in which resident and non-resident taxpayers were not in the same situation. As regards the free movement of capitals dividend payments made by a resident company and to a non-resident company require a similar tax treatment, despite of not being necessarily in the same situation (*ACT Group*, p 57-65). It is not possible to maintain from a *source country perspective* a different approach to dividend payments depending on the resident of the recipient shareholder. In that respect, the reaction of other (Member) States –that is to say, the State of residence of the shareholder- cannot justify the restriction derived from the non extension of the *national tax treatment* to outbound dividend payments. It is to be noted that the application and integration of the effects of double tax treaties does not necessarily alter the conclusion reached by the Court. As regards *outbound dividends*, Tax Treaties only establish a maximum level of taxation, and not a tax rate. For that reason, only if the Double Tax Treaties would guarantee *the same treatment basis* will the tax treatment of outbound dividends be in conformity with EC Law.

The approach to the tax treatment of *inbound dividends*, however, has been broadly considered by the ECJ, not simply taking into account a *national treatment* but also considering the scope, objectives and goals of the legislation taxing the comparable national dividends. In that respect, the analysis of the taxation of trans-national dividends from the perspective of the treatment of the recipient compares dividends received or paid by domestic companies and dividends received or paid by foreign companies (*Verkooijen*). Again a comparison based on the *national comparable situation*, but in that case, the ECJ takes into account the goals and objectives pursued by the legislation being applied to domestic dividends (*Manninen*, *Lenz*). Therefore, the integration between corporate and personal income tax being a goal of integration systems for *dividends received from domestic companies*, the same and similar measures of integration and/or elimination of economic double taxation should have extended to foreign inbound dividends. The fact that the underlying corporate tax had been paid to another Member State is irrelevant from the analysis taken by the ECJ. From that perspective it is clear and perfectly understandable the decision of the ECJ in *Kerckhaert*, which does not consider contrary to EC Law the application to the same tax treatment to inbound dividends from shares in non-established companies and dividends from shares in established companies.

The twofold analysis has already forced some Member States to change traditional integration and imputation systems between corporate and personal income tax into more *classical systems*, at least until greater coordination among corporate taxes –and corporate tax rates- is reached across Europe. Because of the *national comparable approach* required by the ECJ, the European jurisprudence does not take into account the consequences and effects derived from the interrelation of the different systems applied by the (different) source and resident States, and thus, it is for every single Member State (separate or in a coordinated way) to determine the specific goals to be achieved with its specific tax policy, being in conformity with the ECJ analysis of the trans-national situations. Simply saying that prohibiting discrimination based on destination is ultimately inconsistent with prohibiting discrimination based on origin (Graetz, Warren, 115Yale Law Journal, 1219) does not necessarily reflect the reality in Europe. What can produce an incoherent result from an EC Law perspective, on the contrary, is to divide the tax base between the source and residence countries based on a simple compromise and practise basis.

Whether or not this evolution is in line with the objectives of greater competitiveness of European companies exceeds from the objective of this presentation.

9. Double taxation, double tax treaties and EC Law.

The relationship between double tax treaties and EC Law has been object of different approaches and has suffered an interesting evolution along the jurisprudence of the ECJ on direct tax matters.

According to settled case law, primacy of EC Law applies to all spheres of domestic law of Member States, including Constitutional Law or International Conventions, the last ones with the exceptions and requirements of article 307 EC Treaty. Since the first cases on direct taxation, the ECJ made clear that Member States could not condition rights derived from the exercise of fundamental freedoms subject to the application of a Double Tax Convention.

The objective of Tax Treaties and that of the EC Law are not similar, the second being broader. Neither the approach nor the scope are similar, as regards the application of the non-discrimination principles and clauses. Despite the interest of the Commission in considering the alleviation of international double taxation as an European coordinated and coherent objective (COM(2006) 823final), the EC Treaty does not consider such an elimination as a goal directly attainable by the European institutions, strange as it may seem (Lehner, BTR 2006), but through Conventions between Member States. For that reason, the taxation of foreign income by the resident State on the same foot than domestic income, *without providing for the possibility of setting off tax levied by deduction at source in that other Member State* is not contrary to Article 56(1) EC Treaty, as recently declared in *Kerckhaert*.

Despite such a different goal, scope, nature, objectives and approach, for some authors even contradictory, the ECJ has tried to *accommodate* the requirements and effects of the distributing rules established in Double tax treaties to EC Law, *assuming those effects* based on the competence of Member States to distribute between them the tax power over trans-national income (*Gilly, Kerckhaert*), or to determine the connecting factors for the purposes of allocating powers of taxation (*Saint-Gobain*). It would seem that the application and interpretation of Double Tax Treaties by Member States should, at least, accommodate to the *interpretation in conformity with EC Law requirements* applicable to all sectors of the domestic law. However, in some cases, the ECJ *recognizes* the validity of application and interpretation of Double Tax Treaties according to the Commentaries to the Model Convention elaborated by the OECD.

On the other hand, there seems to be recognition of the singular effects and position of Double Tax Treaties as a *reciprocal set of duties and rights*. As the Court declared in *D*, "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*. It follows that a taxable person resident in Belgium is not in the same situation as a taxable person resident outside Belgium so far as concerns wealth tax on real property situated in the Netherlands" (61). From that consideration, the Court considers that benefits derived from a Convention provision "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"*. It is difficult to understand such a proposition regarding Double Tax Treaties *as lex specialis and integralis* inside the EC Law and under its primacy. But the fact is that this doctrine seems to be consolidating in posterior decisions (*ACT*, par. 88-89), considering such effects as regards the validity under EC Law of certain limitation of benefit clauses (92).

A last but one point that I would like to raise in this short presentation refers to the relation between the EC non-discrimination principle and the most-favoured-nation treatment, as regards the possibility for a resident of a Member State A to invoke in a Member State C the benefits of a double tax treaty signed by State C with Member State B. As it is known, the ECJ has declared in *D*, that "Articles 56 ECT and 58 ECT 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 residents of a Member State which is not party to that convention" (63). The clear statement made by the ECJ has led to the tax literature to consider that the most-favoured-nation treatment cannot be applied under EC Law in order to extend the benefits of a double tax treaty to residents in a third Member State.

While considering that the most-favoured-nation scheme and the prevention of discriminatory treatment based on nationality grounds, or the prohibition of restrictions compared to the *national treatment*, represent mechanisms difficult to conciliate, I believe, though, that *certain effects* linked to the most-favoured-nation scheme –and a similar result- can be obtained through the expansive interpretation of the polyhedric configuration of the different restrictions –direct and indirect- to the exercise of the fundamental freedoms prohibited under EC Law. In fact, that is what the ECJ is also saying when it declares that the extension of effects, as in a most-favoured-nation treatment, cannot be obtained *in a situation and in circumstances such as those in the main proceedings*.

Let's consider an example: a company resident in Member State A has a worse treatment in Member State C as a result of the Double Tax Treaty between A and C, and compared to the treatment given by the Double Tax Treaty between Member State B and C. As a consequence of the *Saint Gobain* decision company resident in A, could have access to Double Tax Treaty B-C simply by creating a PE in State B and linking the assets and business in C to the PE. If the *Saint Gobain* decision were to have also an indirect impact on the source State of the income and not just on the state of situation of the PE, the *factual result,* applying the *Saint Gobain* decision, would be similar to the application of a *most favoured treatment*, despite the fact that the rationale of the most favoured nation treatment does not fit into the formulation of the basis of the fundamental freedoms, based on the elimination of discrimination on grounds of nationality. For the same reason, although in my opinion not correctly derived, General Advocate Ruiz-Jarabo Colomer reached in its Opinion on *D* the conclusion that the benefits introduced by a Double Tax Treaty could be extended to a resident in a third Member State.

Another issue of greater relevance, in my opinion, is whether the most beneficial treatment obtained as a result of a Double Tax Treaty fit in the requirements of the single market or in a market without frontiers. In fact, rather than considering that a Double Tax Treaty could or should be extended to *all nationals of other Member States* from an EC Law perspective, it should be considered whether the achievement of a *beneficial treatment* as a result of a tax provision included in a Double Tax Convention by *certain* residents of *a* Member State in another Member State could not fail under the category of *state aid*.

According to the law set in the EC Treaty, the basis for the single market is the national treatment and not the most favourable foreign treatment, or the extension of the most favourable foreign treatment to all foreigners. Therefore, from that perspective, the national treatment requirement would not imply, directly, the extension to the *same treatment to all foreigners*, irrespective of the treatment given to nationals.

Therefore, from a strict perspective of the creation of the market *without frontiers*, the application of a better treatment to certain foreigners should not be seen as a discriminatory treatment to the others, but as a possibility of getting a tax benefit to some foreigners despite the general standard as set out in general terms (domestic law). Either if based on a reciprocal basis, what has to be considered as distorting the market is a state aid given (even on a reciprocal basis) to a certain number of taxpayers (residents in the other State in the present situation). A tax treaty represents a departure from the general pattern of the tax system as foreseen in the domestic law, despite the fact of being possibly justified under the state aid arena.

Put it in another different way, and in the *D* case terms: the fact that the German taxpayer receives a different treatment compared to a Belgian taxpayer merely because the latter enjoys a tax treaty benefit should not lead to an analysis under the national non-discriminatory treatment (based on a comparison with nationals of the state) but rather under the state aid measures. It is not *D* who receives a *worse* treatment in the Netherlands, but *Belgian residents* are, on the contrary, the ones receiving a *tax benefit* in front of the general tax pattern foreseen in the Dutch tax law. For the sake of EC law, it is not the German taxpayer receiving the general treatment which should count, but rather, whether the Belgian taxpayer receiving a *beneficial treatment* in the Netherlands is justified or not under the state aid mechanism foreseen in the EC Treaty. However, the delimitation between the action of the fundamental freedoms over tax measures and the control of tax benefits as state aid is far from being clarified.

10. The double side effect of territorial tax incentives.

The battle against the territorial limitation of *tax incentives and tax benefits* has been taken from a double different perspective: from the inbound/outbound restriction approach, and from the state aid approach. This twofold focus leads to a greater uncertainty about the *consequences* of the potential infringement of EC law by a *territorial tax benefit*.

Let’s suppose a legislation of a Member State that establishes certain tax benefits only to national or resident companies but denies them to foreign companies, including permanent establishment located in the same territory. Clearly, this scheme constitutes an infringement of the freedom of *secondary* establishment. But on certain occasions the Commission has also taken the initiative to open a state aid procedure, considering that the tax benefit favours certain domestic undertakings, affecting trade between Member States and thus being incompatible with the common market. Many examples confirm the application of such a parallel approach to control the compatibility of a certain tax measure with EC Law, such as the first decisions of the Commission on the Basque Country tax allowances.

In general terms, the scope of tax benefits –in the very broad sense employed by the ECJ in the determination of the content of that expression- is normally limited to the activities, persons, contracts, or goods taking place, resident, done or being in the territory of the State articulating such benefits. This was a *normal* territorial component of fiscal policy for many years. But the application of the state aid concept and the expansive approach to see the tax treatment of outbound investments or outbound payments as restriction can lead to the following approach: the same and single tax provision may be considered, on the one hand, as a restriction to any of the fundamental freedoms, and on the other, to be considered as a state aid contrary to EC Law.

The application of a parallel and different control under EC law requirements on tax benefits and allowances gives rise to uncertainties as regards the different consequences linked to one and the other types of control, both for the States and the taxpayers concerned. If no clear mechanisms of distinction between both controls are defined there is a risk to develop EC Law in different directions. The application of EC Law cannot be dependent on the mechanism starting a certain *EU procedure*, whether a complaint, a preliminary ruling or an action taken by the Commission. This is not the proper place to analyze the action of the Commission applying the control of state aids on tax benefits, but a rationalization of the procedures would be desirable. The declaration of incompatibility with the fundamental freedoms may determine the right of those taxpayers who can claim the application of those rights the compensation for damages and the refund of unduly tax receipts. Instead, the consideration of a tax benefit as a state aid may determine the opposite effect, not the right to claim of those who did not benefit of the tax allowance but the duty of those unduly benefiting from the tax benefit to return the sums unduly obtained. Besides, considering a tax benefit as a restriction to the fundamental freedoms leaves some more leeway to Member States to reintroduce compatibility with EC Law.

11. Final considerations.

The ECJ case law adds some more complexity to the interaction between income tax systems of Member States, and between them and tax treaties, forcing to re-establish certain mechanisms and techniques traditionally used to pursue tax policy goals, such as prevention of double taxation, combat of tax evasion and tax avoidance or allocation of taxing rights. What seems clear is that States cannot, if ever, consider external tax relations on a bilateral basis and therefore, for the formulation of a sound tax policy they have to take into account the implications of the ECJ case law, either based on a *per country approach* or on a *European approach*.

Nevertheless, the ECJ case law needs to evolve into a more balanced position in which compatibility between EC Law and income taxes could be precisely identified. The significant proportion of cases declaring the incompatibility shows at present that Member States still need to make a great effort to *adapt* income tax systems to the single market requirements and, possibly, to modify some of the structures and points representing the foundations of income tax systems at present (residence, tax treaties, territoriality, scope of tax benefits, double taxation, withholding taxes, tax avoidance mechanisms, concept of income, allocation of income and/or expenses,…), and some other minor changes.

The needed revision of such concepts, their function and effects emphasize both that some traditional points that served to develop international tax rules need to be updated and that the *specific tax rights* derived from the projection of the fundamental freedoms are vulnerable as a consequence of the State reaction. On the one hand, the ECJ demonstrates that certain contrasts traditionally used to justify different treatment are not so contrasted. For example, most of individuals taxpayers *still* obtain their *total* income in the territory of the single State and, therefore, their *worldwide* and *source* income coincide in such a territory. Therefore, non-residents obtaining most of their worldwide income in such a source are clearly in the same situation and, consequently, should receive the same tax treatment *in that State*. There is no need to have necessary contrast and contradiction, but complement and total correlation, between worldwide income and source income, as confirmed by *Meindl* (par. 24). On the other hand, the absence of formulation of *absolute* tax rights derived from the exercise of fundamental freedoms (on the contrary to what happens in the area of state aid) is turning the path towards a single market without *trans-national fiscal barriers* into a single market with national and trans-national barriers, contrary to the last objectives of improvement of the competitiveness of the European economy. But, as said, it is for the Member States to implement the *compatible reaction* to the ECJ case law, whatever their goals and approach are.

Nevertheless, if the ECJ is going to continue with the defeat of tax rules in front of the position of taxpayers –or the States are reluctant to accommodate to such a new *state of the art*-, there should be recommendable to introduce in EC law some sort of previous control mechanism to declare the *compatibility* of a certain measure with EC Law, as it now happens in the area of *new* state aids. The possibility to ask for a *preliminary interpretation* by Member States before introducing, enacting or giving effect to a certain tax rule or benefit *would prevent* from posterior negative economic consequences and, fundamentally, would give a greater degree of certainty to income tax systems. The introduction of such a new mechanism could develop that important role without prejudice of the right of European Institutions of revising the previous criteria of selection and interpretation and effects of such declarations. Not to talk about the role that should be attributed to the ECJ in the *definition of the parameters of development of income taxes*. Evolution of income taxes should not be mainly dependent on the decisions made by certain particulars and national judges to bring cases into the Court for a 'supreme interpretation' of the effects of EC Law on certain income tax rules. Both from a political and from an institutional perspective, this evolution would be a bad and also probably wrong approach. Other considerations accounting efficiency, justice or administrability should be taken into account (Graetz, Warren, p. 1212).

To that extent, the renewed enthusiasm to definitely enact the Treaty establishing a Constitution for Europe should take into consideration some –if not all- of the proposals and warnings to deal with such significant matters for member States and for taxpayers across Europe.

Valencia, 5th February 2007.