# European direct tax law: *quo vadis*?

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## Introduction

Fifty years have passed since the Treaty of Rome was signed and twenty-one after the European Court of Justice pronounced its famous *avoir fiscal* decision, which marked the date of birth of European direct tax law. Since then European direct tax law kept moving forward and gradually removing discriminatory tax measures of EU Member States through the case law of the European Court of Justice on fundamental freedoms.

What are we now heading for?

For sure most would answer: towards full equal tax treatment between purely national and cross-border situations. For sure European integration requires the removal of direct tax measures that may dissuade EU nationals from exercising fundamental freedoms.

But may I submit that in fact we do not know where we are going. Perhaps all we know is that the European Court of Justice is trying hard to remove cross-border direct tax obstacles, whenever they arise and whatever price we may have to pay in terms of the structure and consistency of our national tax systems.

Whether or not this is enough from a tax policy perspective, that is difficult to say. The fact is that judges must apply the law and should normally not mix up with tax policy issues, at least to the extent that they such issues are not reflected in the provisions to be interpreted. The decision making power has been left with the Member States, which are however no longer free to exercise their prerogatives if not in accordance with the primacy of European law. Consequently, exception being made for the limited domains of direct taxes in which a common European policy exists, a structural anomaly seems to arise in the process of building up European international tax law: each Member State adapts its own national policy to principles of European law that are often conflicting with it. The outcome is not entirely satisfactory of course: think for instance of credit countries, which have traditionally been supporting capital export neutrality and that are now experiencing a development that makes such goal more and more difficult to achieve.

The ECJ's vision of European direct tax law has shifted national sovereignty away from the traditional categories and balances of international tax law towards European international tax law. Accordingly, it is not much whether a State exercises its taxing jurisdiction that matters, but rather whether the tax treatment has achieved consistency at the level of the Internal Market, as well as whether positive and negative conflicts between/among EU Member States have been removed. Accordingly, non-residents may be in a similar situation to residents, losses derived by foreign subsidiaries may have to be imported by the State of the parent that applies group taxation and full relief must be given for foreign company taxes even when higher than those that apply in the State of residence of the shareholder.

This should perhaps lead us to say that European direct tax law is going nowhere at present, or that is dancing in circles. Such answer, I submit, would be just a too pessimistic one, even if undeniable difficulties arise in reconciling the numerous judgements of the European Court of Justice in the field of direct taxes. European direct tax law is living in a long transitional period, whose duration may be further increased insofar as negative integration is not properly supplemented by positive integration through the European Council or equivalent measures of tax coordination adopted at the level of the Member States.

Most tax academics have repeatedly stressed the need to change this pattern and to steer the rudder back to positive integration, but we're all aware that the European Commission lacks the actual support by the Member States to introduce effective measures of tax co-ordination or harmonization. The three communications released in December 2006 prove this unsatisfactory situation, but still make us hope that things may one day change and that cross-border tax obstacles within the Internal Market (and even beyond it) will gradually be removed through common solutions adopted by the European Council or - at least – conceived at the European level.

Meanwhile, a more precise answer to the question where European direct tax law is going may only be given through a closer look at the case law of the European Court of Justice. I shall do so by focusing my attention

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on five *capita selecta*, namely (i) tax treaties, (ii) abusive practices, (iii) procedural issues, (iv) the relations with third countries and (v) the need for an effective and homogeneous protection of taxpayers throughout Europe (an issue that includes the problem of infringement procedures).

## 1. Tax treaties

A reference to tax treaties is included in a considerable number of decisions of the European Court of Justice: from the *avoir fiscal* decision to the recent one on the *Thin Cap GLO*.
Since the very *avoir fiscal* decision, the European Court of Justice made it clear that the primacy of European law may not be made subject to the provisions of tax treaties and their condition of reciprocity[2]. In the *Saint-Gobain* decision the Court refined this principle, when acknowledging that Member States kept the powers to allocate taxing powers on cross-border situations by means *inter alia* of international agreements[3] that nevertheless had to comply with the primacy of European law[4], as stated in the *Schumacker* decision[5]. In other terms, reciprocity as such was not a problem, but the application of such principle in tax treaties should be filtered by the principles of European law. Yet from the wording of the *D* decision, we learnt a couple of years ago that reciprocal rights and obligations only apply to persons that are resident in a Contracting State[6] and that provisions contained in a tax treaty are an integral part thereof and contribute to its overall balance[7].
What may the Court have wanted to add with the *D* decision? How does this decision affect the principle of reciprocity and how may we reconcile *D* with all other ECJ judgement on tax treaties?
In the *D* case a Member State gave national treatment through a tax treaty even to non-residents who did not find themselves in a comparable situation to that of residents. Treating alike two taxpayers that are not in a similar situation could be tantamount to discrimination, but in this case discrimination would go against those taxpayers who had not exercised fundamental freedoms. But this was not what the *D* decision tried to achieve. In that (and other) decision(s) the Court merely wanted to reject the judicial application of the most-favoured-nation doctrine, which in its view would have affected the very essence of tax treaties, since the resident of a country other than the Contracting States was not in a situation in which his situation would have entitled him to national treatment on the basis of the *Schumacker* decision.
The *D* decision – perhaps because of the unclear wording of its paragraphs 61 and 62 – is often improperly recalled by academics with a purely international tax law background to support the view that EU Member States keep national tax sovereignties as to what clauses they should include in their tax treaties.
Nevertheless, it is submitted that the meaning of the two obscurely drafted paragraphs of the *D* decision may only be explained in the light of the Court's view of the principle of reciprocity and of the following decisions that analysed the issue of the overall balance of tax treaties until now.
Despite the not self-executing nature of Article 293 EC Treaty[8], the Court has kept its position on tax treaties consistent across the years. As it stated in the *Bouanich* decision, tax treaties are part of national law of the Member States[9] and as such they must comply with the primacy of European law. Accordingly, when the Court dealt with tax cohesion of cross-border pensions in the *Wielockx* decision, it took into account the exercise of taxing powers in the light of tax treaties[10]. As I previously stated, reciprocity matters, but only in the light of European law. Consequently, if someone is in an equivalent situation to a resident of a Member State, then he should be entitled to claim national treatment regardless of whether the principle of reciprocity of tax treaties would not allow for this. Far from comparing the two general categories of residents and non-residents, the Court has always made a comparison between specific situations. Consequently, even if resident and non-resident individuals are in general terms not in the same situation[11], they may be in a comparable situation in cases like the ones of mr. Schumacker, who derived almost all of his income from a State other than that of which he was a resident of and could not claim his personal and family deductions in

[2] ECJ, decision 28.1.1986, case C-270/83, *Commission vs. France* [*avoir fiscal*], para. 26.
[3] ECJ, decision 21.9.1999, case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland*, para. 56.
[4] ECJ, *Saint-Gobain*, *cit.*, para. 57.
[5] ECJ, decision 14.2.1995, case C-279/93, *Roland Schumacker*, para. 21.
[6] ECJ, decision 5.7.2005, case C-376/03, *D*, para. 61.
[7] ECJ, *D*, para. 62.
[8] ECJ, decision 12.5.1998, case C-336/96, *Gilly*, para. 15.
[9] ECJ, decision 19.1.2006, case C-265/04, *Margaretha Bouanich*, para. 51.
[10] ECJ, decision 11.8.1995, case C-80/94, *G.H.E.J. Wielockx*, para. 24.
[11] ECJ, *Schumacker*, para. 31.

his country of residence because of the absence of taxable income, also due to the method with which such country relieved international juridical double taxation[12]. Likewise, a resident of an EU Member State with a permanent establishment in another Member State, who derived dividends paid from a subsidiary located in yet another country, was to be regarded in an equivalent situation to that of residents of the PE State because dividends were liable to tax in such country[13]. The Court then came to turn this equivalence into a general criterion in the *Denkavit France* decision as far as dividends were concerned[14].

In other terms, from the case law of the ECJ it seems clear that the principle of reciprocity contained in tax treaties may not affect the obligation of EU Member States to give national treatment. Accordingly, we should take this argument into account also when interpreting the reference to the “overall balance of tax treaties” contained in para. 62 of the *D* decision. One may therefore not successfully argue that because of this statement a Member State would no longer be obliged to give national treatment when this would conflict with the wording of the applicable bilateral tax treaty. Furthermore, if we look at later decisions of the ECJ, we may find out that the argument of the overall balance of tax treaties was again repeated – though with a slightly different wording (“balanced allocation”) in the *Marks and Spencer*[15] and in the *Cadbury Schweppes* decisions[16], but specifically at the level of justifications when ascertaining the impact of a possible abusive practice on the allocation of taxing powers between two Member States. After all, had it been otherwise, the whole development of negative integration would have been at risk.

From its latest decisions the Court seems now more and more willing to take tax treaties into account when ascertaining the consistency of taxation at the level of the Internal Market. Insofar as the Court applies the pan-European method first applied in the *Manninen* decision[17], then problems arising in one State could be solved by looking at the tax treatment that is applicable in the other Contracting State in respect of the same cross-border income[18]. Accordingly, in the recent *Thin Cap GLO* decision, the Court looked at whether tax treaties could effectively remove tax mismatches arising when the application of thin cap rules re-characterized interest as dividend[19]. In some other cases, as in the *N* decision[20], the Court rightly invoked Article 13 (5) OECD MTC to support that the view that tax treaties give exclusive taxing powers on capital gains to the Contracting State of residence at time of alienation. Likewise, the Court invoked the arm’s length in the *Thin Cap GLO* decision as a tax treaty principle to achieve a correct and fair allocation of taxing powers on cross-border income[21]. Although the Court may invoke the provisions of tax treaties to prove that agreed rules exist as to the allocation of taxing powers, one should not forget that the Court has no jurisdiction to interpret tax treaties. Consequently, academics may not underestimate problems that arise in case the Court draws from tax treaties principles that they do not actually contain. A clear example of this is given by the *de Groot* decision[22], in which the Court stated that tax treaties deal with the correlation between the total income of resident and residents’ general personal and family circumstances that are to be taken into account by the State of residence. Another controversial example concerns limitation-on-benefits (LOB) clauses, whose negative impact on fundamental freedoms has been totally overlooked by the European Court of Justice in the *ACT GLO* decision[23]. The Court considered such clauses as raising a similar problem to that of the judicial application of the most-favoured-nation: a technically wrong statement that totally ignores the existence of a resident company of one of the Contracting States[24].

## 2. Abuse

[12] ECJ, *Schumacker*, paras. 37-38.
[13] ECJ, *Saint-Gobain, cit.*, para. 47.
[14] ECJ, decision 14.12.2006, case C-170/05, *Denkavit Internationaal and Denkavit France*, paras. 25-27.
[15] ECJ, decision 13.12.2005, case C-446/03, *Marks & Spencer*, para. 46.
[16] ECJ, decision 12.9.2006, case C-196/04, *Cadbury Schweppes*, para. 56.
[17] ECJ, decision 7.9.2004, case C-319/02, *Manninen*, para. 54.
[18] Had the Court used this approach also in the past, then the *Saint-Gobain* decision could have been solved in the light of Article 24.3 OECD MTC with a less radical impact of European law on tax treaties.
[19] ECJ, decision 13.3.2007, case C-524/04, *Thin Cap GLO*, para. 54.
[20] ECJ, decision 7.9.2006, case C-470/04, *N*, para. 46.
[21] ECJ, *Thin Cap GLO*, para. 80 and ff.
[22] ECJ, decision 12.12.2002, case C-385/00, *F.W.L. de Groot*, para. 99.
[23] ECJ, decision 12.12.2006, case C-374/04, *ACT Group Litigation Order*, paras. 89-90.
[24] See further on this Pistone, P., *Expected and Unexpected Developments on European Integration in the Field of Direct Taxes*, in *Intertax* 2007/2, at 72 and ff.

The European Court of Justice has always been extremely concerned with the need to counter abusive tax practices, thus turning this topic into a possible key of interpretation of its own case law across the years. One may argue that in some cases the Court's caution in analysing a preliminary case referred before it has been particularly high because of a possible taint of abuse[25].
One could perhaps even conclude that the Court developed the pan-European approach not just for achieving a consistent tax treatment at the level of the internal market, but also for effectively countering schemes of double dipping and abuse. Double dipping and abuse are not the same phenomenon, but share a common core, whereby the former consists in taking twice an advantage that a tax provision may have intended to give once. However, double dipping could be caused by disparities between two or among more national tax systems and not necessarily imply an abusive practice.
Besides such hypothesis or keys for detecting the presence of abusive practices, an aura of uncertainty has long surrounded their definition. It was not until last year that the Court has defined what abuse of law is for the purpose of European tax law. The occasion was given by the decision on the *Halifax* case, which raised a problem of interpreting VAT in the United Kingdom, whose judges correctly refrain from applying judicial anti-tax avoidance doctrines (developed on the basis of the famous *Ramsay* decision since the early 1980's) to a domain that has been object of EU harmonization[26]. Besides possible difficulties of UK judges to accept that a taxpayer may in fact abuse of a law or of a right, the European Court of Justice made it clear that such case is given when despite the formal compliance with the conditions set by tax law, the taxpayer enjoyed in substance an advantage that conflicts with the purpose of the tax provision. The Court then added that such situation should result from objective elements that prove that the essential aim of the transaction has been to obtain such tax advantage: a matter that does not occur when the economic activity carried out may have some explanation other than the mere attainment of tax advantages. In just as much as two paragraphs the Court achieved an impressive clarity in respect of an extremely controversial domain of European tax law, such as abuse still is.
Summing up the conditions set by the Court, abuse requires a friction between form and substance, a tax advantage and a transaction that may not be justified on objective grounds other than tax saving. By doing so the Court has done away in the field of VAT with problems of giving the difficult evidence of subjective elements, such as the intention to circumvent the taxable event or to unduly benefit from a tax advantage, as well as with a possible need to have tax avoidance only when fully artificial arrangements exist. In other terms, the need to counter abuse requires in the Court's view a purposive interpretation.
For the purpose of ascertaining whether such conclusions also affect direct taxes, one should look at the whole case law on abuse, including decisions on VAT and direct taxes, but also on company law.
During the 1980's the Court first faced a tax avoidance scheme in the *Direct Cosmetics* case[27]. Because of its unclear arguments and analysis, this decision should not be taken as the true starting point of the ECJ's case law on abuse[28]. Nevertheless, it was in this decision that the Court started mixing up technical terms of the tax idiom in the various languages with its own idiom. Accordingly, in some languages avoidance turns out to be evasion or even fraud, thus making it impossible for a national judge to effectively understand what the position of the ECJ is[29]. The confusion in terminology was not entirely removed in the decisions of the 1990's when the concept of abuse in European law started to develop. Probably, a decision of company law and another one on direct taxes - namely the *Kefalas* and the *ICI* decisions - can be considered as the judgements in which the European Court of Justice first expressed its position on abuse. On the one hand, in the *Kefalas* decision the Court followed the position of AG Tesauro (motivated also in the light of the precedent of the *Pafitis* decision[30]) to argue that abuse may not undermine the uniform and effective

[25] Examples of this kind could be given in respect of group transactions, as the ones analysed in the *Marks & Spencer*, *Cadbury Schweppes* and *Thin Cap GLO* cases.
[26] A new case of abuse has been referred on 29.9.2006 by the Italian Supreme Court in the *Part Service* case C-425/06, whereby the national judges essentially asks whether in the absence of a GAAR and in an harmonised domain, a common notion of abuse under European law may allow him to recharacterise a complex leasing scheme as a single composite transaction aimed at circumventing VAT.
[27] ECJ, decision 12.7.1988, joined cases C-138 and 139/86, *Direct Cosmetics et aa.*
[28] Pistone, P., *Abuso del diritto ed elusione fiscale*, Cedam, 1995 at 177-178.
[29] Pistone, P., *Abuso del diritto ed elusione fiscale: l'impatto del diritto comunitario sull'ordinamento tributario italiano*, in AA.VV., *Atti del Convegno per gli LXXX Anni di Diritto e Pratica Tributaria*, Cedam, 2007, forthcoming.
[30] ECJ, decision 12.3.1996, case C-441/93, *Pafitis*.

application of European law[31]. On the other hand, in the *ICI* decision, the Court indirectly implied that tax avoidance arises in the presence of wholly artificial arrangements set up to circumvent tax legislation[32]. The relation between avoidance and abuse became somehow clearer in the X & Y decision, where the Court, after making reference in the English text to tax evasion, quoted the *Centros* decision[33] to state that "the Kingdom of Sweden is entitled to take measures designed to…improperly to circumvent their national legislation or to prevent individuals from improperly or fraudulently taking advantage of provisions of Community law"[34]. Less than a month later the Court substantially reproduced the same position in the *Lankhorst-Hohorst* decision[35]. Despite a more general reference in the English text to tax evasion, the constant use of the term *évasion fiscale* in the French text and the fact that the case dealt with a problem of thin capitalization allow us to have no doubt that the Court again wanted to mean tax avoidance in this case.
The settled case law in the field of direct taxes has developed an approach in common with company law, under which the European Court of Justice seems to links the concept of abuse up to wholly artificial arrangements. This is also proved by two decisions that were pronounced after the *Halifax* decision, namely those on the *Cadbury Schweppes* and *Thin Cap GLO* cases. However, while the presence of abusive practices is still linked by the first decision to a subjective element[36], the second one does away with that and only mentions the need for an objective element with a view to detecting the existence of a purely artificial arrangement[37]. In other terms, at least one of the conceptual developments occurred in the *Halifax* decision has now been applied by the ECJ also in the field of direct taxes. When wondering whether there should or may be a different concept of abuse according to whether or not we are in a harmonised domain of European law, we should be aware that the Court's approach to abusive practices is based on general principles. Based on an empirical analysis of the Court's case law I am not too persuaded that the difference between abusing of a right or abusing of a law matters for our specific purposes, nor that it would do so the fact of abusing of a freedom. When dealing with abusive practices, the Court essentially has tax avoidance schemes in mind and therefore always draws a link between the taxable event and the transaction or scheme entered by the taxpayer, with a view to ascertaining whether he has sought a friction between form and substance of both. In other terms, I acknowledge that abuse of law may be a difficult term to understand to English authors, certainly more difficult than abuse of rights. However, insofar as English is currently the most commonly used vehicle for exchanging tax views and theories, then it should also use words and expressions that make sense from the perspective of Community law. Abusive practices raise similar problems in the field of VAT and direct taxes. Therefore, I submit that the European Court of Justice should soon make clear that the notion of abuse given in the *Halifax* decision also applies to direct taxes. Despite the authoritative attempts in tax literature[38], I feel that this could not be done yet at the level of interpretation after the *Cadbury Schweppes* decision, at least without the explicit support of the European Court of Justice. Nevertheless, especially if we take into account the wording of the *Thin Cap GLO* decision, the Court seems willing to go in that direction, since it mentions purely artificial arrangements, but adds a reference to their essential purpose being that to circumvent tax legislation of the Member State[39].
The Court's case law on abuse not only implies an analysis of conceptual issues, but also some remarks on the approach that may justify a restriction on (or a discrimination to) fundamental freedoms. Since the *Leur Bloem* decision the Court has consistently required that a justification based on anti-abuse must comply with the principles of effectiveness[40] and proportionality, namely be able to achieve its goal without having an impact that exceeds what is strictly needed for such purpose[41]. Accordingly, despite their clear anti-abuse function, *iuris et de iure* presumptions have generally been regarded as incompatible with fundamental

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[31] ECJ, decision 12.5.1998, case C-367/96, *Kefalas*, para. 23.
[32] ECJ, decision 16.7.1998, case C-264/96, *ICI*, para. 26.
[33] ECJ, decision 8.3.1998, case C-212/97, *Centros*, para. 24.
[34] ECJ, decision 21.11.2002, case C-436/00, X & Y, para. 41.
[35] ECJ, decision 12.12.2002, case C-324/00, *Lankhorst-Hohorst*, para. 37.
[36] ECJ, *Cadbury Schweppes*, para. 64.
[37] ECJ, *Thin Cap GLO*, para. 81.
[38] Vanistendael, F., *Halifax and Cadbury Schweppes: one single theory of abuse in European tax law?*, in *EC Tax Review*, 2006/4, at 192 and ff.
[39] ECJ, *Ibidem*.
[40] In some cases, like for instance in the *ICI* decision, para. 28, the justification based on tax avoidance could not apply because the Court did not consider that the measure could achieve the goal for which it had been established.
[41] ECJ, decision 17.7.1997, case C-28/95, *Leur Bloem*, paras. 44-46.

freedoms[42]: Often problems arise also in respect of *iuris tantum* presumptions, thus the mere reversal of the burden of proof, as we will now more precisely analyse among the problems of procedural obstacles[43].

### 3. Procedural issues

Although one may be tempted to consider that a tax obstacle to fundamental freedoms could only arise when a cross-border transaction is subject to a more burdensome taxation than the one that would apply in a purely domestic situation (the so-called substantive obstacles), one may not deny that the European Court of Justice has always included procedural tax problems among the possible obstacles. Drawing a dividing line between substantive and procedural obstacles is thus normally unnecessary, since European law requires the removal of both and the European Court of Justice has applied the protection of fundamental freedoms along the same pattern in respect of both categories of obstacles.

Since the *Schumacker* decision the European Court of Justice has analysed procedural issues from two main perspectives, namely as a type of obstacle, or in the framework of justifications.

In the *Schumacker* decision[44] the Court made its first clear statement on the need to remove procedural tax obstacles, but also on that to require tax authorities to make an effective use of the exchange of information directive (77/799/EEC). Such directive represents a more proportionate instrument for allowing tax authorities to carry out an effective fiscal supervision than measures implying an additional burden on the taxpayer. This position was so consistently applied by the European Court of Justice that only a few years after the *Schumacker* decision Member States have no longer put this argument forward among their grounds of justification.

A couple of years later another interesting procedural issue was raised in the *Futura* case, which the Court decided by considering that a Member State may not make a tax advantage subject to the requirement that a non-resident with a permanent establishment keeps regular accounting books in compliance with tax law of the PE State besides the one of his State of residence. The main point for the Court was the fact that the taxpayer was prevented from giving evidence for not complying with the accounting requirements of the PE State.

In the *Bent Vestergaard* decision the Court stroke down more burdensome procedural requirements for claiming deduction of business-related expenses that only applied in respect of a supply of service (a training course) from another EU Member State[45].

Two recent decisions, such as the ones in the *Cadbury Schweppes* and *Scorpio* cases, could perhaps reopen the issue. In particular, the Opinion delivered by Advocate General Léger on the first case –which the European Court of Justice did not follow when deciding the case – suggested that in cases tainted of abuse, like that falling under the scope of controlled foreign company legislation, the exchange on information directive would have been insufficient to effectively counter abusive practices. Consequently, he submitted that a rebuttable (or *iuris tantum*) presumption would not have posed an unreasonable burden on the companies to which it applies[46]. Surprisingly, such view influenced the decision of the European Court of Justice on the *Scorpio* case, in which the Opinion of Advocate General Léger had instead concluded that requiring a certificate of exemption would be a disproportionate way to ensure the proper function for taxation at source[47]. The Court’s position in the *Scorpio* case[48] has dramatically changed a pattern that had been accepted for over a decade, including points that are still now difficult to reconcile with other decisions of the European Court of Justice. For instance, since the *Gerritse* decision the Court has implicitly held that liability to tax by means of withholding taxes should not lead to a more burdensome taxation of non-residents in respect to resident taxpayers of the State where income is sourced[49]. In the *Scorpio* decision the Court justified withholding taxes without further comparison with the level of taxes applicable on resident persons. However, the Court then confirmed the position held in *Gerritse*, when affirming in the *Denkavit*

[42] ECJ, decision 18.12.1997, joined cases C-286/94, 340/95, 401/95 and 47/96, *Garage Molenheide et aa.*, para. 52; and, implicitly, *Cadbury Schweppes, cit.*, para. 69.

[43] ECJ, decision 28.10.1999, case C-55/98, *Bent Vestergaard*, para. 21 and ff.

[44] ECJ, *Schumacker, cit.*, para. 49.

[45] ECJ, *Bent Vestergaard*, cit., para. 21 and ff.

[46] Opinion delivered on 2.5.2006 by Advocate General Léger on the *Cadbury Schweppes* case, *cit.*, para. 136.

[47] Opinion delivered on 16.5.2006 by Advocate General Léger on the *Scorpio Konzertproduktionen* case, para. 89.

[48] ECJ, decision 3.10.2006, case C-290/04, *Scorpio Konzertproduktionen*, para. 59.

[49] ECJ, decision 12.6.2003, case C-234/01, *Arnoud Gerritse*, para. 54.

*France* decision that the application of withholding taxes on cross-border flows of income should not lead to a more burdensome taxation than that which would apply domestically[50]. For sure problems of withholding taxes will always raise a cash flow disadvantage in respect of taxes that are ordinarily levied on the basis of tax assessment.

Furthermore, never before the *Scorpio* decision had the European Court of Justice considered the directive on mutual assistance in collection of taxes when ascertaining whether a restriction could be justified and proportionate. The Court however did so in *Scorpio* thus possibly implying that from now on all measures aimed at ensuring an effective collection of taxes, such as withholding taxes, can represent a valid justification until the directive has come into force, as well as that from that moment on, will no longer be such. The implications of such decision on procedural tax issues could therefore be much more far reaching than the ones already derived from the *Gerritse* decision.

However, the most recent decisions of the European Court of Justice might suggest that the *Scorpio* decision will not significantly alter the settled case law on procedural issues. In the *Talotta* decision, the Court supported the view that the existence of the exchange of information directive makes it possible for a Member State to obtain all information that is required to carry out an effective fiscal supervision[51]. Furthermore, in the *Thin Cap GLO* decision the Court has made clear that the taxpayer must be given the opportunity to give evidence without "*undue administrative constraints*"[52]. In other terms, the position of the European Court of Justice on procedural tax issues has not substantially changed. On the one hand, still today procedural tax obstacles could at most justify a reversed burden of proof, but without making it hardly possible for the taxpayer to prove the contrary. On the other hand, the exchange on information directive still remains the main instrument to allow tax authorities to carry out an effective fiscal supervision. The question remains instead obscure in all relations that are not covered by this Directive, as for instance with EFTA States and other non-EU countries.

## 4. Third countries

The relations with third countries in the field of direct taxes have long remained out of the main focus of the European Court of Justice.

Initially, statements involving third countries were isolated implications of problems affecting the internal market. This occurred for instance in the *Halliburton Services* case[53], where the problem involved the transfer of a permanent establishment from one EU subsidiary to another EU subsidiary of an US parent company. In the *Svensson and Gustavsson* case[54] more burdensome conditions applicable to a loan entered by two nationals of an associated country (such as Sweden at that time) established on the territory of a Member State conflicted with the free movement of capital and payments of two nationals of an associated country (such as Sweden at time of the facts). Perhaps the most important decision involving third countries was the one on the *Saint-Gobain* case, where dividends paid from a third country subsidiary to a resident parent of an EU Member State and attributable to its PE located in another Member State were treated less favourably than if they had been paid to a resident subsidiary of the latter country. The *Saint-Gobain* decision proved that third countries could be indirectly relevant also for the right of establishment.

This scenario has substantially changed, after many obstacles within the Internal Market have been removed. National judges now more frequently refer direct tax cases involving third countries to the European Court of Justice in the framework of preliminary ruling procedures, especially after the process of liberalization of capital and payments gave an external dimension to this freedom, which was once regarded as the Cinderella of the internal market. For well over a decade Article 56 EC Treaty has been including an explicit reference to the movements of capital and payments with third countries. Perhaps the application of fundamental freedoms in the relations with third countries is one of the most complex issues that the European Court of Justice is currently facing. Over the past years the Court of Justice has been interpreting the scope of fundamental freedoms in a fairly homogeneous way. Accordingly, differences among fundamental freedoms have been fading away, gradually losing their importance in the field of direct taxes. Many years ago, in the

[50] ECJ, *Denkavit Internationaal and Denkavit France, cit.*, para. 27.
[51] ECJ 20.3.2007, case C.383/05, *Raffaele Talotta*, para. 36.
[52] ECJ, *Thin Cap GLO, cit.*, para. 82.
[53] ECJ, decision 12.4.1994, case C-1/93, *Halliburton Services*.
[54] ECJ, decision 14.11.1995, case C-484/93, *Svensson and Gustavsson*.

*Baars* decision, the European Court of Justice drew the dividing line between the right of establishment and the free movement of capital by stating that the first covered all situations in which a taxpayer could exercise a definite influence over the company decisions[55]. The recent decisions on direct taxes in the relations with third countries have confirmed this interpretation, though not without raising some degree of perplexity. In the *Thin Cap GLO* case the European Court of Justice was asked to ascertain whether the application of German thin capitalisation rules that had already been declared incompatible with fundamental freedoms in the *Lankhorst-Hohorst* case could nevertheless apply in the presence of third country elements (e.g. a related lending company controlled by the same non-EU parent, or located in a third country or other similar situations). Following the Opinion of Advocate General Geelhoed[56] - whose concise analysis of the issue was just as controversial as the one in which he equated issues of compatibility raised by limitation-on-benefits clauses to those raised by the judicial application of the most-favoured-nation treatment[57] - , the Court answered the question in the affirmative. The motivation was mainly relying on the function of thin capitalisation rules, which applied in presence of at least 75% owned participations and tried to avoid that group transactions could escape arm's length or market conditions. Since the right of establishment would not apply in this context, the Court concluded that the negative effects must be seen as an unavoidable consequence of any restriction on the freedom of establishment, without justifying an independent examination in the light of Articles 49 and 56 EC Treaty. A similar interpretation had been given by the European Court of Justice only a few months before in the (non-tax) *Fidium-Finanz* case, though in respect of the relations between the free movement of services, on the one hand, and the free movement of capital and payments on the other hand. Since the case dealt with financial services that a Swiss company had supplied into the EU (to EU nationals), the Court decided that the main freedom involved was that to supply services. After ascertaining that such freedom lacked an external dimension because the EU Council had failed to activate the measures that were needed for the purpose of extending to such context the liberalization of services under Article 49.2 EC Treaty, the European Court of Justice surprisingly did not go on to ascertain whether the free movement of capital and payments could apply, but only affirmed that the possible restrictions on such freedom were unavoidable consequences of the impossibility to apply the former one[58]. It is submitted that the path chosen by the Court did in both decisions does not solve the issue in an entirely satisfactory way. One may say that both decisions are theoretically correct, or perhaps even that the one on the *Fidium-Finanz* is formally impeccable, since indeed the supplier of services was not investing his capital, but first and primarily trying to sell his financial service. Furthermore, the need for a specific caution in the financial services and the Court's traditional great concern for possible abusive situations are additional good reasons for not criticising this decision. However, the pattern seems different in respect of the *Thin Cap GLO* for various reasons.

The most important one is based on the wording of the EC Treaty. Articles 43, 3rd sentence (right of establishment) and 58.2 (free movement of capital and payments) contain reciprocal safeguard clauses, thus implying that when the one free may not apply, the other one should automatically be released, could thus expand its scope[59]. Accordingly, if a portfolio investment always enjoys protection under Article 56 EC Treaty, a direct investment should do so at least when Article 43 EC Treaty becomes geographically inapplicable. Were this not the case, then one may wonder about the need to include an explicit reference to direct investments in Article 57 EC Treaty. Certainly, one should not forget to interpret fundamental freedoms in the light of the historical events that brought Europe to support a complete liberalization of movements of capital and payments before the introduction of the Euro[60]. In the light of this legal interpretation one should thus wonder whether it may be correct to state that capital invested in a loan to a related company should not enjoy the protection of the free movement of capital as an indirect implication of the impossibility to apply the right of establishment.

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[55] ECJ, decision 13.4.2000, case C-251/98, *Baars*, para. 22.

[56] Opinion delivered by Advocate General Geelhoed on 29.6.2006, case C-524/04, *Thin Cap GLO*, para. 100.

[57] Opinion delivered by Advocate General Geelhoed on 23.2.2006, case C-374/04, *ACT GLO*, para. 88-90 and, for a critical analysis see Pistone, P., *Expected and Unexpected Developments on European Integration in the Field of Direct Taxes*, in *Intertax* 2007/2, at 72 and ff.

[58] ECJ, decision 3.10.2006, case C-452/04, *Fidium-Finanz AG*, para. 48.

[59] See further on this Pistone, P., *The Impact of European Law on the Relations with Third Countries in the Field of Direct Taxes*, in *Intertax* 2006/5, at 237.

[60] Based on this argument Schoueri, L., *European Erga Omnes Liberalization of Capital and Payments in the EC Treaty*, in *Tax Notes International*, 29.1.2007, at 345 and ff. has convincingly supported the *erga omnes* scope of Article 56 EC Treaty.

My feeling is that this outcome is just unsatisfactory.
Facts of this case proved that there shareholding were normally above 75%, but what about a case in which the threshold is lower? What about two companies whose share capital is owned for a percentage well below 50% by another company, which, according to thin capitalisation rules is to be regarded as a parent company, thus a company that can exercise a control over the other two entities? Taking into account the wording of the EC Treaty provisions, as previously analysed, would it really be fair to conclude that an independent examination in the light of Article 56 EC Treaty is not justified? I am not so sure. Not to mention that giving protection to portfolio investments, while denying it to direct investment seems just unfair and economically counterproductive: we care about the little and ignore the big. Is this really how Europe may want to contribute to worldwide liberalization of capital movements and how Europe wishes to receive capital from third countries (as in the case of the Thin Cap GLO case)? Again, I am not so sure. And how about then situations in which several non-EU companies undertake a joint initiative to keep their shareholdings below the criterion set by the European Court of Justice in the *Baars* decision and enjoy protection of European law in respect of the movement of their capital and payments? Or, what should an EU company do to enjoy protection in respect of income produced from its investment in a third country? Should it set up a PE in another EU Member State as in the *Saint-Gobain* case and try to invoke that tax problems arising in the relations with a third country have indirect implications on its right of establishment in the other Member State? The European Court of Justice is the only body competent to interpret European law and academics should neither please the judges, nor tell them what to do, but only duly submit their critical analysis whenever that is technically and impartially required. Perhaps the occasion for a reconsideration could be given by the pending case *Skatteverket vs. A & B*[61], whereby the Court will have to judge on the application of Article 56 EC Treaty to a situation involving two Swedish individuals and shareholders of a consulting company with seventy shareholders that has carried out operations in Russia[62].
But many more issues are still open, hopefully not for too long, in respect of the different categories of third countries[63].

## 5. The search for an effective and homogeneous protection of taxpayers throughout Europe

Twenty-one years of case law in the field of direct taxation make it fairly hard for the European Court of Justice to reconcile the decisions and principles that have been applied to the most different situations referred by the national judges.
However, one should not forget that – except for the case of not-self-executing provisions of the EC Treaty - European law gives all EU nationals immediate rights, which receive a judicial effective protection, should there need be through the mechanisms of preliminary ruling, or of the infringement procedures. However, once the European Court of Justice has interpreted the problem of compatibility with European fundamental freedoms, protection should become immediately available at the level of the national judge, who should disapply domestic rules of the kind that have been stroked down by the European Court of Justice.
The search for an effective and homogeneous protection of taxpayers throughout Europe is a matter that requires more attention. If we look at the origin of the preliminary ruling procedures, we'll find out that some countries, like Germany and the Netherlands have regularly been referring cases to the European Court of Justice, others have done so more occasionally, but others - like in particular Italy, Ireland and Spain among the old Member States – have almost never done so. Different reasons may have given rise to this problem, which should however be seriously analysed, taking into account its repercussions on the degree of legal protection that taxpayers receive in such countries. Since none of these countries may have discovered the secret formula for complying with European law, the failure of judges to refer cases to the European judges increases the importance for national legislators to timely amend their statutes with a view to complying with the development of negative integration driven by the European Court of Justice and originating from other Member States. Likewise, the European Commission's role to initiate infringement procedures becomes more important, especially when national legislators do not comply with the mentioned role. Accordingly,

[61] ECJ, case C-102/05, *Skatteverket vs. A & B.*
[62] For an overview of the facts of the case see Cadosch, R., Fontana, R., Russo, R., Szudoczky, R., *The 2006 Leiden Alumni Forum on Taxation of Cross-Border Dividends in Europe and the Relation with Third Countries: the Cases Pending Before the European Court of Justice*, in *Intertax*, 2006/12, at 632.
[63] See my categorization of third countries in Pistone, P., *The Impact*, *cit.*, at 239 and ff.

one should positively welcome the considerable increase in the number of infringement procedures that the European Commission is taking before the European Court of Justice in the field of direct taxes. Some nineteen cases are pending now, which is an enormous number, if compared to the only eleven cases so far decided by the European Court of Justice in the framework of infringement procedures. However, the most immediate instrument of legal defence that taxpayers have been given by European law is the right to claim disapplication of national law conflicting with *acte clair* before the national Court. I believe that, especially after the enlargement of the European Union to 27 Member States and in a moment in which the number of procedures has rapidly increased, an effective use of this instrument will reduce the pressure on the European Commission to start infringement procedures and that on the European Court of Justice to deal with constant waves of direct tax cases. Furthermore, I am of the opinion that an effective use of this instrument will also limit the interventions of national legislators only to the cases when the provision declared incompatible by the European Court of Justice needs be replaced by a new statute. Consequently, in all other cases and even when the incompatibility was declared in respect of a measure adopted by another Member State, the instrument of disapplication by the national judge should be widely used to achieve an homogeneous degree of legal protection across the European Union. After all if it is for the European Court of Justice to interpret European law, it is for the national judge to do the same in respect of national law. And we all know that during the past few years the European Court of Justice seems willing to more extensively invite national judges to do so. Put together this approach with a revitalised positive integration and perhaps we’ll be able to know and predict where European direct taxes may go.